Strategic Vision

CPP Investment Board

Strategic Vision at the CPP Investment Board

Remarks by

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Thank you for the invitation to be your luncheon guest today. I look forward to sharing some information and thoughts and then answering your questions.

I have been on the job at the Canada Pension Plan Investment Board for just over a year now. While I have been warmly received by the pension fund industry … I must admit I still feel very much like the new boy on the block.

Despite more than 30 years in the investment business … there is so much to learn about the subtleties of pension fund investing … from funding requirements to asset mix policies, risk management and benchmarking.

Well, I'm still learning – and thoroughly enjoying it.

In part because the CPP Investment Board has made such an embarrassingly good start – a 40 percent total fund return in our first full year.

Of course, we'll never do that well again. But it was a gratifying way to start.

The title of my address is "Strategic Vision at the CPP Investment Board." To understand our strategic vision, it is important to know why the CPP Investment Board was created in the first place.

We come from polygamous parents -- the federal government and the nine participating provinces that are joint stewards of the Canada Pension Plan … and the designers of the CPP Investment Board.

Together, they set contribution rates, benefit levels and the funding policy … although the federal government alone administers the plan.

However, the CPP Investment Board exists at arm's length from both levels of governments. We were sent out to stand on our own two feet right away.

But let's go back to the CPP to sketch out the background.

The Canada Pension Plan was created by both levels of government 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.

And 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.

From the beginning … the idea was to replace a portion of the worker's pre-retirement earnings with a guaranteed pension. In other words, the Canada Pension Plan is not … nor was it conceived as … an income redistribution program.

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 in CPP contributions … while 3.5 million Canadians were beneficiaries drawing close to $17 billion in benefits … for a deficit of $6 billion in that year alone.

Clearly more money was going out than was coming in.

The plan was headed for serious trouble due to escalating costs from improved benefits … lower contributions than originally expected … and demographic change.

The baby boom generation will start to retire in large numbers around 2011. By 2030 … about 23 percent of Canadians will be 65 or over.

Today there are five Canadian contributors for every pensioner. By 2030 … there will be only three workers to support every pensioner … a dramatic and costly demographic shift.

As a result of these factors … the federal chief actuary in Canada estimated in 1995 that the plan reserve would be exhausted by 2015 … and future generations would have to pay 14.2 percent of their contributory earnings to keep up with the needs of retired Canadians.

To put it mildly … the financial burden on future generations would be intolerable.

This impending crisis sparked an extensive review of the Canada Pension Plan … 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 plan's most recent actuarial report, the present value of accrued pension benefits under the Canada Pension Plan totalled $465 billion on December 31, 1997. The plan had $36.5 billion in assets, mostly government bonds.

As a result, assets represented about 8 percent of liabilities.

According to the federal and provincial finance ministers, the CPP will be funded in future on a "steady state" basis. This concept means that contributions will level off after 2003 at 9.9 percent of pensionable earnings for employed Canadians.

The 9.9 percent rate is expected to remain steady indefinitely and be sufficient to sustain the pension promise.

Under the steady-state formula, the Canada Pension Plan will build a reserve equivalent to five years of benefits … instead of two years previously … or about 20 percent of liabilities.

The federal government feels strongly that this partial funding … coupled with the higher contribution rates … will be sufficient to keep the long-term pension promise.

In the literature sent this year to Canadians with their first annual pension statements it states that the latest report on the financial state of the CPP (and I quote) “confirms that the Plan is financially sound for the next 100 years.”

The steady-state funding concept assumes the CPP reserve not needed to pay current pensions will earn a 4 percent real rate of return.

With inflation projected by the actuarial report to grow at 3 percent annually over the next few years, the nominal investment objective is therefore approximately 7 percent.

That’s where the CPP Investment Board comes in.

The CPP Investment Board 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.

We have one job -- to invest all funds received from the Plan. By increasing the long-term value of these assets … we will ultimately help the plan to meet its pension obligations.

In essence, we are an investment company building a diversified portfolio of assets.

Let me explain our investment mandate, current investment activities, and future direction.

First, our investment mandate.

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

The key decision affecting long-term investment returns is the allocation of funds between equities and fixed-income securities … that is, principally between stocks and bonds.

In developing our asset mix policy, we consider the existing assets in the Canada Pension Plan. These are fixed-income securities, mostly bonds, and are managed by the Department of Finance.

Historically, the Plan lent surplus funds at preferred rates to the provinces. The federal government also borrowed funds from time to time. The result today is a government bond portfolio owned by the Plan valued at more than $30 billion.

To offset the dominance of these fixed-income securities … and to diversify the asset base … we at the CPP Investment Board are investing 100 percent of the cash flow received from the Plan in equities.

How are we doing that?

In 1997, the federal and provincial finance ministers thought it would be prudent during our formative years for us to invest passively any funds we allocated to Canadian equities. That is, to put the money in stock index portfolios that replicated an established stock market index.

This made sense for several reasons. As a new organization, it would take time to recruit investment professionals. For example, I did not join the organization until almost one year after it was created by legislation.

Another reason is that investing in stock index funds is cost efficient. It's an easy way to gain exposure to equity markets in a hurry.

A further reason is that the historical data shows passively managed index funds have an excellent performance record.

So, while we were restricted to passive equity investing in Canada during our start-up period – I think we would have chosen that approach anyway.

As we did in making foreign equity investments … where we face no restrictions on passive versus active investing.

In Canada, we invest in the TSE 300 index … and

outside Canada in the S&P 500 Index of large public companies in the United States … and the EAFE Index of about 1,000 companies in Europe, Asia and Australasia.

How we allocate capital between Canadian and foreign opportunities is straightforward. We strictly adhere to the foreign property limit set by the federal government.

The limit was increased to 25 percent this year. However, in our last fiscal year, the limit meant we invested 80 percent Canadian and 20 percent foreign.

Our timing in launching an equity program that was 80 percent Canadian could not have been better. In our first full-year ended last March, the TSE 300 index was one of the best performers in the world … returning approximately 45 percent.

Our foreign stock funds earned 16 percent to give us a blended total fund return of 40 percent.

At the end of March, we had $3.5 billion invested in equities. The combined assets of the Canada Pension Plan and the CPP Investment Board were 90 percent fixed-income securities and 10 percent equities.

That is an extremely low equity ratio compared with other large pension funds. Clearly we have a long way to go before we achieve a reasonable asset mix.

The funds available to us will grow extremely fast in the next few years. At the end of June, we had about $5 billion invested. Within the decade, we expect to have more than $100 billion.

This will position us as one of the largest institutional investors in Canada and an important investor on the global stage.

However, I should stress that we are still very much in our start-up mode.

I joined the CPP Investment Board in September 1999 … and have since hired a vice-president of finance and operations, a vice president of research and risk management and a vice president of private market investments. There are two key positions yet to be filled – vice president of public market investments, and vice president of communications and stakeholder relations.

Our plan is to build a virtual corporation with a very small team of senior professionals.

The executive team will develop our longer-term investment strategies and retain outstanding external capabilities to implement those strategies through a series of partner-like relationships.

Of course, retaining external expertise may not always be the best course available to us. We will build staff resources where equal or better performance can be achieved at lower cost.

But we don’t need a big organization. A small one can be focused … have access to the best talents available at home and abroad … have the flexibility to respond to the rapidly changing global marketplace and economy … and, in all this, serve the public interest by being cost effective.

As I mentioned, we currently invest only in equity index funds.

A few months ago, the federal and provincial finance ministers relaxed the restriction that limited us to passive equity investing in Canada.

We can now actively invest up to 50 percent of the funds we allocate to Canadian equities … and expect this restriction to be removed entirely in the coming months.

When that happens, we will be able to invest on the same basis as other pension funds.

Once we have assembled our executive investment team, we will look at the benefits of passive and active investing in equity and debt, merchant banking, private equity, infrastructure projects, venture capital opportunities, real estate investments and derivative contracts.

In other words, we will consider the range of investments available to other investors.

An issue that many Canadians raise – and quite properly so -- is how can we protect the integrity of the investment function against political influence.

First, we have clearly defined the roles and responsibilities for each of the different players in the pension picture – the federal and provincial governments … our board of directors … and my management team.

The CPP Investment Board is accountable to both levels of government … as we should be in those areas where our legislation requires us to be.

After all, the Canada Pension Plan is an important expression of our nation's capacity to care for one another. The CPP Investment Board has a role to play in securing the plan's long-term financial future … and helping elderly Canadians to retire with a little more grace.

But what does this mean in practice?

The federal and provincial finance ministers are required to review the Canada Pension Plan every three years. That, by the way, is an improvement over every five years historically.

The review includes the role and responsibilities of the CPP Investment Board. It was at the last review in December 1999 that the minister amended the restriction on our ability to invest actively in Canadian equities.

Another practical example is that the federal finance minister … in consultation with the participating provinces … is required to initiate a special examination of our financial and management control, and information systems and management practices, at least once every six years.

But the finance ministers themselves recognized that the CPP Investment Board must be at arm's length. To ensure that, they introduced a rather ingenious process for electing our board of directors.

The federal government and nine participating provinces have one representative each on a nominating committee that consists of public officials and business leaders, with a private sector executive in the chair.

This nominating committee recommends candidates for appointment by the federal finance minister who then seeks input from his provincial counterparts.

Our legislation states that it is desirable to have sufficient directors with proven financial ability or work experience relevant to the goal of maximizing investment returns.

As a result, the nominating committee recommended directors with expertise in investment, business, economics and financial management.

The initial board has staggered terms … with half the directors serving a two-year term that expires later this year … and the remainder serving a three-year term that expires late next year.

Each director can be appointed or re-appointed for a three-year term … and can serve a maximum of three terms, or nine years.

Still, is there a risk of political interference in our investment decisions?

We think not. Remember that the federal finance minister must consult with provincial counterparts before making board appointments. That alone is a powerful check on any temptation to make narrowly partisan or ideological appointments.

A second check against political intrusion is that any change in our legislated mandate or related regulations requires the approval of the federal government and the agreement of two-thirds of the provinces with two-thirds of the population. In effect, this is a constitutional check, and a powerful one.

Furthermore our commitment to extensive public accountability ensures that Canadians will be kept current with what we are doing and any proposed changes.

All in all, we have a lot of checks and balances in our accountability … two levels of government, the CPP Investment Board with its own board of directors and management, and millions and millions of Canadians who contribute to and benefit from the Canada Pension Plan.

Let me close by commenting a little further on accountability to stakeholders.

We must publish an annual report and make it available to all interested Canadians. Our second annual report, for the year ended last March, was widely distributed in June.

We must publish quarterly financial statements. That is unusual for a pension fund, recognizing that our investment horizon is three decades rather than three months.

We also communicate with Canadians on a regular basis through the news media, our Web site, public speeches and participation in private meetings and conferences like this.

On top of all this, we must hold a public meeting at least once every two years in every participating province.

Think about that – an average of five annual meetings every year. That’s accountability!

We plan to hold our first bi-annual public meetings across Canada in January in each of the provincial capitals … except Quebec, of course as it has its own plan, the QPP.

If you reside in one of the provincial capitals and would like to come in from the cold in January for a warming discussion on our investment activities – please let us know through our Web site at www.cppib.ca.

The details on our public meetings will be posted there in the next couple of weeks.

I hope my remarks have helped you to better understand the role of the CPP Investment Board … its arm's length relationship with the Canada Pension Plan and both levels of government … and our independence in implementing our investment mandate.

Our skill in managing the funds entrusted to us will help to deliver the pension promise and thereby make retirement more comfortable and secure for the millions of Canadians who are counting on us.

Thank you for the invitation to be with you today. I now look forward to your comments and questions.