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LA CAISSE DE DEPOT ET PLACEMENT DU QUEBEC
POLITICAL AND MANAGERIAL ERRORS

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Abstract

La Caisse de Depot et Placement du Quebec represents the largest institutional fund manager in Canada. It manages public pension plans in the province of Quebec. In 2002, the fund welcomed Henri-Paul Rousseau, former president of the Canadian Laurentian Bank and prominent public figure, as its new president. Under his administration, the institution changed many objectives and shifted away from its original purpose, which was to provide a reasonable return on investment for the population's future retirement money while acting as a financial instrument to help the economy of Quebec. Rousseau quickly implemented a strategy based on short-term returns and gambled on the interest levels. Furthermore, the fund adopted aggressive strategies based on complex models and made its most important mistake in the accumulation of asset-backed commercial papers. The new structure adopted by Rousseau was fundamentally wrong for a fund like La Caisse de Depot et Placement du Quebec and resulted in a 25% loss in total net assets for the year 2008, which was far worse than the performance of the other major Canadian pension funds. My analysis suggests that the poor performance of La Caisse de Depot was not due only to the recent financial crisis or bad luck. Apparently, Henri-Paul Rousseau's personality and management style also contributed to the poor performance. His overconfidence and quest for fame pushed the institution towards the short-term investment market where La Caisse de Depot lost a total of 4 billion dollars on the asset-backed commercial paper scandal. A lack of regulations and support from the government in place enabled Rousseau to control every move inside the institution.

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1. Introduction

La Caisse de Depot et Placement du Quebec is currently managing a total of \$220 billion in total assets, making it the largest institutional fund manager in Canada. The institution is closely tied to the population of Quebec since it receives its money from 25 depositors primarily consisting of public pension funds and assurance plans managed by Quebec government entities. In 2008, La Caisse reported a total return of -25%, its first major setback since its creation in 1965. Other major Canadian pension funds (hereafter, the benchmark), reported a return of -18.4%, leaving La Caisse in the fourth quartile in terms of performance (Caisse de Depot Annual Report 2008 p. 30).

For the 2008 period, La Caisse lost a total of 39.8 billion dollars, which is allocated to the different portfolios of La Caisse de Depot (Exhibit 1). The announcement of the results created a big scandal around an institution that meant a lot for the population.

I investigate one basic issue in this paper: the relationship between the results of 2008 and the fundamental changes implemented after 2002. There is a strong presumption in the press and within the political class, that the fund's performance could be related to political and managerial changes. For instance, Jacques Parizeau, former Prime Minister and primary founder of the institution in 1965 argues:

-“The new philosophy preached by La Caisse was totally inappropriate and led us to the results of 2008. This is not a hedge fund where investors gamble the money furnished by the shareholders, we are playing with money given by public pension funds which ultimately belongs to the population and the state of Quebec.” (<http://videos.argent.canoe.ca/video/choix-de->

lediteur/choix-de-lediteur/21160528001/caisse-de-depot-jacques-parizeau-souhaite-la/26184538001/page/7)

In spite of importance of La Caisse for Quebec and the seriousness of claims made against its management, there are, so far, few in-depth analyses of the circumstances leading to the fund's dismal performance. My analysis supports the notion that the fund was poorly managed. In particular, it suggests that the ambitious and confident nature of Henri-Paul Rousseau played an important role in the investment strategy adopted in 2002. Mr. Rousseau wanted to bring impressive results as quickly as possible and consequently moved the fund towards a more aggressive strategy. According to Andre Duchesne, former Vice-President Executive, the fund began to act like a hedge fund in 2003 (Pelletier p. 324).

La Caisse accumulated one third of all the asset-backed commercial paper in circulation around Canada. When the economic situation became problematic in 2007, the asset-backed commercial paper market crashed and faced a long restructuring which was concluded in December 24, 2008. Through the restructuring, the economic situation became worst and the asset-backed commercial paper lost \$4 billion in value. The annual report of La Caisse refers to this devaluation as an additional charge/expense on asset-backed commercial paper.

A lack of regulations provided opportunities for Henri-Paul Rousseau to make these managerial changes that shifted the focus on a short-term approach. The government of Jean Charest along with the board of directors were also responsible for the loss of 2008 as they showed a lack of awareness towards the operations of La Caisse. Diane Francis appropriately resumed the situation in her Financial Post article. She wrote:

-“ La Caisse de Depot et Placements du Quebec lost a staggering \$39.8 billion in 2008, through a combination of internal mismanagement, poor controls and an inappropriate appetite for gambling.” (Francis 2009)

Following the results of 2008, the Quebec government acted relatively quickly and significantly increased the regulations placed on the institution. Mr. Michael Sabia, elected president of La Caisse in 2009, also made a series of changes in order to refocus the fund on the long-run while increasing the procedures to control the risks more effectively.

2. Background information

In this section, I analyze how La Caisse progressed through the different stages of its history and relate its operations prior to 2002 to the changes that were implemented between 2002 and 2008.

2.1 The early days of the fund

In 1965, Mr. Claude Prieur, high executive at Sun Life, is named the first president/director of La Caisse de Depot et Placement du Quebec. The institution was originally established to receive deposits from the public pension fund called “La Regie des Rentes du Quebec”. A variety of parameters differentiate this fund from any other similar institution around Canada. First of all, La Caisse was established as a dual purpose entity where it must find a good balance between being a financial organization with strict profitability quotas and being a financial instrument for the economical development of the state of Quebec.

In February 2006, La Caisse received its first deposit from the provincial pension fund (Regime des Rentes du Quebec) and consequently made its first investment; a bond investment in the International Bank for \$500,000 (Pelletier p.34). Quickly thereafter, the fund took significant steps forward with the introduction of two additional branches: the equity and real estate portfolios. In order to increase its role in the development of the Quebec economy, the institution also began direct-capital stock investment in Quebec PMEs (small-medium enterprise) by providing them with essential capital to start and finance their businesses. The initiative increased the amount of quality businesses that were fundamentally sound in the province of

Quebec. By 1972, La Caisse de Depot had already reached the important mark of two million dollars (Pelletier p. 63).

Following the unexpected death of Claude Prieur in 1973, La Caisse named Claude Cazavan as the second president of the institution. His introduction marked the birth of a new political ideology; the sovereignty movement. To lead this new way of thinking, a political party was created in 1968 called the “Parti Quebecois” who had for mission the sovereignty of Quebec and the protection of the French language. The Parti Quebecois is elected for the first time in 1976 which had an important impact on the operations of La Caisse.

It is important to mention that during the 70’s 80’s and even 90’s, the government of Quebec was involved in the decision making process of the institution. So, when the Parti Quebecois was elected, the contribution of La Caisse towards the interests of Quebec became more important.

2.1 The 80’s

In the early 80’s, La Caisse who had become a major player in the economy faced a series of dispute with the Canadian government and other institutions based in Toronto. In 1983, it was banned from the Toronto Stock Exchanged for a total of 9 months because it failed to report acquisitions in time (Pelletier p.124). This event marked the end of 3 incredibly successful years (80,81,82) where La Caisse not only acquired interest in great companies but helped specific Quebec PME’s (small and medium enterprise) become large corporations that helped the economy grow. With the Canadian market becoming increasingly restrained towards them, it had to move in a new direction: international. They began by investing in Japan, the US and Europe

and mostly concentrated their investments in areas that were considered weak on the Canadian market: technology, pharmaceuticals, aeronautics. By the end of 1985, international investments were found to be more profitable than Canadian investments and reached a total volume of 410 million dollars (Pelletier p.135).

The second part of the 1980's is marked by a serious globalization of worldwide markets and the exit of the "Parti Quebecois" in 1985. Quebec's economy grew a lot in the 80's and by the end of the century, the Canadian financial community had to admit that Quebec could now economically sustain independence.

2.4 The 90's

The beginning of the 90's is marked by the introduction of Jean-Claude Delorme and Guy Savard as the new leaders of the institution. This period is known as the dual-presidency era. Due to divergence of opinions between both men, La Caisse was unable to take a significant step forward and hit a plateau for a period of 4 years (90-93). In 1994, an important political change would, once again, have a lot of influence on the operations of the institution. Jacques Parizeau (Finance Minister under Lévesque and part of the first sovereignty association) was now leader of the "Parti Quebecois" and had clear plans for the future of the province; he wanted a second vote on the sovereignty association as soon as next year (first vote in 1980 and was rejected). At the beginning of 1995, Parizeau revoked the bill on the dual-presidency and Jean-Claude Scraire is named the new president of La Caisse. At the same time, Quebec was getting ready for the second sovereignty association vote on October 30, 1995. It was extremely close but once again the "No" prevailed with 50.58 percent of the votes and marked the last significant event of the

sovereignty movement. From that point on, the influence of politics on La Caisse became less important and the fund began to act more independently.

Following the vote of 1995, Mr. Scraire initiated an expansion plan where La Caisse created subsidiaries specializing in niche sectors in order to develop intelligent capital and provide more flexibility. By 2000, La Caisse now had a strong representation all over the world; a total of 11 offices (United States, Mexico, Europe, Korea, China, Japan, Argentina, Morocco, and Algeria) where investments were flourishing and its expertise valued to the highest level. La Caisse concluded the century with over 105 billion dollars in total assets under management (a total of \$40.5 billion since 1995) (Pelletier p. 268). The fund's return was among the best in North America over the second half of the 90's (Pelletier p. 268).

2.5 The 2000's

Pushed by a well established strategy in the previous 5 years, La Caisse was named "best management fund in Canada" for the year 2000. However, in 2001, the situation changed as the technology bubble of the last 6 years had begun to deflate, resulting in difficult results for La Caisse in 2001 and 2002. Under a load of pressure, Scraire decided to step down as the president of La Caisse in Mai 2002. He is replaced a week later by Henri-Paul Rousseau.

When Henri-Paul Rousseau became president in 2002, he had one goal in mind: remodeling the activities at La Caisse by focusing on providing a greater return for the depositors. Rousseau was a man of great stature who had the ability to gather interests behind his ideas, not to mention that he was a great public speaker. In December 2002, quickly following his nomination, Rousseau made massive changes to the organization by releasing 19 directors,

suppressing 138 jobs, closing a total of 8 offices out of 11 in foreign countries and by abolishing 5 subsidiaries (Pelletier p. 308). Following the -5% return in 2001, added to the difficult results anticipated in 2002, the former president of the Laurentian Bank was seen as the sergeant who will bring back justice and discipline in the fund's operations.

After a difficult economic period, the markets were back on top from 2004 to 2007. The real estate market was flourishing along with an increase in the price of natural resources which was very beneficial to the Canadian financial market. La Caisse experienced very good returns during those years and placed among the top quartile compared to the other comparable investment funds (Pelletier p. 327). Rousseau's reputation among the financial community was extremely high and it seemed like the changes he made were profitable. Everything seemed too good to be true.

In fact, in July 2007, the market in New-York started to crash with the collapse of two major investment funds from Bear Stearns. With a mortgage and subprime crisis looming ahead in the United States, La Caisse found itself in the middle of the storm extremely quickly. Over the last 5 years, the fund had acquired a large quantity of asset-backed commercial paper (ABCP) which happened to be filled with risky debt titles. Suddenly, on August 13, 2007, due to a major disruption on the international markets caused by the United States subprime mortgage crisis, the Canadian third party asset-backed commercial paper market faced serious liquidity problems and eventually crashed. A misunderstanding on the liquidity agreements helped the foreign banks to remove their committed liquidities in case of market disruption. From one day to the other, 32 billion dollars worth of asset-backed commercial paper were now frozen on the financial markets (Pelletier p.338). On the night of August 15, Henri-Paul Rousseau reacted quickly and gathered all the major actors in the market around Canada in order to restructure the investment. On April

25 2008, all major holders of asset-backed commercial papers agreed to the solution proposed by comity Crawford to restructure them as long term-titles, providing potential for a high percentage of recuperation. Just as the situation seemed to be getting a little better, Henri-Paul Rousseau announced on May 30th,2008, that he will be leaving La Caisse de Depot et Placement du Quebec to join Power Corporation in January. Following the resignation of Rousseau, the fund faced tremendous pressure from the media as people requested answers concerning the financial situation behind the closed doors of the institution.

2.6 The results are released in 2009

La Caisse would be governed by a total of 4 different presidents in 2008 and was placed under scrutiny as many analysts and political figures believed it could experience a terrible year in 2008. The final blow arrived in October when the world experienced one of its worst financial weeks as Fanny Mae and Freddy Mac had to be put under the surveillance of the American treasury along with the collapse of Lehman Brothers. With confidence levels at an all-time low, La Caisse experienced major devaluations of its assets around the world and suffered an additional expense of 4 billion dollars in the scandal of the asset-backed commercial paper. Finally, in February 2009, the results were announced with a return of -25% (\$39.8 billion loss) which was on average 6.6% worst than the benchmark established at -18.4% (CDP Annual Report 2008 p. 30). The announcement created a huge buzz around the province of Quebec and all over Canada. Since then, the organization is still trying to fall back on its feet.

2.7 The current situation at La Caisse de Depot et Placement du Quebec

Following the disappointment of 2008, La Caisse appointed Michael Sabia on March 13, 2009, as the new president of the institution. Once again many disagreed with his nomination as people don't think he has the capabilities to turn around the operations of the fund. Born in Ontario, he is the former president at Bell Canada Enterprise and had a brilliant career as a federal government official where he contributed to the instauration of the TPS (Tax on products and services). He is mostly criticized for his lack of experience in fund management and for his lack of connections throughout Quebec's financial network. On February 25, 2010, La Caisse released a total return on investment of 10% for the year 2009 compared to the benchmark situated at 14%. Its weak position in equity markets can explain why the fund was not able to bounce back as well as the benchmark (Caisse de Depot Annual Report 2009 p. 4). In spite of the recent difficulties encountered in the past years, La Caisse de Depot et Placement du Quebec remains an extremely solid institution who receives money from a total of 25 public depositors.

3. Analysis of the 2008 loss

The previous section provided a summary of the operations and practices that were preached by the institution since the very beginning. In 2008, for the first time in the history of the institution, a major loss on investment was recorded. Moreover, La Caisse de Depot experienced a loss of 25%, which was 6.6% worst than the average performance of other major similar Canadian funds (the benchmark). The population wanted answers as to what really went down behind the closed doors of the institutional fund and what explained the difference compared to the benchmark. Over the last 10 years, La Caisse always reported numbers that were extremely similar to the benchmark. According to my calculations, the average annual difference compared to the benchmark in the last 10 years is 2.02% and only in 2002 did we see the difference exceeding 3.5% (Exhibit 2). The difference for 2008 is almost twice as big as the second biggest difference (2002) and more than three times the average difference over the last 10 years. The following section evaluates where La Caisse lost compared to the other funds.

Exhibit 1 explains where the \$39.8 billion loss was made on the asset portfolios of La Caisse. After comparing the different portfolio returns with the benchmark portfolio returns as well as reading through the annual report, three major issues emerged as the main reasons to explain the 6.6% difference compared to the benchmark: the fund's position on currency hedging; an unrealized loss on the real estate portfolio; and the additional expense on asset-backed commercial paper.

3.1 Currency hedging

La Caisse always had a strong policy on currency hedging because it provides peace of mind to the fund's managers. They are able to look for the best possible investment opportunities without having to worry about currency fluctuations around the world. Based on the annual report, only U.S. equities and foreign equities are partially hedged, all the other investment sectors are hedged at 100% (Caisse de Depot Annual Report 2008 p. 33). In 2008, the value of the Canadian dollar plummeted compared to other currencies, which was extremely costly for La Caisse: it lost 16% to the euro, 20% to the American dollar and 35% to the Yen (Caisse de Depot Annual Report 2008 p. 33). According to the annual report, the decline caused the fund's foreign investments to increase by 11.3 billion dollars. The foreign exchange hedging policy, designed to smooth out currency fluctuations, reduced this value by \$8.9 billion (Caisse de Depot Annual Report 2008 p. 33). Exhibit 3 provides a table of the cost of foreign exchange risk hedging for 2008. Here is statement taken from the Annual Report of 2008 concerning the position on currency hedging:

-“The level of the Caisse’s currency hedging costs is due to a proportion of foreign private equity and real estate investments that is far higher than that of its peers, as well as to its more extensive currency hedging policy. The cost of foreign exchange hedging in 2008 has to be put into perspective. For the 10-year period that includes 2008, the effect of the hedging is slightly positive. The Caisse adopted its currency hedging policy about 15 years ago, and studies show that the effect of such hedging is neutral over the long term, provided that it remains consistent”. (Caisse de Depot Annual Report 2008 p. 33)

All in all, we can't blame La Caisse for its position on the currency hedging. Under the circumstances, bad luck played a huge factor on this issue as the Canadian dollar plummeted in 2008 and caused a negative contribution of \$8.9 billion to the net investment results.

3.2 Decrease in value on the real estate portfolio

An important decrease in the value of the institution's real estate investments occurred in 2008 and it provides the second explanation for the difference in return between the benchmark and La Caisse. It accounted for a total of 2.1% of the entire 6.6% difference (Caisse de Depot Annual Report 2008 p. 31). The Real Estate Group covers a variety of different sectors and is divided in two specialized portfolios: Real Estate and Real Estate Debt. Both portfolios have similar distribution between their active sectors: office and business park, retail, hotel and residential sectors (Exhibit 4). Overall, the portfolios earned a return of -16.1% in 2008, or 1,352 b.p. (13.52%) less than the benchmark index (Caisse de Depot Annual Report 2008 p. 72). According to the annual report, the high proportion of investments on the worldwide markets and especially in the United States played an important factor in the difficult results of the real estate portfolio compared to a benchmark which was far less exposed to worldwide markets (Caisse de Depot Annual Report 2008 p. 33) (Exhibit 5). A statement taken from the annual report of 2008 provides us with the problems faced by La Caisse in this difficult economic period:

-“After a moderately active start to the year, the commercial real estate market went into the doldrums. The credit crunch and the economic slowdown curtailed transactions, and investment volumes fell considerably in all regions of the world. The widespread increase in capitalization rates reduced the valuations of the Caisse's properties in all its market”. (Caisse de Depot Annual Report 2008 p. 72)

Cadim, one of the real estate subsidiaries, faced a serious reduction in the fair value of its assets in the hotel sector while Ivanhoe Cambridge (subsidiary specializing in shopping centers) experienced difficult results in the United Kingdom and Spain. The office sector subsidiary “SITQ” essentially faced the same fate and saw its properties in the United States and Europe devaluated like never before.

It is fair to say that La Caisse has a fairly aggressive strategy when it comes to real estate acquisitions. La Caisse holds the 8th largest real estate portfolio in the world and is always on the lookout for the emerging worldwide markets. It experienced great success throughout the years and it played a crucial role in the overall expansion of the institution. However, a statement from the 2008 Annual Report explains a gamble that was taken from the institution:

-“The proportion of investments in Canada decreased in favor of the United States and emerging markets in 2008”. (Caisse de Depot Annual Report 2008 p. 75)

From 2007 and 2008, the fund’s real estate investments increased by almost 2% in the United States and by 0.6% in the emerging markets while the investments in Canada (excluding Quebec) went down by 3.1% (Exhibit 5). With the difficult situation that was looming overhead in the United States, it is hard to explain the 2% increase in the U.S. investments. More importantly, La Caisse just faced a long restructuring of its asset-backed commercial paper, which should have been a great indication of the upcoming situation. According to a series of articles that were published in 2006 and 2007, a difficult real estate situation was expected by many in the years to come. Here are two titles that were published in well known newspapers or financial magazines:

-“Welcome to the dead zone! Real estate survival guide: The great housing bubble has finally started to deflate, and the fall will be harder in some markets than others”. (Tully 2005)

-“The No-Money-Down Disaster. A coming crisis in housing will cause a sharp selloff in stocks. But if the U.S. reacts quickly, long-term pain might be avoided”. (Witter 2006)

According to Diane Francis, who published a series of articles on La Caisse de Depot in the Financial Post, La Caisse made a mistake when it acquired huge amounts of real estate at bubble prices between 2002 and 2008 (Francis 2009). In my opinion, the fund ignored the economic situation ahead and kept investing in a crumbling U.S. market. It should have adopted a more conservative strategy at the start 2006, when clear signs pointed to a difficult situation ahead. With a Canadian market that was much less severely hit, the benchmark was able to post a return that was 13.5% better than La Caisse on the real estate department.

3.3 Asset-backed commercial paper

The crucial reason why La Caisse experienced its 2008 loss relies behind the crash of the asset-backed commercial paper market which it accumulated with eyes closed between 2002 and 2007; a total of 12,6 billion dollars which represented 40% of the asset-backed commercial paper in circulation throughout Canada and two thirds throughout Quebec (Argent 2009). Its position on the asset-backed commercial paper market caused a total expense of \$3.9 billion and it is considered the biggest mistake made by the Rousseau Administration (Exhibit 1). It is the main reason why La Caisse was outperformed by the benchmark because it contributed to 2.5% of the entire 6.6% difference compared to the benchmark (Caisse de Depot Annual Report 2008 p. 31).

When it originally came out, the asset-backed commercial paper's composition was well detailed and clear for most investors. Through the years, it became extremely complex with a variety of debts and engagements (credit card receivables, auto-loans, mortgages etc.) and it became difficult to trace the quality of those debts. The "AAA" quotation from the Dominion Bond Rating Service misled La Caisse into believing it held a short- investment that was extremely safe. It also ignored crucial warnings from the Standard and Poor who claimed the investments were not guaranteed by some foreign banks. When the Deutsche Bank removed its credit from the market in August 2007, the situation got extremely bad. The market froze in the summer of 2007 and the asset-backed commercial paper was eventually restructured through a long run recuperation approach. Duncan Mavin, writer from the Financial Post, provides the best explanation as to what happened in the asset-backed commercial paper scandal in Canada. He argues:

- "Before the crisis began, Canada was home to one of the world's fastest growing markets for ABCP. In 2000, there was about \$60-billion of ABCP outstanding, but by the end of 2006 issuance had doubled to about \$120-billion. At the root of the problem is a misunderstanding .The paper is supposed to roll over every 30 to 90 days, and in case of a collapse in demand, the companies that manufacture ABCP have typically arranged with a bank to provide emergency liquidity.

The ABCP market is global, but liquidity agreements in a part of the Canadian market that has now collapsed were unique in that providers of the emergency funding - mostly foreign banks - would only cough up in the case of "general market disruption." When the world's capital markets came to a grinding halt last year, leading to a dearth of buyers for ABCP and

other structured products, this definition was exposed as woefully inadequate. Some of the foreign banks - giants like Deutsche Bank, HSBC, and Merrill Lynch that made huge profits out of the Canadian ABCP market - balked at providing emergency liquidity and investors were left holding paper they had expected to roll over without even blinking.” (Mavin, 2008)

After the publication of the results, the organization admitted the mistake in the asset-backed commercial paper and realized that gambling the depositor’s money on such derivative products was a lack of judgment.

The entire scandal at La Caisse was well resumed by economic journalist, Francis Vailles, from the newspaper “La Presse Affaire”. According to him, during the governance of Henri-Paul Rousseau, high amounts of liquidities were borrowed in order to acquire short-term investments like the asset-backed commercial paper. At the end of 2001, La Caisse had 2.4 billion dollars that was borrowed and scheduled to be placed on the short-term financial market (Vailles 2009). In the following years, the amount exploded to reach a total of \$46.5 billion, the most important increase in any investment sector throughout Rousseau’s era. The strategy was fairly simple; La Caisse estimated that the interest rates on the asset-backed commercial paper would outweigh the interest rates on the money borrowed. To acquire the liquidities, La Caisse used a technique called “REPO” where an institution lends a certain title to another institution and will receive cash for it. According to Francis Vaille’s research, at the end of 2002, La Caisse only had \$450 million in the “REPO” portfolio and by the end of 2006; the activity reached \$24.4 billion dollars (Vailles 2009). The asset-backed commercial paper was found to be a good alternative to invest the new liquidities as it provided a higher return on investment. Between 2004 and 2006, the asset-backed commercial paper sold on markets increased by 198% and the entire volume reached \$33.1 billion in 2006, which \$12.6 billion was held by La Caisse (Vailles 2009). When

the market froze in 2007, it was too late to go back and La Caisse suffered a loss in value of 4 billion dollars through the restructuring of the entire market in Canada. La Caisse classified the loss as an additional expense on third-party and bank-sponsored asset-backed commercial paper in the 2008 annual report.

This new investment policy was totally inappropriate and showed reckless management of the risk factors. The asset-backed commercial paper scandal will be remembered and talked about for a long time in the province of Quebec.

3.4 Reflections on the loss

The mistake on the ACBP represents the core of the problem for La Caisse de Depot and the entire scandal surrounding the institution relies on this issue. There were other misjudgments made in the real estate decisions but they are of lesser importance compared to the asset-backed commercial paper catastrophe. What caused a fund like La Caisse to make such drastic changes? Why was the emphasis placed on short-term returns when the strategy should be placed on the long run? Finally, what are the causes of this mistake? The following section provides my understanding on what really went down behind the door of La Caisse.

4. Analysis of the causes

How can we explain the position of a fund like La Caisse in such a risky market like the asset-backed commercial paper? A total loss of 4 billion dollars was wasted towards this investment and the executives claimed that they did not see it coming. My understanding is that a series of political and managerial issues caused a major shift in the operations of this major institution, resulting in the losses. Below, I discuss several of these issues.

4.1 Change in the law at La Caisse in 2004

The first explanation relates to an important political decision. In 2004, the government of Jean Charest presented amendments to the law of La Caisse de Depot et Placement du Quebec. For the first time since its creation, the government decided to clarify the mission of La Caisse by adding a new section to the law of the institution. Prior to 2004, the unwritten mission of the institution had always been to provide a good return for the depositor's investments and to contribute to the economical development of the province. In the amendments, the mission statement was formulated to significantly increase the emphasis placed on having an optimal return on investments. Here is statement taken from the 2004 annual report of La Caisse de Depot:

-“The year ended with an event of historic importance for the Caisse de Depot et Placement du Quebec. In December, the National Assembly of Quebec passed a bill that amends its constituting statute considerably. The new text of the Act includes a section that, for the first time since the Caisse was created 40 years ago, formally states the institution's mission. The new section states that the Caisse's mission is to receive money on deposits as provided by law and

manage them with a view to achieving optimal return on capital within the framework of depositors' investments policies while at the same time contributing to Quebec's economic development." (Caisse de Depot Annual Report 2004)

Jacques Parizeau, who was involved in the creation of the laws and regulations of the institution, gave a precious interview following the results of 2008 where he made a series of important statements:

"La Caisse totally changed its fundamental structure in 2004 and it resulted into a major setback. Now, it must go back to the basics and not only learn from its mistakes, but act quickly in order to change the current trend. La Caisse must rethink and change the legal structure of the organization." (<http://videos.argent.canoe.ca/video/choix-de-lediteur/choix-de-lediteur/21160528001/caisse-de-depot-jacques-parizeau-souhaite-la/26184538001/page/7>)

This change was also made during a period where the government of Quebec became increasingly less present in the operations of the provincial fund. This period was characterized by former Finance Minister Parizeau as the years of deregulation. According to the laws of La Caisse, apart from its intervention in the appointment of the board of directors, La Caisse received minimal regulations from the government of Quebec (Canadian Legal Information Institute 2007). Moreover, Mr. Rousseau claimed during his hearing in front of the Board of Trade of Montreal following the results of 2008 that during his six year reign as president, he only received one phone call from the prime or finance minister and it was when the asset-backed commercial paper market froze in 2007. (Delean 2009)

If we go back to the 70's and 80's, the government (especially the "Parti Quebecois") played a huge role in the decisions of the institution and closely monitored every move made by

the institution. The board of directors was always filled with political figures to ensure that the money received from the depositors was invested to mirror the dual purpose of the institution. Furthermore, Jacques Parizeau claimed during his eight years as the finance minister that he was always in close contact with both presidents who governed the institution at the time. Consequently, by looking at the history of La Caisse, we can conclude that the institution experienced its first scandal at a time when the government placed the emphasis on higher returns and where its independence from the government reached its highest peak.

A recent study made by the EDHEC-RISK Institute provides evidence that having regulations among pension funds can be beneficial. It found that pension fund regulations should encourage risk management over a long run approach. According to the study, the increasing emphasis placed on the short-term is worrying for pension funds and the challenge of the regulator is to place the emphasis on the long-run, consistent with the nature and purpose of pension funds (EDHEC-Risk 2009).

To conclude, the changes made to the law of La Caisse de Depot along with the lack of regulations from the government of Jean Charest represent the first significant explanation to the results of 2008. The new structure in place enabled Henri-Paul Rousseau to move in a direction that presented increased risk for the depositor's investments. The administration began to look for short term investment that could be extremely profitable for La Caisse and it came during an international trend where a huge quantity of new financial instruments were created in order to yield high returns quickly. Rousseau's administration jumped alongside many others in the ride for derivative products and acquired high amounts of those risky investments (ABCP). In nature, there is absolutely nothing wrong with those products if they are acquired by a hedge fund who gambles the money of their shareholders. However, La Caisse de Depot et Placement du Quebec

receives money from its depositors (total of 25) who are mostly public pension funds and consequently invests the retirement money of the population.

4.2 Henri-Paul Rousseau's hubris

Henri-Paul Rousseau was the first president of La Caisse who was a prominent public figure in Montreal's financial network. Chairman and CEO of the Laurentian Bank of Canada prior to his nomination at La Caisse, Rousseau was extremely well spoken and known by almost everyone in the Canadian financial world. His life achievements were extremely impressive, starting with his undergraduate economic degree from the University of Sherbrooke, followed by a doctorate in economic science from the University Western Ontario. He then went on to become a famous economic professor at Quebec's University in Montreal and at Laval University where he held the presidency of an economist movement for the sovereignty movement in 1980. In 1986, he enters the private business world when he became vice-president of the National Bank of Canada and quickly moved up as he became the CEO of the "Boreal Assurance Company". Finally in 1994, he is named CEO of the Laurentian Bank where he will stay until his departure for La Caisse de Depot et Placement du Quebec.

Mr. Rousseau had been extremely successful everywhere he has been and many signs showed that he brought with him a lot of confidence and arrogance. First, following the scandal of 2008, Mario Pelletier published a book on La Caisse de Depot et Placement du Quebec which provided many insights about the nature of Henri-Paul Rousseau. During his writing, he gave an interview to former vice-president of the fund, Jean-Claude Cyr, where he provided important anecdotes relating to the introduction of Rousseau at La Caisse. For instance, following the

nomination of Rousseau as president, Mr. Cyr gave a presentation in front of all the high executives, including Rousseau, in order to present an overview of the situation at La Caisse.

Jean Claude Cyr commented in his interview with the author:

-“The new president did not listen to one word of the report and did not even acknowledge any of the facts that were presented in his following speech. I knew at that point that major changes were coming soon.”

Only a couple months later, Rousseau announced the most important restructuring in the history of the fund where he released 19 directors, suppressed 138 jobs, closed a total of 8 offices out of 11 in foreign countries and abolished 5 subsidiaries (Pelletier 308). According to Mario Pelletier, on that December 2002, Rousseau was seen as the one and only savior who will bring justice after the difficult results of the early 2000's. Those events illustrate that Mr. Rousseau had a lot of confidence in his own way of managing La Caisse and it is fair to say that he was arrogant towards the previous administration. Along the same lines, Mr. Marcel Cote, economist and co-founder of Secor, mentioned that Rousseau never had a vehicle worth of his talent and La Caisse should provide him with the opportunity to show his abilities. Also, former colleagues referred to him as being “excessively ambitious” and who loves being part of the action (Baril 2002). According to my research, everything leads towards the fact that Mr. Rousseau over estimated his own competence and capabilities which resulted in hubris management at La Caisse de Depot.

Rau and Vermaelen (1998) could provide us with some explanations as to why the history and confidence of Henri-Paul Rousseau represented a part of the problem. The authors explain that managers of glamour firms are more likely to overestimate their own ability to

manage an acquisition. If we relate this study to La Caisse, we are in the presence of a confident and arrogant president and despite the difficult results in the early 2000's, a very successful management fund throughout its history. Both Henri-Paul Rousseau and the institution itself suffered from the "Glamour Syndrome" and it created an excess of confidence around the organization. Amir Khadir, elected representative and leader of the political party "Quebec Solidaire", touched an important point in a press conference following the scandal of La Caisse which follows this idea of a glamour mindset. He argued:

- "The culture at La Caisse de Depot et Placement du Quebec reflected an environment of monarchs and bankers. Instead of modeling its practice for the service of province of Quebec, it followed models of the high financial elite where they take part in luxurious lifestyles and excessive spending." (Seguin 2010)

This statement adds to the argument that the institution's status contributed to an excess of confidence from the president and was passed along the other employees. Once again, La Caisse de Depot et Placement du Quebec is managing money deposited by public pension funds and public insurance plans. High executives looking for short-term glamour should direct themselves towards the private sector and not towards the management of public pension funds. Mr. Rousseau's philosophy and ambitions are appropriate for investment funds that are focusing on short-term results and accordingly did not match the goals of La Caisse. His early departure for Power Corporation in 2008 explains where he should have been all along.

Following the scandal of 2008, many caricatures were made of Henri-Paul Rousseau which, in some way, illustrated the managerial issues faced by the institution (Exhibit 6). Each picture puts an emphasis on a problem faced by La Caisse during the reign of Rousseau:

Caricature 1: Lack of awareness by the board of directors.

Caricature 2: Overconfidence of Rousseau mixed with a lack of professionalism and awareness.

It also implies that he could blame the results on the difficult economic situation.

Caricature 3: A government that was scared to intervene in the affairs of La Caisse.

Caricature 4: It illustrates Rousseau's hubris which was allowed by a government who provided too much power and freedom in the hands of a single individual.

To conclude, Rousseau's hubris led to a position on short-term investments that was inappropriate for La Caisse de Depot. There was a philosophy of invulnerability at La Caisse because people relied on the views and opinion of Mr. Rousseau. The board of directors should also take some of the responsibilities since it showed a lack of awareness in the investment position of La Caisse. Nobody really questioned the direction that was taken and management followed their powerful leader. To make a quick analogy, Henri-Paul Rousseau could be compared to the captain of the Titanic who looked for fame and increased the speed of the ship to a point where it became increasingly dangerous. On the other hand, everyone thought the Titanic was unsinkable, just like La Caisse de Depot.

4.3 Where was the good judgment?

My third point relies on a managerial issue which is directly related to the everyday operations of the fund. Following his nomination as president, Mr. Rousseau quickly introduced a new line of thinking when he set ground at La Caisse. He decided to bring back the calculators and to go back to the computer screens. Rousseau profoundly believed in mathematical models in order to measure the level of risk in specific investments. Rousseau, who started his carrier as an advance professor in economics felt extremely confident in his approach to measure risk through a mathematical analysis. According to Mario Pelletier's book, he even took multiple trips to Harvard in order to become more familiar with new complex models that would impress any economic professor. The addition of such models was appropriate to measure risk factors on more complex investments. However, according to Mario Pelletier and other inside sources at La Caisse, the fund relied on those models with eyes closed and it lost balance between business judgment and technical/mathematical judgment (Pelletier p. 351). Former vice-president at fixed income and currencies, Andre Duchesne, also mentioned in a closed interview with Mario Pelletier that starting in 2003, a quantitative approach began to dominate the operations of the institution and it started to act like a hedge fund. (Pelletier p. 324)

This new philosophy represents another reason why it acquired the asset-backed commercial paper for a period of 5 years. The investment managers of La Caisse became blinded by the quantitative approach and forgot to evaluate the pure business side of things. As the market began to crash, La Caisse still believed the investments were extremely safe as it received a quotation of AAA from the firm Dominion Bond Rating Service. However, the quotation firm was for a long time the only one to rate such investments in Canada (Pelletier p. 336).

Accordingly, La Caisse accumulated the debt title in huge quantities because it had no limit on

investments marked as “first quality or AAA”. Finally, La Caisse ignored warning signs from major agencies like Moody and Standard and Poor, which issued warnings on asset-backed commercial paper because certain foreign banks did not guarantee such investments (Pelletier p. 336).

La Caisse became book-minded and focused on its own new paradigm. When the economic situation began to change, management failed to adjust the investment philosophy and it kept going on its current paradigm which involved a high level of risk. Often, when someone missed a paradigm shift it can be attributed to a problem called paradigm paralysis; the inability or refusal to see beyond the current way of thinking. At La Caisse, the situation was extremely similar. Management only relied on the Dominion Bond Rating Service notation for the asset-backed commercial paper and ignored all the other signs indicating trouble ahead. La Caisse was stuck in its own investment paradigm and failed to react as the train went by.

4.4 Bonuses based on performance

To conclude, another important managerial change was brought during the Rousseau administration: performance-based bonuses. With a new president looking for higher returns and a government who supported the same ideology, it was only natural to introduce an incentive to have higher returns right? Indeed, starting in 2003, a portfolio manager was entitled to a bonus if its yield exceeded the parameters calculated through the risk management models. In 2006, La Caisse distributed a total of 39.7 million dollars in bonuses based on performance; an increase of 55% from the previous year (Pelletier p. 352). The new incentive pushed those managers in the acquisition of the asset-backed commercial paper which had the highest return compared to other

short-term financial investments (Pelletier p. 352). With such a policy, it was easy for administrators to close their eyes and accumulate assets that were becoming more and more risky. Depending on the type of organization, the use of performance pay can become misleading. For example, the use of bonuses for employees who sold the most items or had the best productivity can be appropriate to increase profits. However, the use of performance bonuses at La Caisse de Depot appears irrational to me. Berman, Bowman, West and Van Wart examined the relevance to have merit pay in public services. The study refers to a discontinuity between the general opinion and the reality when referring to performance-based salaries. According to the authors, performance-based salaries may not be as desirable, as easy to implement or as widely used as commonly believed. A series of negative consequences are analyzed throughout the research and some of them relate specifically to the operations of La Caisse:

- 1- Focus on the short-term at the expense of the long-term.
- 2- Promotion of self-interest above the interest of others.
- 3- Negative impact on team work as it increase the dependence on individual accomplishments.
- 4- Generation of counter-productive results (Win-lose)

The factors mentioned above affected the operations at La Caisse de Depot through the distribution of high bonuses based on performance. Such policies are not appropriate and do not encourage a focus on long-term returns which should be the ultimate goal for a fund like La Caisse. Never in its history, had performance-based bonuses played such a huge role in the operations of the institution.

4.5 Conclusion on findings

All in all, the last section covered the changes that were implemented by the Rousseau administration and by the political team of Jean Charest. The addition of all the factors led to a reckless gamble on the asset-backed commercial paper and set the institution back 3 years.

5. Changes following the loss of 2008

Following the results of 2008, the government acknowledged the lack of regulations and quickly implemented a series of new measures to closely monitor the operations of La Caisse. The statements below were taken directly from the press release announcing the new measures. (Quebec's Finance Ministry 2009)

Improve accountability and transparency:

- The government is asking the Caisse to appear before the Public Finance audition each year for four hours to present its annual report and answer parliamentary questions. This time will be reserved specifically for the Caisse and the exercise will take place outside the annual examination of the estimates of the Finance Minister
- The government is asking the Caisse to prepare, once every three years, an orientation plan setting out its vision and priorities. The Caisse will have to present this plan in the course of the parliamentary commission, starting in 2010.
- The government is asking the Caisse to present, at the same time as its annual results, a report dealing specifically with risk management.
- The government is asking the Caisse to table, during the 2010 parliamentary commission, a report on its remuneration policy.
- Lastly, the government is asking the Caisse to further enhance the section of its annual report in which it provides an account on its statutory obligation to contribute to the economic development of Québec.

Improve governance:

- The government is asking the Chairman of the Board to prepare a report on the actions taken to improve the governance of the board of directors of the Caisse. This report will be examined in the course of the 2010 parliamentary commission on the Caisse.

More importantly, Mr. Sabia, new president of La Caisse, also proceeded to a series of changes in order to adapt to the new financial market reality. On April 30, 2009, Michael Sabia issued a press release where he stated that risk management is the top priority for the organization. Mr. Sabia explains:

-“The plan builds on the progress made in risk management in recent years, incorporates lessons learned from the ABCP crisis and the financial crisis and is forward-looking. In addition to an increase in staff, it is based on four key components: development of new risk management practices to deal with unforeseeable circumstances, optimization of the approval process for new operations, refinement of risk measures and methodologies, and strengthening of the risk management culture.”(La Caisse de Depot et Placement du Quebec 2009)

Investment operations were also affected as the hedge fund sector will see a drop in activity which resulted in the abolition of the Executive Vice-President, Hedge Funds. (La Caisse de Depot et Placement du Quebec 2009). On January 25 2010, Mr. Sabia announced more changes which he characterized as being “plain old common sense”. President Sabia explains further:

-“We simplified the way we work and returned the organization to its core capabilities, where we have a strong track record. Going forward, we aim to invest only in financial instruments that we understand and that we have mastered.

Given that we are a long-term investor, we need solid financial foundations that can weather market turbulence. So we have taken action to almost double our liquidity and we have reduced our financial exposures, including our debt, by some \$20 billion. We’ve also cut our dependence on short-term financing, replacing it with more stable, long-term bonds. In only two months, we have been able to refinance more than \$7 billion — a testimony to the confidence global investors have in the new directions at the Caisse.” (La Caisse de Depot et Placement du Quebec 2010)

6. Conclusion

In the end, the 2008 financial results of La Caisse de Depot et Placement du Quebec showed to be strongly correlated to the changes implemented by the political government of Jean Charest and the administration of Henri-Paul Rousseau. The ambition and confidence of Mr. Rousseau pushed La Caisse towards a new and risky philosophy. A strong emphasis was immediately placed on yielding short-term profits, creating a sudden rise in the amount of liquidities that was acquired through debts. Consequently, La Caisse began to bet on fluctuations in interest rates and placed the liquidities on the short-term investment market. A prime choice was the asset-backed commercial paper, which had been showing impressive results in the prior years. La Caisse acquired more than a third of the all the asset backed commercial papers in circulation throughout Canada between 2002 and 2007. This investment was not guaranteed by all international banks and most of them had no liquidity arrangements. The market for asset-backed commercial papers crashed causing an additional expense of 4 billion dollars for La Caisse de Depot.

Furthermore, doubtful strategic decisions on the real estate market caused a high devaluation of assets on the world-wide markets. La Caisse eventually lost 25% of the depositor's assets and was outperformed by the benchmark by 6.6%, the first major setback in the history of the institution.

La Caisse recently published its 2009 annual report which showed encouraging signs for the future. First of all, the institution reduced its debt level by 41.5%, explaining a new strategy based on the appropriate long-run focus for pension funds (CDP Annual Report 2009). A section was also added providing a detailed plan to support the Quebec economy. This feature

demonstrates a certain will power to reach back to its core values. La Caisse de Depot et Placement du Quebec remains an extremely sound institution and I have no doubt that it will regain the top of the podium among the best investment funds in North America.

7. Exhibits

7.1 Exhibit 1: Main financial data

MAIN FINANCIAL DATA

TABLE 7
NET ASSETS, RETURNS AND VALUE ADDED
(for periods ended December 31)

Asset class	2008		3 years 2006-2008		5 years 2004-2008					
	Net assets \$ billion	Return %	Value added ¹ \$ million (b.p.)	Return %	Value added ¹ \$ million (b.p.)	Return %	Value added ¹ \$ million (b.p.)			
Fixed Income and Currencies	52.2	4.4	2,231	(145)	4.1	5,563	(41)	5.2	10,434	(21)
Equity Markets	26.4	(36.7)	(21,257)	(89)	(6.9)	(9,313)	24	1.3	1,899	(2)
Hedge Funds	5.3	(21.3)	(1,487)	(42)	(4.3)	(788)	32	1.0	(290)	264
Private Equity	14.0	(36.0)	(7,968)	281	(3.9)	(2,941)	535	5.5	572	648
Real Estate	25.4	(16.1)	(4,910)	(1,352)	4.1	1,874	(576)	11.9	7,628	(117)
Asset Allocation and other ²	0.3	-	(2,013)	-	-	(1,671)	-	-	(1,784)	-
Expense for third-party and bank-sponsored ABCP	(5.8)	-	(3,969)	-	-	(5,866)	-	-	(5,866)	-
	120.1³	(25.0)	(39,816)³	(658)	(3.2)	(14,221)	(238)	3.1	11,754	(100)

¹ In relation to benchmark indexes.

² The results of these operations include those of Rebalancing Decisions and are presented net of expenses.

³ The net assets and the return in dollars are those presented in the combined financial statements audited by the Auditor General of Québec. For more information, see note 11 to table 1 of the section "Financial statistics and review" in Annual Report 2008 – Additional Information.

Source: CDP Annual Report 2008

7.2 Exhibit 2: Variation in returns between La Caisse and the benchmark

	CDP Return	Benchmark Return	Difference
2007	5.5	6.2	0.7
2006	14.6	12.7	1.9
2005	14.7	12.9	1.8
2004	12.2	11.1	1.1
2003	1.2	3.3	2.1
2002	-9.6	-5.7	3.9
2001	-4.9	-1.5	3.4
2000	6.2	5.6	0.6
1999	16.5	14.1	2.4
1998	10.2	7.9	2.3
Average	6.66	6.66	2.02
Sources: CDP Annual Report 2007-1998			

7.3 Exhibit 3: Hedging Costs

TABLE 22
COST OF FOREIGN EXCHANGE RISK HEDGING IN 2008
(in millions of dollars)

	Net increase in the value of investments denominated in foreign currencies (before hedging)	Cost of foreign exchange risk hedging	Breakdown of foreign exchange risk hedging cost	Net increase in the value of investments denominated in foreign currencies (after hedging)
Equity Markets	2,578	(804)	9.0%	1,774
Private Equity	3,490	(3,453)	38.6%	37
Real Estate	3,462	(3,551)	39.8%	(89)
Fixed Income and Currencies, Hedge Funds and Asset Allocation	1,755	(1,129)	12.6%	626
Total	11,285	(8,937)	100.0%	2,348

Source: CDP Annual Report 2008

7.4 Exhibit 4: Real estate sector breakdown

FIGURE 78
SECTOR BREAKDOWN – REAL ESTATE DEBT
 (in percentage of fair value as at December 31, 2008)

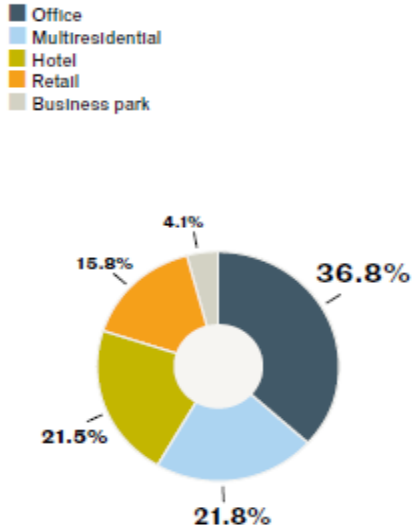
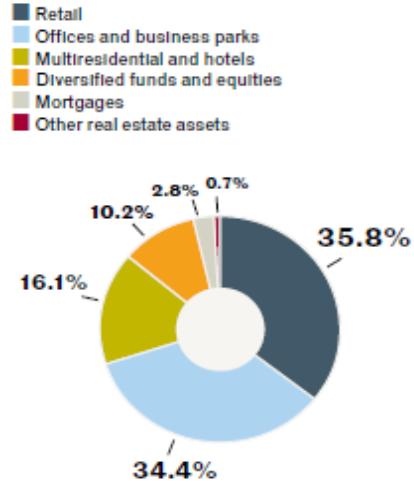


FIGURE 80
SECTOR BREAKDOWN – REAL ESTATE
 (in percentage of fair value as at December 31, 2008)



Source: CDP Annual Report 2008

7.5 Exhibit 5: Real estate geographic breakdown

FIGURE 79
GEOGRAPHIC BREAKDOWN – REAL ESTATE DEBT
 (in percentage of fair value as at December 31, 2008)

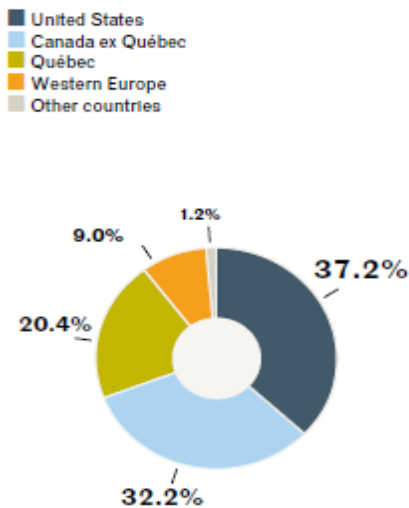
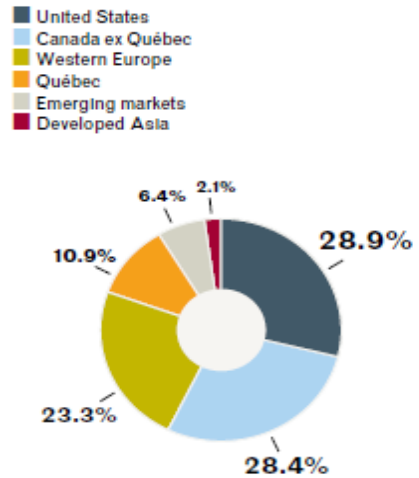
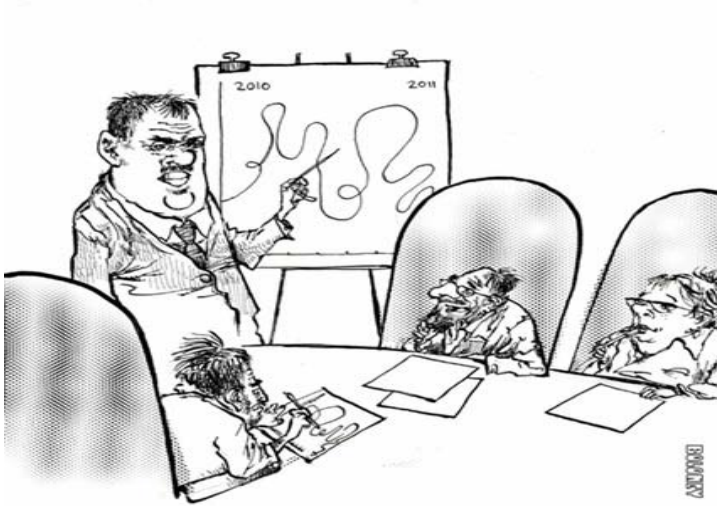


FIGURE 81
GEOGRAPHIC BREAKDOWN – REAL ESTATE
 (in percentage of fair value as at December 31, 2008)



Source: CDP Annual Report 2008

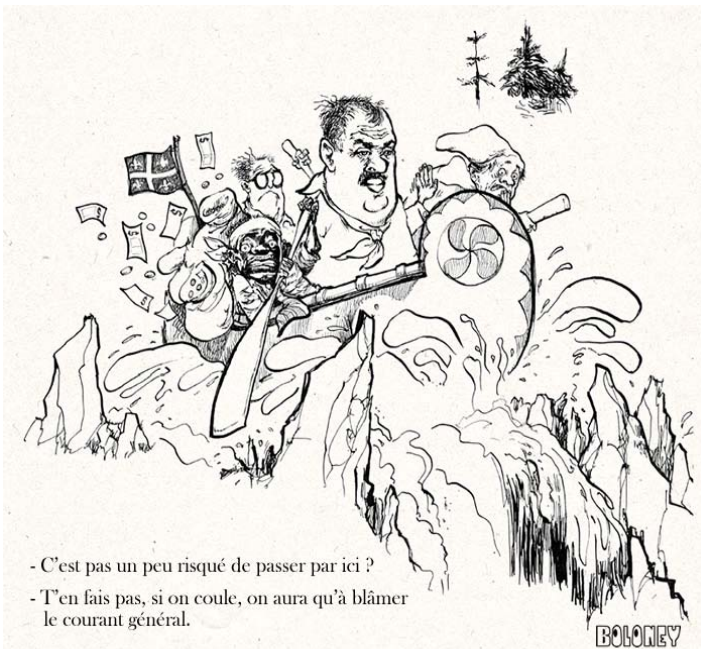
7.6 Exhibit 6: Caricatures



- ...et donc, nous parlons ici d'une gestion saine et d'investissements clairs.
- Fabuleux, monsieur Rousseau! Tout à fait convaincant.

*“...and therefore, we have clear
investments and a sound management
philosophy.*

*- Fabulous Mr. Rousseau! Extremely
convincing”.*



- C'est pas un peu risqué de passer par ici ?
- T'en fais pas, si on coule, on aura qu'à blâmer
le courant général.

*“Isn't a little risky to go this way?
- Don't worry, if we sink, we can always
blame it on the general current”.*



It was the perfect storm! I did not see it coming!

(Wearing red is current Prime Minister Jean-Charest)

(The indication mentions: Parliamentary Commission)



THE GLUTTONOUS MILLIONAIRE

“Thank you to Jean Charest and all his team...”

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Academic Vita

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Education

Schreyer Honors College
Smeal College of Business
Pennsylvania State University
Undergraduate degree in Accounting with minor in Economics

Work Experience:

Menard-Girardin Academy – Montreal May 08-Aug. 08
Tennis Coach

- Chaperoned a group of 10 teenagers ranging in ages from 10 to 14 on a 3 week trip to Grenoble, France for a series of international tennis tournaments
- Helped develop international junior tennis players

Laurentides Regional Tennis Association - Montreal Summer 06-07 (May-Aug.)

- Regional Coordinator and Tennis Coach
- Managed and coordinated the Laurentides regional tennis league consisting of 150 members

Skills:

- Bilingual. (English and French)
- Acquired international experience while travelling for tennis tournaments
- Learned to develop a complex business plan in BA 301H
- Proficient in Microsoft Office XP

Honors/Awards:

- Named ITA All-Academic team and awarded men's best team GPA for the 07-08 school year
- Named Academic All Big Ten