Investments Toward Innovation

Next two decades will call for different investments than in past to optimize innovation

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I usually describe my business as the financing of innovation; innovation being defined as the commercialization of an idea or an invention. I would like to point out that there can be fascinating innovations in finance as well as in technology, and that finance always plays a role in innovation whether funds are provided through companies such as ours, or through the research and development expenditures of corporations, or by governments through institutional outlets. In other words, innovation can be looked at as the synergism between inventing and investing. This paper will discuss the necessity of attempting to make sure that Canadian and American savings are directed intelligently and efficiently into those investments most appropriate to our needs over the next few decades.

During the postwar period until at least 1970, and probably somewhat beyond, our savings were directed largely toward obvious ends. After a decade and a half characterized by depression and world war, the apparatus of industry needed to be refurbished and the real fabric of our countries restored. Houses, apartment buildings, offices and shopping centers were constructed, superhighways built, and the aerospace and electronic age established.

During this period, it was inevitable that the process of intermediation — the collection of savings by such institutions as banks, life insurance companies, trust companies and pension funds — was tuned to the needs of the time. Not only was the investment philosophy dictated by those needs, but so were the actual institutions and mechanisms themselves as well as the regulations by which governments sought to protect the saver while permitting the institutions to pursue their own corporate policies.

I believe that few matters are of greater importance at this time than the re-examination of the investment objectives toward which our savings should be pointed in the remaining two decades of this century. And the means and mechanisms by which they will get there.

While it is easy to argue that during the postwar period the flows of savings were appropriately directed into those capital investments most needed, it is much less easy to argue that over the next 25 years we should do more of the same. We in Canada clearly do not need to twin the Trans Canada highway, build another Mirabel, or even construct an additional high-rise bank office building in Toronto.

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Energy Projects

On the contrary, we will need to deploy savings safely and efficiently on the one hand into the massive capital investments related to energy projects and the development of our arctic regions without the necessity of placing governments in the direct role of intermediation; and on the other hand, to provide an attractive route by which institutionalized savings can provide young, innovative, private companies with a greater access to term financing.

The lack of term financing has stunted too many companies who have not reached a size to permit the public marketing of their bonds or shares with the result that they are purchased by large public companies and their vigor becomes stifled under the impact of administrative disciplines suitable only for mature corporations.

Any discussion of our ability to pursue new investment objectives must be shadowed by an awareness that over the past decade we have witnessed a decline in the efficiency of primary capital markets, a taxation philosophy which has increasingly eroded away incentives, the growth of government regulations and the decline of investor confidence in the traditional outlets for savings.

Primary issues of stocks and bonds have dwindled from a spate a decade ago to a trickle in the past two years. This has not only meant that the financing of industry has become significantly more difficult and that of the smaller more innovative segment of industry near impossible, but that government securities have filled the vacuum.

At the same time, we have witnessed a most interesting phenomenon — that of a considerable increase in the institutionalization of savings. Some of the factors in this institutionalization have been the development of the mortgage market, the creation of the Canada Deposit Insurance Corporation and the subsequent rapid development of the flow of savings into Guaranteed Investment Certificates, and the development of Retirement Savings Plans. Two most important factors have been the exponential growth of savings deducted from payrolls and invested through pension funds; and that governments have played an increasingly important role as intermediator.

Over the past decade, we have watched the primacy of a tax philosophy that has been prepared to erode incentives in favor of ensuring at any cost an equality of incomes. But if necessity is the mother of invention, so is incentive of initiative. And, the time may have come to change an attitude that seems to be that it doesn't matter how many unemployed Canadians there are as long as there are no Canadians who may benefit from success.

It is obvious that any tax structure that does not provide an incentive to be efficient is inflationary. High standards of living can only be derived from increases in efficient production methods and from access to the most efficient tools of production.

I believe a taxation philosophy that appears to hold forth the proposition that it doesn't matter how poor in absolute terms the poorest member of society is provided there are no members of society who are relatively less poor, must be amended to one that seeks the smallest amount of poverty in absolute terms even if the cost is a much greater diversity of economic means. Similarly, it must surely be obvious to all and sundry that the way the gross national product is redistributed by taxation has an effect on the growth in real terms of the gross national product.

Over the past decade, we have also witnessed a significant growth of government regulations which have affected all of us. Over the past two decades, I have been lucky enough to know many senior civil servants and it has never occurred to me to think of them in terms of bureaucrats.

Nevertheless, over the past few years Ottawa seems to have been increasingly viewed by businessmen as some sort of cave of mediocrity in which bureaucrats hibernate until they can emerge into the warmth of an indexed pension. This viewpoint has become silly and very dangerous. To do those things which need to be done it is essential to build a true synergism between the public and the private sectors. This is becoming a priority.

Interface

It seems to me only realistic to assume that the technologies of the future will not be put in place to help achieve our desired well-being without significant government activity. What is needed is the examination of new ways in which the public sector can interface with the private sector to accomplish our investment objectives.

For example, I am beginning to become convinced that the system whereby governments grant money to industry needs reexamining on a fundamental basis. The most effective way to achieve a government grant is actually to be in the business of getting government grants rather than in a business oriented by marketplace demands. The reason is that the grant system has been distorted by the need to protect the granter from criticism at all costs even if one of those costs is a less effective benefit to the grantee.

You must all be well aware that we have witnessed a decline of investor confidence over the past decade. This has partly been the result of epidemics of unemployment and inflation coupled with an erosion of the values of industrial enterprises on the stock market and, more recently, in the decline in the value of the dollar.

Inevitably, there has been a significant increase in investor caution and some of the reasons for this were touched on above. A major factor has been the institutionalization of savings inasmuch as institutional investing tends to put a higher premium on not making a mistake than on striving for superior performance with some attendant risks. For business in general the tax structure on the one hand and the growth of regulations on the other have both acted to water down our entrepreneurial spirit.

Investment decisions are based on expectations of future benefits. If at this time we expect to achieve the greatest benefit from an aggressive development of the nation's energy potential we must make sure that our savings serve future needs and do not mindlessly flow along the well-worn channels of the past. If we need to bolster secondary industry financing and provide funds for massive projects capable of serving energy needs, and if we cannot rely with total confidence on primary stock and bond markets, then we had better look at the possibility of developing new investment techniques.

In other words, if we are to marry the investor to the innovator or the pension fund to the pioneer, I believe that we will have to develop new techniques of intermediation and examine ways in which institutional mechanisms, whether in the public or the private sector, can be tuned to future needs.

Default Insurance

Over the past year or so, I have been particularly interested in examining ways in which our experience in developing the mortgage market in Canada can provide lessons which will lead to needed changes in industrial finance. In particular, we have been examining whether or not the concept of default insurance, so widely used in mortgage lending both in the States and Canada, can play an equally significant role in industrial financing.

The cost of any and every loan, i.e. the effective rate of interest, is comprised of three parts: the cost of money to the lender for an equivalent term; the cost of the administration of the loan; and the risk factor. To those of you who are familiar with the mortgage industry, you will know that these three factors are frequently handled separately. If the loan is insured against default, the premium is known; and if the loan is administered by a mortgage banker on behalf of a passive lender the cost of administration is also isolated. In Canada, the leading pension funds had become active investors in privately placed mortgage loans by 1970. I do not hesitate to attribute this to the development and accepted use of mortgage insurance.

At the moment, in Canada, we are examining the possibility of developing a system of default insurance for industrial loans for those companies not yet large enough to have their issues placed on the public markets. The proposal is that private default insurance companies will underwrite the insurance policies and that a passive reinsurance facility will be created in Ottawa to provide increased credibility and overcome some of the technical problems involved. It is interesting because the reinsurance facility should not be a charge on the state and I am hoping that it will provide an example of a new way through which the public and private sectors can combine to the benefit of the economy.

One of the problems of junior industrial companies, particularly if they are growing fast, is that they tend to be chronically short of equity. What we are trying to create is a responsible lending mechanism which would tend to permit a somewhat greater debt-to-equity ratio than might otherwise be achieved and would allow the after-tax equity base of an industrial company to go that little bit further.

Similarly, a mechanism that tended to stretch the term of a loan over a larger number of years would permit a slower rate of amortization of principal and accordingly allow underlying equity funds to achieve a more effective role in the operations of a company. There is no way of knowing whether or not Ottawa will proceed in this matter, but if it does and if there is a suitable response from the private sector, I believe a very interesting experiment will have been started in Canada.

In conclusion, I might suggest that such experiments are going to be needed if we are to find successful ways in which savings can flow into those investments which we think will optimize future benefits. I regard it as most important that there be a widely based debate on our national investment objectives. And I regard it as equally important that we address ourselves to contriving new and more effective mechanisms by which we improve the process of intermediation and by which the cooperation between governments and the private sector becomes increasingly productive.