Building the CPP Investment Board

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Remarks by

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Thank you.

I am very pleased to be here with you this evening and to have our Chair, Gail Cook-Bennett, in attendance as well. As I look around the room, I see a number of former partners … and many former competitors.

This gathering brings back happy memories of 31 years on the Street. And I will confide with you that … while my life plan always included a vision of having more than one career … and while I am fully enjoying and engaged by my new responsibilities … there are aspects of the investment business that I miss.

I miss the adrenaline rush that comes on learning that you have just won a huge bought deal … or hearing on the car radio first thing in the morning that overnight markets moved dramatically … or that a takeover bid has just been launched for a favorite client --- at a lowball price.

I also miss the camaraderie … of my own firm in particular … and of the investment dealer community as well.

That is part of why I am so pleased to be here tonight … simply for the pleasure of your company.

The other reason is that I welcome the platform to tell you about the CPP Investment Board. I want to share some observations from my new perch on how I think the Investment Board will affect capital markets … and where I see both risks and opportunities for the investment community.

Because I am just recently departed from your industry … and still care about it and want it to be strong and dynamic … and because I am recently arrived in the pension fund world … where I want to succeed on behalf of my stakeholders … I find myself on the fulcrum between the two.

I hope this gives me a vantage point from which I can look both backwards to the investment industry … and ahead to the world of public sector pension fund management … and provide you with some useful insights.

Given that we are in the month of January … named for the Roman god Janus … who had the ability to look forwards and backwards at the same time … it seems that the planets are aligned for us to do the same thing this evening.

In my remarks I am going to touch on four topics.

First, a quick history of the Canada Pension Plan.

Second, a brief profile of the CPP Investment Board and our mandate.

Third, the role that we and other pension funds will play as a force of change in Corporate Canada and capital markets … and where this might create both perils and opportunities for the investment community.

And fourth, I want to share some details on our current thinking on the kind of team and organization I hope we will create to discharge our duties. And also how we hope to work constructively with the financial services industry.

Let's start with a review of the Canada Pension Plan.

It was created in 1966 as a pay-as-you-go plan. The idea was that each generation would pay the pensions of the previous generation. It was never intended to be a fully funded plan.

That made sense 30 years ago. The number of Canadians over 70 … the retirement age in those days … was small relative to the working population.

Back in the 1960s we had a booming economy … plentiful jobs … and rising wages.

Canadians could afford to be generous to the generation that had endured the hardships of the Great Depression in the 1930s … and the sacrifices of the Second World War in the 1940s.

The Canada Pension Plan was designed to provide all working Canadians with retirement income … as well as financial help to their families in the event the breadwinner died or became disabled.

That made sense, too. In the 1960s many Canadians did not have a pension. Those who did sometimes lost it if their employer went bankrupt.

Few had pension portability among employers. Workers who hated their jobs had to grin and bear it … or lose their pension entitlements if they quit.

By introducing pension portability and a guaranteed retirement income … the Canada Pension Plan accomplished important social change.

All in all, the plan was a great idea. It delivered full coverage, portable benefits, inflation protection and the major source of income for many seniors. And substantially more money came in to the plan each year than went out.

Let's fast forward 30 years to the mid-90s.

By 1996, more than 10 million Canadians were paying $11 billion a year in CPP contributions … while 3.5 million were drawing close to $17 billion in benefits … a deficit of $6 billion in that year alone.

Clearly more money was going out than was coming in.

Several factors caused the imbalance … and the plan was headed for serious trouble.

If something wasn't done quickly either contributions would have to go up substantially or the plan reserve would be exhausted by 2015. The burden on future generations would be enormous.

This impending crisis sparked an extensive review by Federal and provincial governments … which led to fundamental change in 1997.

It was decided to put the Canada Pension Plan on a firmer financial footing by increasing contribution rates and improving plan administration. As a result, the plan will move over the next 20 years from exclusively pay-as-you-go to fuller funding.

According to the last federal actuarial report … at the end of 1997 … the plan's assets of $36 billion represented about 8 percent of liabilities. Under the new funding formula … assets will eventually reach 20 percent of liabilities … a big step back from the edge of the fiscal abyss.

Let me turn now to my second topic – the CPP Investment Board itself.

It was created by an Act of Parliament to manage the Canada Pension Plan's reserve assets … and commenced operations in October, 1998. We are independent of the Canada Pension Plan … which is administered by various federal departments.

Both the federal and provincial governments are responsible for setting CPP contribution rates and determining benefits … although Ottawa collects contributions and pays entitlements.

The Investment Board has one job -- to invest funds received from the Canada Pension Plan. By increasing the long-term value of these assets … we will ultimately help the plan to meet its pension obligations.

Our role, then, is one familiar to all of you – we are essentially a large money manager.

But just what is our investment mandate?

Our legislation sets two clear objectives: First, to manage the assets entrusted to us in the best interests of the Canada Pension Plan's contributors and beneficiaries … and second, to maximize investment returns without incurring undue risk.

As you know … the key decision affecting long-term investment returns is the allocation of funds between equities and fixed-income securities.

In developing our asset mix policy, we take into consideration the existing CPP bond portfolio, which is currently managed by the Department of Finance. This portfolio forms the bulk of CPP assets.

To offset its dominance and to diversify the asset base … we adopted an interim policy of investing 100 percent of cash flows in equities.

At the present time, during our start-up phase, 80 percent of our cash flow is being invested by TD Quantitative Capital in the TSE 300 Composite Index … while Barclays Global Investors is putting the balance into the S&P 500 Index and the EAFE Index.

During our first 10 months of operations, we have received almost $2 billion from the Canada Pension Plan.

Today, about 95 percent of the combined assets of the Canada Pension Plan itself and those managed by the Investment Board are fixed-income securities and roughly five percent are equities.

Clearly we have a long way to go before we achieve a reasonable asset mix. By the end of next year, we expect that equities will still represent only 20 to 35 percent of the combined assets …

depending on how much we receive from the Canada Pension Plan in surplus contributions as well as maturing funds from the bond portfolio.

It is expected that we will have at least $88 billion of assets under management within 10 years. This will position the CPP Investment Board as one of the largest institutional investors in Canada.

Which brings me to my third topic – the role we and other pension funds will play as a force in Corporate Canada and capital markets.

When I look back to the early years of my career as an investment dealer in the 1960s and 1970s … way back in the 20th century … public sector pension funds were invisible.

And with good reason. Governments required them to invest a large portion of their contributions in non-marketable government debt, often of the sponsoring government. In fact, many large public sector funds had no choice but to invest in government debt.

One of the first fund managers to pursue a diversified mandate was the Caisse de dépôt et placement in 1966 … followed by OMERS in 1974.

But the institutionalization of pension capital had not happened to any serious extent by the 1970s. Private mutual fund companies, banks, insurance and trust companies and corporate pension funds were much more visible as pools of investment capital.

The big rush to pension fund capitalism occurred in the 1990s. Today, all provincial public sector funds … as well as virtually all federal funds … invest in domestic publicly traded stocks and bonds. As well, some have reputations as merchant bankers … or owners of large income-property portfolios … or as venture capitalists. Several are prominent directly in international markets.

The migration of public sector pension assets to capital markets will be complete this April when the four remaining federal funds start to invest their members' contributions.

The Public Sector Pension Investment Board will invest on behalf of the federal civil service, the RCMP and the Armed Forces … while Canada Post will invest its own pension assets.

Together … these four funds will invest about $3 billion a year in capital markets.

So the Canada Pension Plan Investment Board is very much part of a trend that has been underway for some time … and still has some distance to go.

Pension assets have grown rapidly during the boom markets of the 1990s.

The top 100 Canadian funds have combined assets in the order of $500 billion … and the majority of them are public sector plans. Together, the public sector funds are responsible for over 75 percent of total assets.

Of the 10 largest funds … eight are public sector … each with more than $10 billion in assets.

Within just a few years … probably all 10 of the largest investment accounts in Canada will be public sector pension funds. The CPP Investment Board will be among them.

For investment dealers … pension funds generally … both public sector and private sector … will not only be large customers but also demanding customers.

Nowhere will this be more apparent than in fees, commissions and spreads. There is nothing new here … all have been under pressure for years.

This is a trend that will continue and, I would argue, intensify. If I were still in the investment industry, I would plan accordingly.

Part of my plan would be built on recognizing that … not withstanding these pressures … new opportunities will abound. Pension funds will have enormous amounts of capital to put to work. All funds need the help of the financial services industry in its various manifestations to do so. Because of the challenges pension funds face they will continue to be major consumers of services and reward providers of liquidity and pay handsomely for attractive new products, new ideas and sound long-term research, delivered through relationships based on trust.

Business … meaning revenues … will flow to the best-in-class providers of traditional products and services as well as to nimble firms … whether long-established or new entrants … who are creative in what they offer and how they offer it.

In addition, my expectation is that incentive fees will grow as a basis of compensating providers.

I spoke a few moments ago about the growth of pension funds. They are growing in more than size and number. As leading owners of Corporate Canada, they are also growing in influence.

For public companies the good news in this development is that it inextricably aligns the retirement income of Canadians with the financial well-being of the private sector. The better Canadian firms perform financially over the long term… the better off Canadians will be in their retirement years.

The bad news … at least for some … may be that these funds are becoming increasingly active as shareholders. The reason why is simple.

Pension funds are investing billions upon billions of dollars in a relatively small number of public and private companies in Canada. They have little flexibility to liquidate their holdings if they are unhappy with a company's performance.

The sometimes dismissive suggestion to shareholders that … "If you don't like the way we run the company, sell your shares" …. is not actionable advice.

That is why most large pension funds … including public sector funds … take a keen interest in the governance practices of directors … and the commitment of management to enhancing shareholder value.

For our part … in exercising our voting rights … we will act sensibly, responsibly and with a long-term view.

Happily we do not have to be pre-occupied with the quarterly performance sweepstakes. We are long-term investors. In fact, for us the longer the better.

So to summarize …. pension funds generally will be a force for continuing change in Corporate Canada and our capital markets … and I believe a positive one.

Let me turn now to my final topic -- our current thinking on the kind of organization we hope to build to invest funds on behalf of our millions of contributors and beneficiaries.

As a preface to the comments that follow I want to point out that the broad strategic elements that I am sharing with you have been agreed by our Board of Directors and the detailed business plan that flows from them will be presented for their consideration and approval in mid-February. Subject to that important condition precedent, I hope to go into implementation mode in the Spring.

The first major element of our vision is that we will build a virtual corporation with a very small team of professionals to capitalize on outstanding external capabilities through a network of what some call external managers but I intend to be partner-like relationships.

I don't believe we need a big organization. To be emphatic I believe it would be a mistake to try and create one. A small team can be focused … have access to the best talents available through external relationships at home and abroad … have the flexibility to respond quickly to the rapidly changing global marketplace and economy … and, in all this, serve the public interest by being cost effective.

Item two: I envisage that this small team will consist of five very senior professionals. Three will be responsible for investments … one for finance and administration … and another for communications and stakeholder relations. Over time each will add other professionals as required, but only a few.

The initial three investment professionals will bring years of relevant experience and reputation. One will be responsible for research and risk management … another for investments in private markets … and the third for investments in public markets.

Along with me, they will develop investment strategies … establish networks that will generate deal and idea flow … and form external relationships through which we will execute our strategies.

I expect that candidates for these senior positions will come from the investment dealer community … as well as other institutions and professions within the financial services industry.

This team will have the scope to consider a full menu of investment alternatives and bring new strategies to our board of directors for consideration. Our team will explore opportunities in both public and private markets, domestically and internationally … and implement them actively and passively as appropriate. Obviously we will consider the full range of strategies in publicly traded securities. We will also research merchant banking, private equity, real estate and venture capital, as well as other alternative investments.

We recognize that external implementation, which I reiterate is our strong preference, may not in every case or forever be the best course available to us. Consequently, we will be open to building internal expertise or operations wherever and whenever equal or better performance can be achieved at lower cost.

As well, and this is an important contextual point, at the CPP Investment Board we are managing fiduciaries. As I said earlier, we have a statutory obligation to maximize investment results without undue risk. And we know the public will scrutinize our performance intensely.

We intend to measure our performance on an absolute and risk adjusted basis … as well as a gross and net basis … all in comparison with relevant capital markets benchmarks, the returns of our peer group, and the assumption of the federal chief actuary.

The final major element of our proposed organization is our commitment to full, open and timely communications with all stakeholders.

Canadians from coast to coast have a direct financial interest in how we manage the assets entrusted to us.

They have a right to know what we are doing with their money. And they will.

We will publish an annual report and … most unusual for a pension fund … quarterly reports as well.

And we will hold a public meeting at least once every two years in every province. That's equivalent to five annual meetings per year.

On top of all that, part of my job is to communicate through private meetings, public meetings, the news media and on the Web…to answer questions and tell our story.

Planning, recruiting, investing and communicating.

This will be an exciting time for me and those who join with me as we build a new and important investment organization.

The CPP Investment Board is embarked on a noble quest: namely, to help deliver the pension promise and thereby make retirement more comfortable and secure for the millions of Canadians who are counting on us.

I am well aware of the enormity of the challenges and expectations that lie ahead. And I am enthused and seized by them.

I look forward to working with you in the years ahead as we strive to fulfill our mandate. Thank you for inviting me to be with you this evening.