Management Discussion and Analysis of Financial Condition and Results of Operations

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The CPP Investment Board is a single-purpose corporation dedicated to increasing the long-term value of Canada Pension Plan assets through prudent investments. These assets will be used in the future by the Canada Pension Plan to pay pensions to Canadians.

The Investment Board is in the early stages of development. It had one month of investment experience in March 1999 and had assets of $12 million on March 31.

CPP Funding

The present value of accrued pension benefits under the Canada Pension Plan totalled $465 billion on December 31, 1997, according to the plan's 17th actuarial report. The plan had $36.5 billion in assets, mostly government bonds. As a result, assets represented almost 8% of liabilities.

The CPP will be funded on a "steady-state" basis – that is, contributions will level off after 2003 at 9.9% of pensionable earnings for employed Canadians and are then expected to remain steady to sustain the pension promise. (Contribution rates and benefit levels are decided by the federal and provincial governments.) Under the steady-state formula it is expected that the total of CPP and Investment Board assets will eventually reach about 17% – 20% of liabilities.

The Investment Board was created to help the CPP achieve its steady-state funding by earning investment returns on cash flows transferred from the CPP. The Investment Board is essentially an investment manager building a diversified investment portfolio.

Investment Objective

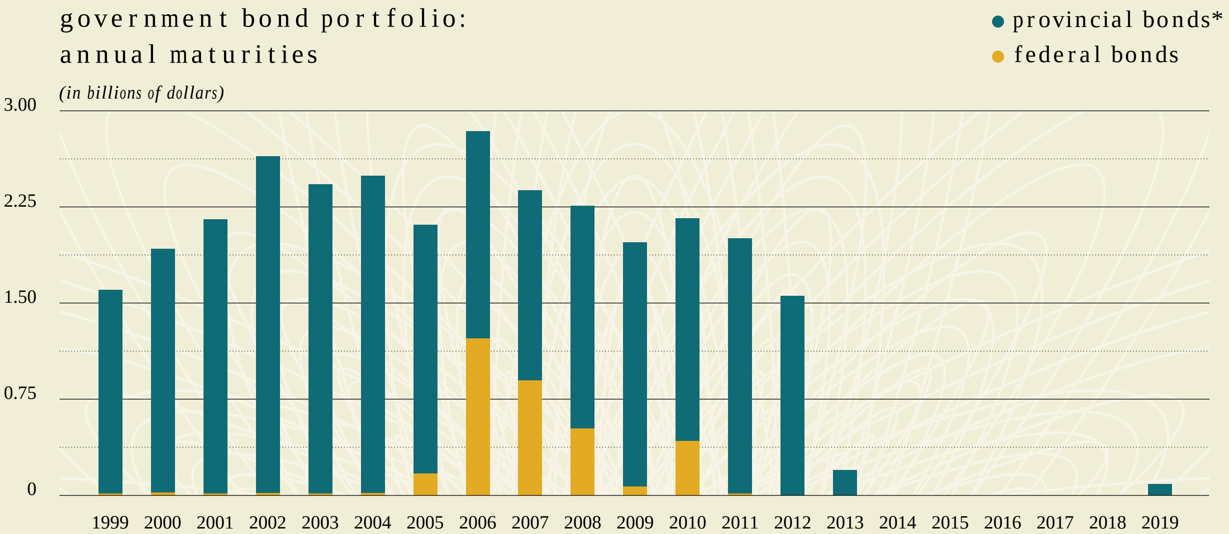
The actuarial report assumes that cash flows not needed to pay current pensions will earn a 4% real rate of return (that is, over and above inflation) to keep the Canada Pension Plan in a steady-state funding status after 2003. With inflation assumed by the actuarial report to grow to 3% annually over the next few years, the nominal investment objective is approximately 7%.

Sources of Cash Flow

The Investment Board will receive cash flows, not required to pay current pensions, from three sources, as illustrated in the diagram on page 3:

- CPP contributions by employees and employers;
- the government bond portfolio, currently administered by the federal Department of Finance, when these bonds mature; and
- income generated by its own investment activities.

The flow-through of CPP contributions will grow rapidly. A January 1999 projection by the federal government estimated that the Investment Board will receive approximately $66 billion in CPP contributions by 2008.



*Includes approximately $4 million of territorial bonds.

Between 1994 and 1998 no bond rollovers were permitted as the funds were required by the CPP. This accounts for the absence of maturing 20-year bonds from 2014 to 2018. The bonds maturing in 2019 reflect rollovers in the first three months of calendar 1999. There could be new maturities subsequent to 2019 if the provinces roll over bonds due between now and 2013.

It is difficult to project the cash flow from the government bond portfolio. Historically CPP funds have been lent to the federal, provincial and territorial governments in the form of non-negotiable 20-year bonds. Under a 1996 agreement among these governments, each province has the option to roll over its existing bonds for one further 20-year term. Funds not rolled over are transferred to the Investment Board, unless needed by the CPP.

Over the next 10 years, the federal government estimates that the Investment Board could receive as much as $80 billion in total cash flow (i.e., from contributions and bonds) from the CPP if the provinces decide not to roll over maturing bonds.

The government bond portfolio includes $3.4 billion in federal bonds (at cost) that cannot be renewed and will be transferred to the Investment Board when they mature.

The third source of cash flow will be income, such as dividends, capital gains and interest, generated by the Investment Board from investing in capital markets.

Investment Policy

The board of directors is required to develop, and review at least annually, a formal investment policy, known as the Statement of Investment Policies, Standards and Procedures. This is a public document and copies are available on request. The policy will be reproduced on the Web site www.cppib.ca, scheduled to be online in mid 1999.

The Investment Board is required to "adhere to investment policies, standards and procedures that a person of ordinary prudence would exercise in dealing with the property of others." (*Canada Pension Plan Investment Board Act,* section 35.) It must invest in the best interests of CPP contributors and beneficiaries by maximizing investment returns without incurring undue risk. However, as discussed in this section, investment activities are restricted by federal legislation and regulation.

The investment policy considers factors that may affect the funding of the CPP and its ability to meet the long-term pension promise to Canadians. It addresses such matters as investment asset mix, asset diversification and expected investment returns; risk management and liquidity; the use of derivative products; asset valuation; and the exercise of proxy voting rights attached to share ownership.

The directors adopted an interim investment policy on December 18, 1998 that will continue at least until a Chief Executive Officer is appointed. At that time, the directors will evaluate the strategic options with the CEO and develop a longer-term investment policy.

Asset Mix

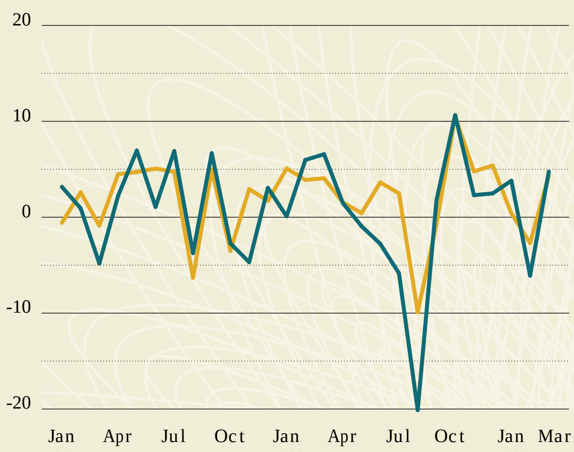
The key decision affecting long-term investment returns is the allocation of funds between equities and fixed-income securities. In developing the asset mix, the Board is required to take into consideration the CPP's bond portfolio.

To diversify the asset base and offset the dominance of the CPP's fixed-income securities, the Investment Board has adopted the interim policy of investing 100% of cash flows in equities.

In the short term stocks are volatile…

monthly equity returns

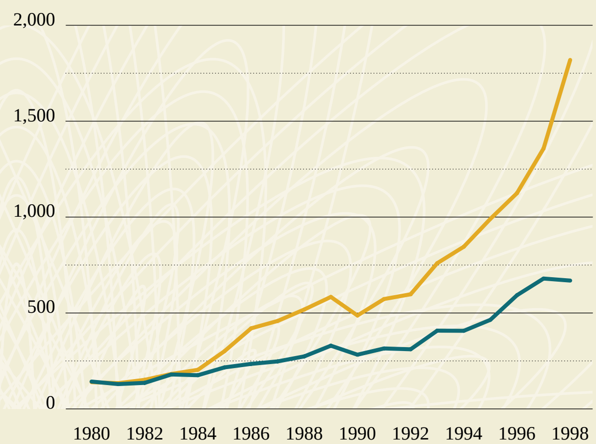
(% total return)



…but show steady growth over the long term.

value of $100 invested in 1980

($)



● msci world index ex-canada

● tse 300 composite index

Stocks can be highly volatile in the short term and even produce negative returns, as occurred with Canadian markets in 1998. Based on historical experience, equity values increase over the long term despite short-term market downturns. Regardless of market cycles, the Investment Board's cash flows are invested as soon as they are received.

Even if all new cash flows continue to be invested in equities over the next three years, the combined mix of investment assets held by the Canada Pension Plan and the Investment Board would only range between 20% and 35% equities by the end of 2001, depending on bond rollovers by the provinces. As the asset mix moves to higher levels of equities, the Investment Board will review its investment policy.

Current Investments

Under its interim policy, the Investment Board is investing in equity securities through stock index funds that substantially replicate stock exchange indices; short-term securities, such as treasury bills and bankers' acceptances; and derivatives that replicate direct investments in relevant stock indices. Cash flows are not invested in debt securities, such as bonds.

Foreign Investment Restriction

The Investment Board cannot invest more than 20% of assets (at cost) outside Canada. As a result, at least 80% of cash flows at cost are being invested in Canadian equities and up to 20% in non-Canadian equities.

In recent years, stock markets in the United States, Europe and other major economies have generally performed better than Canadian markets, although this could change in the future. Foreign investing diversifies risk, reduces volatility and can improve the long-term value of assets by earning returns from world economies that grow at different rates and on different cycles than the Canadian economy.

Use of Derivatives

Derivatives are financial contracts that derive their value from an underlying asset, such as a stock, stock index, bond, interest rate or exchange rate.

Certain non-North American stock index funds are only open to new investments at certain times of the month. To ensure continuous exposure to equity markets, cash flows destined for these stock index funds are invested temporarily in a synthetic equity-based fund utilizing derivatives until equity index fund units can be purchased.

Under the interim policy, the Board does not currently use derivative contracts to increase effective exposure to foreign equity markets above the 20% foreign limit.

Interim Equity Strategy

The federal and provincial governments are conducting a triennial review of the Canada Pension Plan. Until the review is completed, federal regulation requires that cash flows allocated by the Investment Board to Canadian equities must substantially replicate the composition of one or more broad market indices.

(This is known as passive investing. Active investing involves the selection of individual stocks and bonds, and the regular buying and selling of these securities to realize gains, with the objective of outperforming market indices.)

The Investment Board has retained an external fund manager to invest in a Canadian stock index fund and another manager to invest in foreign stock index funds.

The Canadian stock index fund mirrors the Toronto Stock Exchange 300 Composite Index, which represents over 90% of the market capitalization of Canadian-based companies listed on the TSE and includes Canada's largest public corporations. The stock exchange selects companies for inclusion in the index.

The foreign stock index funds are the Standard & Poor's 500 Index of large companies in the United States and the MSCI EAFE Index of about 1,000 companies in Europe, Australia, New Zealand and the Far East. Together, these indices represent more than 70% of the combined market capitalization of 22 countries.

Government Bond Portfolio

The government bond portfolio has an average yield to maturity of 11.36%, with interest paid semi-annually to the CPP. This coupon rate of interest reflects past high levels of interest rates, especially in the early 1980s, and is substantially higher than the Investment Board's long-term investment objective of 4% plus the inflation rate. Interest rates are currently low and bonds being renewed at market rates today yield close to half the current portfolio rate.

In March 1999, $251 million of the government bond portfolio matured. Of this amount, $88 million was renewed for a further 20 years at an average yield to maturity of 5.8%. Approximately $151 million was needed by the Canada Pension Plan to replenish its operating reserve to pay current pensions, and the Investment Board received the remaining $11.9 million.

Investment Return Expectations

It is inevitable that the CPP Investment Board's performance will be compared with other Canadian pension funds. However, it is important to note that many large pension funds have diversified portfolios that include passively and actively managed stocks, private placements, income-producing real estate, and foreign derivative portfolios, as well as corporate and foreign bonds, mortgages, and real-rate bonds that are indexed to inflation. The Investment Board is not acquiring these types of assets under its interim policy and is investing only in stock index funds that generally match the returns of their respective markets.

Stock markets, most notably in the United States and Europe, have generally produced the strongest investment returns in the 20th century during the past few years. While there is some risk that the Investment Board may be initiating its passive equity program toward "the top of the market," history suggests that better returns can still be expected from equities over the long term compared with most other investment opportunities. Furthermore, recognizing that the CPP's existing government bond portfolio is a large part of the asset mix, investing in equities is a prudent risk diversification strategy.

Financial Performance

The Investment Board received $11.9 million in cash flow from the CPP during March 1999 and, therefore, had only one month of investment experience. Investment activities earned approximately $202,000 (net of investment expenses) with almost $10 million invested in Canadian equities and about $2 million in foreign equities.

The Board incurred slightly more than $1 million in expenses, which are discussed in Note 7 to the financial statements. These expenses were deducted from a $6 million allocation by the federal government to cover start-up costs. The remaining allocation, approximately $5 million, will be repaid in the first quarter of fiscal 2000.

Investment Performance

To measure performance objectively, the Canadian equity portfolio is compared with the TSE 300 Index; and the two foreign equity portfolios combined are compared with the Morgan Stanley Capital International (MSCI) World Index, excluding Canada. The MSCI World Index, excluding Canada, measures the performance of approximately 1,400 companies listed on stock exchanges in the U.S., Europe, Australia, New Zealand and the Far East. This index is converted to Canadian dollars for measurement purposes.

The total fund return is measured against a composite benchmark weighted 80% for the TSE 300 Composite Index and 20% for the MSCI World Index. The asset mix policy specifies the target percentage of assets to be invested in each approved asset class.

The investment returns are calculated on a time-weighted basis, consistent with methods established by the Association for Investment Management and Research and the Pension Investment Association of Canada. The returns are before investment management fees.

Investment Returns vs. Benchmark Returns

For the month of March 1999	**Actual**	Benchmark
Canadian index equity	**4.9%**	4.8%
Foreign index equity	**5.4%**	4.4%
Total Fund	**5.0%**	4.7%

Stock index funds are expected to closely match their respective benchmarks. The Investment Board's returns were above the benchmarks, notably the foreign index equity fund. It earned 100 basis points (one full percentage point) more than its benchmark because (as explained in the subsection Use of Derivatives) cash flows allocated to the EAFE fund were temporarily invested in a synthetic equity-based fund that utilizes derivatives. The timing of the purchase and sale of these synthetic fund units produced higher returns in March, 1999 than the benchmark.

Risk Management Policies

The Investment Board has investment risk management policies and procedures in place and will develop new policies consistent with the expanding scope of its activities.

Proxy Voting Rights

Owning shares gives the Investment Board the right to vote on management proposals that could affect equity values. The directors have reviewed the proxy voting guidelines of the external fund managers and assigned voting powers to them as their policies are acceptable to the Investment Board at this stage. The fund managers are required to provide a voting report to the board of directors.

Year 2000 Readiness

The Investment Board has taken steps to ensure its computer systems are able to handle the transition to January 1, 2000 without interruption in service. As a start-up organization, the Investment Board's systems are new and Year 2000 compliant. The Investment Board has completed an analysis of the information provided by external fund managers, its custodian, and key suppliers to ensure that they have processes and resources in place to prepare for the year 2000. There is, of course, no guarantee that problems will not arise with services provided by third parties.