CPP INVESTMENT BOARD

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Remarks by

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to the

Canadian Pension & Benefits Institute

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Good afternoon ladies and gentlemen. I'm pleased to have the opportunity to discuss the CPP Investment Board with this distinguished audience, because communicating openly with Canadians is an important responsibility for us.

Your agenda calls for me to address the vision, mission and strategies of the Investment Board, and I'm happy to discuss these matters to the extent that they have been developed during our relatively short period of existence. What I don't intend to do is debate Mr. Greenspan's views on investing public funds in the equities market as described in the session programme. This policy and other related matters were decided by the federal and provincial governments before the Investment Board was created.

Mandate

The CPP Investment Board, which invests new Canada Pension Plan funds has a mandate of increasing the long-term value of Canada Pension Plan assets through prudent investment in capital markets. In this way, the Investment Board will help the CPP to keep its long-term pension promise to Canadians.

Agenda

Let me start this afternoon by giving you a brief introduction to the Investment Board and outlining our progress in the first few months of our existence. Then I'll discuss two policy initiatives, and some of the more important objectives we have set for the next year, before opening the floor to your questions.

Introduction

The CPP Investment Board was created by an Act of Parliament in December 1997, and the directors were named in October 1998. The Investment Board receives funds not required by the Canada Pension Plan to pay current pensions.

The CPP Investment Board is managed independently of the Canada Pension Plan and federal and provincial governments. It is governed by a 12-member board of directors with extensive business, professional and financial expertise, who come from various regions of Canada.

The first $12 million of funds were transferred to the Investment Board last March. By mid-June, we will have invested close to $500 million. From a modest beginning, assets, as projected by the federal government, should grow to $88 billion in 10 years.

Canada Pension Plan

The Canada Pension Plan itself, as you are aware, is administered by the federal government, which collects contributions and pays pensions, and in conjunction with the provinces, sets contribution rates, and determines benefit levels.

According to the latest actuarial valuation by the federal government on December 31, 1997, the present value of accrued pension benefits under the Canada Pension Plan totalled $465 billion. The plan, at that time, had $36.5 billion in assets. As a result, total assets represented 7.8% of CPP liabilities.

The federal government and participating provinces have agreed that the CPP will be funded on a "steady-state" basis. Under this funding plan, contributions will level off after 2003 at 9.9% of pensionable earnings for employed Canadians. Contributions are then expected to remain steady at that level to sustain the pension promise indefinitely. 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 CPP 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 Federal Chief Actuary has assumed that cash flows directed to the Investment Board will need to earn a 4% real rate of return. With inflation projected by the Chief Actuary to grow to 3% annually over the next few years, the nominal investment objective is approximately 7%.

With CPP assets reaching only 17-20% of liabilities, it is important to recognize that, even if returns from the capital markets were to significantly outperform the nominal target, this will not have a major impact on the contribution rate.

Cash Flow

The Investment Board will receive cash flow from three sources:

• CPP contributions by employees and employers that are not required by the Canada Pension Plan to pay current pensions;

• the proceeds of maturing bonds in the government bond portfolio, currently administered by the federal department of finance for the CPP; and

• income generated by the Investment Board's investment activities.

Bond Portfolio

The cash flow from the government bond portfolio is not fully predictable. CPP funds have historically been lent to the federal and provincial governments in the form of non-negotiable 20-year bonds. Under a 1996 agreement among the federal, provincial and territorial 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 required by the CPP.

First Six Months

In preparation for receiving the first cash flow from the federal government, the directors of the CPP Investment Board met for the first time on November 18, 1998 to implement the legal framework for the new organization. During the ensuing months, the board of directors has:

- formulated corporate governance procedures,
- developed investment policies,
- developed procurement guidelines,
- identified external fund managers to handle the first cash flow
- invested the cash received in the domestic and foreign equities markets
- and undertaken the very important search for a Chief Executive Officer.

Organizational Flexibility

The board of directors made the deliberate decision to maintain organizational flexibility until the Chief Executive Officer joined the organization. Accordingly, we retained outside advisors and employed contract staff during the start-up period.

Experienced professionals were brought in to lead the transition team, and to develop monitoring and accounting procedures for investments. During the start-up period, I have discharged the functions of the Chief Executive Officer at the request of the federal and provincial governments and with the consent of the board of directors.

The start-up activities obviously called for a greater commitment of the directors' time than would have been the case if we had started with a permanent management team.

Investment Policy

I'll turn at this point to a discussion of the investment policy which is critical to an understanding of the direction we are taking.

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." It is required to invest in the best interests of CPP contributors and beneficiaries by maximizing investment returns without incurring undue risk. However, as I will describe, investment activities are currently restricted by federal legislation and regulation.

Interim Policy

The directors adopted an interim investment policy on December 18, 1998 that will continue substantially in the same form until after a Chief Executive Officer is appointed. At that time, the Investment Board will evaluate its strategic options and develop a longer-term revised 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 Investment Board is required to take into consideration the government bond portfolio to which I referred earlier.

To diversify the asset base and offset the dominance of fixed-income securities, the Investment Board has adopted the interim policy of investing 100% of cash flows in equities. Going forward, it is reasonable to expect that in Canada, the relative returns of equities and bonds will be more like the relative rates experienced in other countries.

I need hardly remind you that stocks can be highly volatile in the short-term and produce negative returns. Based on historical experience, however, equity values increase over the long-term despite short-term market downturns.

No attempt is made at market timing; cash flows arrive at least monthly and are invested immediately.

Current Investments

Under the interim investment policy, the Investment Board invests in equities through units in stock index funds which substantially replicate the indices chosen.

Through an external fund manager, the domestic portion of cash flows are being invested in a pooled fund that mirrors the Toronto Stock Exchange 300 Composite Index. The Index represents a significant proportion of the market capitalization of Canadian-based companies listed on the TSE.

The Investment Board cannot invest more than 20% of assets outside Canada. As a result, at least 80% of cash flows are being invested in Canadian equities and up to 20% in foreign 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. In any event, foreign investing diversifies risk, reduces volatility and improves the long-term value of assets by earning returns from world economies that move at different growth rates and on different growth cycles than the Canadian economy.

In making Canadian equity investments, we are currently required to replicate broad market indices. This requirement will be reviewed by the federal and provincial governments as part of their current triennial review of the Canada Pension Plan. The Investment Board will present recommendations on this issue as part of the review.

Current Investments - Foreign Equities

With respect to foreign equities, although regulations permit active management, the Investment Board selected an external fund manager to replicate the Morgan Stanley Capital International World Index, excluding Canada.

The index is composed mainly of the Standard & Poor's 500 Index of large companies in the United States and the EAFE Index of approximately 1,000 large companies in Europe, Australia and the Far East.

Cash flows are being invested in the S&P 500 and EAFE indices that together represent about 70% of the combined market capitalization of 22 countries.

Current Investment Returns

I will note, at this point, that portfolio investment returns in March of 5% slightly exceeded the index benchmarks. Obviously a long-term investor should not focus on very short-term results. I do so only to introduce the concept of tracking variance, the difference between the index results that we are attempting to replicate and our own results. The tracking variance was caused mainly by the timing and size of cash flows relative to the size of the portfolio. These tracking variances may continue for a considerable time period.

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

Return Expectations

As I've described, the Investment Board is operating under a policy that includes only Stock Index Funds. The Index strategy is a way to obtain market exposure quickly and to do so in a diversified fashion.

The Index Funds generally will, over time, match the returns of their respective markets. Because of the size of our cash flow relative to the size of the portfolio, we may have significant tracking variance for some time.

As we are investing in index funds, the appropriate point of comparison is the index itself, not the performance of other large funds which may have actively managed portfolios that include other asset classes and derivatives.

Stock markets, most notably in the United States and Europe, have produced some of 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 at a temporary market peak, history suggests that better returns can still be expected from equities over the long-term compared with most other asset classes.

Conflicts Of Interest

Another important policy matter about which the board of directors felt strongly is a code of conduct together with conflict of interest guidelines.

Because the Investment Board requires directors with financial and investment expertise, conflicts of interest must be expected from time to time and managed appropriately. Conflicts are most likely to arise because directors serve on the boards of companies in which the Investment Board owns shares.

The Investment Board's legislation sets conflict-of-interest provisions that are even stronger than those found in the Canada Business Corporations Act and the Bank Act. Specifically, directors are required to:

• make timely disclosure of any investment transactions, and not just material transactions, between the Investment Board and entities in which they have a material interest;

• abstain from voting on resolutions concerning transactions in which they have a material interest; and

• abstain from participating in discussions about transactions in which they have a material interest.

Conflicts of interest must be disclosed in writing and entered into the minutes of board or committee meetings.

Directors' Code Of Conduct

The board of directors has established a code of conduct and conflict of interest procedures which go beyond ensuring compliance with minimum statutory requirements. They provide a workable process for minimizing and resolving conflicts of interest so directors can fulfill the CPP Investment Board's mandate effectively while maintaining their independence and integrity. The guidelines have been developed to ensure directors have a full understanding of the Investment Board's principles and values and assist them in determining the appropriate business practices and behavior.

The code of conduct is designed to create a corporate culture of trust, honesty and integrity. When there is doubt that is not addressed by written policies, situations are to be tested against a number of key questions including:

• is it in the best interests of the Investment Board, and thus CPP beneficiaries and contributors, and

• will it meet or exceed the standard of behaviour expected by the Canadian public?

Looking Ahead

Let me conclude my remarks by reviewing our objectives for the year ending March 2000. The first among these is to staff the Investment Board with a Chief Executive Officer. It will be the CEO's responsibility to review the priorities established to date, to develop a longer-term strategic direction and decide how best to implement it.

A second major priority is to invest in excess of $1.5 billion of new cash flow, which we will receive from the CPP, in domestic and foreign equities, and to monitor the success of our investment managers in tracking the performance of the indices, and minimizing transaction costs.

Third, we will continue to keep stakeholders informed of our progress through quarterly reports, the annual report, a web site, by finalizing plans for public meetings to be held in each province, and through participation in conferences like this.

And finally, the Investment Board will further advance corporate governance policies by adding performance evaluation processes for the CEO and board of directors. In addition, the board of directors will ensure strategic planning as well as succession planning processes are in place.

When the CEO arrives, that person will clearly face an array of pressing tasks, and so may re-prioritize, or even add to this list.

Conclusion

Ladies and gentlemen, this concludes my remarks. Thank you for your attention. At this point I'll be happy to take questions.