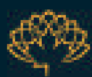

Helping Keep the Long Term Promise

CPP Investment Board

Helping to keep the Long-Term

Pension Promise to Canadians

Keynote Address

by

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to the

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It's a pleasure for me to be your keynote speaker this morning.

I have been asked to discuss how the CPP Investment Board is helping to keep the long-term pension promise to Canadians.

In discussing this topic, no audience is more important to us than the financial planners of Canada. To convince many Canadians that we can make a difference, I know that we must win your confidence in our mission and capabilities.

That is what I hope to accomplish this morning.

Let me first establish some basic points as a reminder of the CPP Investment Board's relation to the Canada Pension Plan and to the federal and provincial governments.

The CPP Investment Board is separate from and independent of the Canada Pension Plan.

We are not involved in its administration, its policies, or the setting of contribution rates and benefits.

As you know, the federal and provincial governments are the joint sponsors of the Plan and the federal government is its administrator.

Our job, by contrast, is to invest funds not needed by the Canada Pension Plan.

Our mandate is to achieve a maximum rate of return without undue risk of loss. By doing that, we can contribute to the plan's long-term financial strength.

The CPP Investment Board is governed and managed independently of governments.

We are governed by a 12-member board of directors selected for their investment and business expertise in such areas as accounting, economics, actuarial science, investing, banking and business generally.

These directors are selected by an arm's length nominating committee appointed by both levels of government and chaired by a private sector CEO. The federal finance minister … in consultation with his provincial counterparts … appoints the directors from the list of nominees recommended by the arm's length committee.

The directors, in turn, recruited me as the President and Chief Executive Officer … and I am assembling the senior management team.

This team is drawn from the private sector … and supported by managers who also have private sector experience.

Our operating and investment strategies will be implemented in large part through partner-like relationships with private sector investment firms across Canada and around the world.

In brief, while the CPP Investment Board is a federal crown corporation … we operate on the private sector corporate model very much like a mutual fund manager or other investment management company.

I tell you all this so that you can re-assure your clients that private sector professionals based in Toronto are managing their CPP assets … not government officials in Ottawa.

What I would like to do this morning is take you inside our thinking about our mandate and investment strategy and share with you our progress to date.

For all this to make sense, let's first quickly review essential background on the Canada Pension Plan itself.

As you know, the Canada Pension Plan was created in 1966 as a pay-as-you go scheme with compulsory contributions by both employers and employees.

The idea was that the current contributions of one generation would pay the current benefits of the previous generation.

Thirty years later, in 1996, the federal and provincial governments conducted an extensive review of the Canada Pension Plan.

They decided to put the plan on a firmer financial footing by, among other things, gradually increasing the contribution rate until it reaches 9.9 percent of the employee's pensionable earnings. That is projected to happen in 2003.

Moving to a firmer financial footing does not mean moving to a fully funded position. The ministers agreed to build the plan to a level where assets should represent 20 per cent of liabilities and five years of pension benefits. That is projected to happen by 2017.

At that point, the contribution rate would be held steady indefinitely.

Currently, more money is flowing into the plan than is needed to pay pensions, a situation that the Chief Actuary in Ottawa expects to continue for at least another 20 years.

This is an important point. It means that Canadians who are already retired have nothing to worry about. The current pay-as-you go scheme will see them through.

Canadians retiring in the next 20 years will also draw most of their pension benefits from the inflow of contributions.

The investment income generated by the CPP Investment Board will contribute most to the pensions of younger Canadians … the ones most inclined to believe the Canada pension will not be there for them when they retire.

We will prove them wrong. And we have at least 20 years in which to do that.

Creating retirement income later in this century for today's younger workers is a noble cause. But I should point out that the real beneficiaries of our efforts will be Canadians who cannot afford to save for their future.

In other words, those who are counting on us most are people who are not your clients. They are the ones at risk.

In 1999, Statistics Canada published an article using 1996 data that found only 37 percent of workers enjoyed the benefits of a registered pension plan … and only 36 percent of tax filers contributed to an RRSP.

It also found that … contrary to expectation … RRSP participation was considerably higher among employees with a registered retirement plan than among workers without such coverage.

Generally, low-income earners did not participate in a registered pension plan … and could not afford to contribute to their own RRSP.

In other words, most Canadians … especially those at the bottom of the economic scale … will depend on the Canada pension when they retire.

I stress this point because our mission is to help those millions of Canadians who are not in a position to afford your services … let alone discuss investment and tax deferral strategies with you.

I ask those of you who are not impressed by the Canada Pension Plan … and may be inclined to diminish our role in helping it to work … to think about these Canadians. We are in business to help them retire with dignity.

Back in 1996, the federal and provincial ministers had to decide what to do with the excess funds flowing into the Canada Pension Plan until they areneeded to pay benefits?

The first part of their answer was the decision to invest excess funds in capital markets. The second part was to create a corporation under professional management … and independent of government … to make the investment decisions.

That is why the CPP Investment Board was created by an Act of Parliament in December 1997. The directors were appointed in October 1998 … and we invested our first cash inflow in March 1999 … just over two years ago.

I know the question you are pondering is – how much should those excess funds earn from the market to help keep the Canada Pension Plan financially viable?

The Chief Actuary addressed this question. He concluded that funds not needed to pay current pensions should earn a 4 percent real rate of return.

As you know, earning 4 percent real year-after-year is not easy. Since the Canada Pension Plan was founded in 1966, the TSE 300 Index has reached or exceeded a 4

percent real return only half the time … although it did exceed that threshold on an annualized basis over those 35 years.

Of course, if you bring foreign equities into the picture, the returns are a little better.

And the bull market of the 1990s certainly helped. Now that we are in a period of more modest expected returns, we need to persuade Canadians to lower their expectations to realistic levels. I know many of you still face this challenge with clients unable to get over the dot.com implosion.

The real challenge is to get Canadians to understand the importance of prudent long-term investing … especially for a rapidly aging population.

In 1966 … when the Canada Pension Plan began … there were seven workers for every pensioner.

Today that ratio has shrunk to five contributors for every beneficiary. In 30 years from now … there will be only three workers to support every pensioner.

This is a dramatic demographic shift with huge economic repercussions.

Let me tell you how we are responding to the challenge.

First, we are building a small and lean virtual corporation to implement our mandate.

Our managers will creates strategies … develop partner-like relationships with external fund managers … and leverage their expertise.

This approach will give us broad exposure to ideas, deal flow and investment opportunities from around the world.

The virtual corporation model also leaves open the option of developing staff expertise to implement components of our strategy wherever and whenever equal or better results can be achieved internally at lower cost.

Whether we implement our strategy through staff or partner-like relationships … let me stress that our senior team is accountable for all aspects of our investment and business performance as well as for compliance and control.

Most of our key executives and several managers are already on board … although we continue to recruit. Our staff of 15 will likely double over the next year.

In the meantime, we have the knowledge and experience to drive the CPP Investment Board forward with vigor and confidence.

To help you understand how we will do that … let me talk about our thinking on an appropriate investment strategy.

As I noted earlier … our legislation requires us to maximize returns without incurring undue risk of loss. That means balancing risks and rewards.

I also noted that the Chief Actuary has assumed we should earn 4 percent real on the funds transferred to us.

If we could find a risk-free asset that paid a 4 percent real-return … and we could buy enough of it … our job would be done and we could all go home.

In our context, risk free means an asset that is impervious to inflation and credit risk, one that would be a perfect match with pension benefits indexed for inflation.

Such an asset exists – the real-rate bonds issued by the federal government. Unfortunately, these bonds currently pay only 3.5 percent … and besides not enough are available to meet our requirements.

So clearly we have to look elsewhere for suitable assets and assume risk in the process. Otherwise, we will fall should of our mandate to maximize returns … and to meet the Chief Actuary's assumption.

We have spent a lot of time analyzing the risk/reward tradeoffs of various asset classes.

One of our conclusions is that equities best meet our risk/reward expectations over the long term.

Remember, we have at least 20 years before we have to contribute to the payment of pensions. In that time, we will see several short-term and severe market downturns … offset by generally longer market upturns that more than compensate for short-term losses.

Our decision to invest so far solely in equities must also be seen in the bigger picture of the assets available to the Canada Pension Plan.

It owns a large portfolio of federal and provincial bonds. This bond portfolio is currently administered by the Department of Finance Canada.

The bulk of the portfolio is 20-year loans to the provinces. Each province can renew its bonds when they mature for one further 20-year term at market rates. Otherwise, the proceeds of matured and redeemed bonds flow through to us … unless the money is needed by the Canada Pension Plan to pay benefits.

We are required to take these fixed-income assets, including the Plan's cash reserve, into consideration in developing our investment strategy … even though we do not manage them.

Recently, we valued the CPP fixed-income securities at $42 billion. By contrast, our equity holdings were $7 billion … or about 14 percent of the total assets available to the Canada Pension Plan.

Clearly it will be some time before our equities are anywhere near the equity allocation of many large public sector pension funds. According to industry information, they already have 65 percent of their assets on average invested in equities.

So our decision to invest in equities can be seen first as an attempt to balance the enormous CPP bond portfolio … and second as an attempt to take advantage of a long investment horizon to earn the expected higher returns that these assets can generate.

We realize, as you do as investment counsellers, that risk is something that is better assumed by the young who are still distant from retirement than by those who are within a short time of needing a pension.

We are a young organization investing primarily to help pay the long distant pensions of today's younger generations.

Our objective then is to generate risk-adjusted net value added – that is, returns after costs that are appropriate to compensate for the risks taken.

The risk management framework we have developed also looks at the amount of risk we can tolerate. We have quantified from historical data the risk for different asset classes as the prelude to developing an investment strategy to monitor and manage risk.

Real-rate bonds are the logical performance base because they are risk free with respect to inflation. At the other end of the spectrum is venture capital, which has both a high risk and high potential return.

In between is the normal range of fixed-income securities and equity choices at home and abroad.

We have also established a maximum risk tolerance ceiling for our equity portfolio. To do that, we used a metric that may be familiar to many of you called VaR for Value at Risk.

From this analysis, we have been able to develop our long-term required real return. At the start of our current fiscal year … on April 1 … our required real return was 5 percent.

That is a full percentage point higher than the Chief Actuary's assumption. And we believe it is a realistic target to strive for. If we assume 3 percent annual inflation over the long term … our nominal target is 8 percent annually.

Let me tell you what we have done to date, before indicating where we are going next with our strategy.

Since making our first investment in March 1999 … we have invested in equity index funds. Basically, 70 percent of our investments are in a fund that replicates the TSE

300 Index … 15 percent in a fund based on the S&P 500 in the United States … and 15 percent in a fund based on the EAFE international index developed by Morgan Stanley Capital International.

During our first 18 months in business, federal regulation restricted our Canadian equity assets to passive investing by requiring us to substantially replicate a stock index.

Outside Canada, we can invest actively or passively … and so far have chosen the stock index fund route.

In December 1999, we persuaded the finance ministers to relax the domestic equity regulation. They agreed to let us invest half of our Canadian equity allocation actively.

When the regulatory change finally took effect in late August 2000, we responded immediately with a risk management initiative. Our goal was to reduce our exposure to Nortel … which represented 35 percent of the TSE 300 Index at the time and about 28 percent of our total assets.

That level of concentration in a single stock carried far too much risk, no matter how good the company. And at the time, let's remember investors had extraordinary confidence in Nortel's future.

In essence, we divided our Canadian equities … effective September 15 … between the TSE 300 fund and a TSE 299 that excluded Nortel.

The difference in their performance through the second half of our fiscal year was dramatic. The TSE 300 Index fell by 31 percent … but the TSE 299 fell by only 8 percent.

As a result, we avoided $535 million of potential losses.

Clearly we need the flexibility to invest actively … and we expect the federal and provincial finance ministers will remove the remaining regulatory constraint on our Canadian equity assets later this year.

Now, continuing to invest in publicly traded equities … especially through index funds … may not get us where we want to go – to that 5 percent real expected long-term return.

We will have to actively manage a larger portion of our assets through a variety of investment styles ranging from enhanced index funds to individual stock selection. We will start to do this over the next year or so.

We will also expand into private market investments, starting this fiscal year.

These investments include venture capital for early-stage companies and new technologies… merchant banking investments in established firms seeking expansion

and growth capital … and corporate buyouts and acquisitions that result in stronger and more profitable companies.

Our plan is to position ourselves as a preferred investor for the top private equity managers and merchant banks in Canada and around the world.

Our target is to earn an 8 percent annual real-rate return from private equities over a 10-year period on as much as 10 percent of our asset base. With inflation of 3% our private equities are targeted to earn an 11% nominal return over a decade.

Again, the risk/reward tradeoff comes into play. It can take time for private market investments to show their worth … which is why the risk-adjusted return is substantially higher than the historical returns on public equities.

We will also consider other private market investments … such as real estate, infrastructure projects, electrical power projects, and natural resources … over the next year or two.

As you can tell, we have given a lot of thought to defining our expected long-term return … to the risks we can afford to accept for different asset classes … and to how we should roll out our strategy gradually to achieve a diversified investment portfolio.

In all this, we will of course maximize foreign content to enjoy the benefit of different investment strategies and asset classes on a global basis.

For now, our total portfolio performance is driven by the three index-based equity funds in which we have been investing.

Permit me a moment or two to review our recently released results for the fiscal year ended last March 2001.

We registered an $852 million loss for the year … of which more than 90 percent occurred in the fourth quarter.

The rate of return was a negative 9.4 percent … compared with a positive 40.1 percent return in fiscal 2000. Annualized over the past two years, our return was nearly 15 percent.

Our fiscal 2001 return compared favourably with the markets in which we invest, recognizing that in our third and fourth quarters we witnessed the worst six-month stock market declines since 1974.

In fact, when we aggregate the performance of the indices of markets in which we invest … we beat our total portfolio benchmark by 840 basis points.

Needless to say, we are not deterred by the severity of the recent market downturn that undermined our short-term results. We remain confident in our equities-only strategy.

Few investors rejoice at the sight of falling stock prices. We are one of the few that does. Why? Because we are in the fortunate position of being able to put to work at more advantageous prices the substantial cash flows that come to the CPP Investment Board each month. High cash inflows allow us to dollar cost average by buying equities at lower prices, putting us in a stronger position to benefit when markets recover.

I am sure an audience as sophisticated as this one recognizes the benefits of dollar averaging. The CPP Investment Board, with heavy monthly cash inflows for at least 20 years, is the ultimate dollar averager.

I noted that our equity assets of $7 billion represent about 14 percent of the consolidated assets available to the Canada Pension Plan.

The $42 billion of fixed-income assets owned directly by the CPP earned approximately $3.8 billion in fiscal 2001.

And the estimated return on the consolidated assets of the Plan and the CPP Investment Board was a respectable 7 percent for fiscal 2001.

I know people like to compare the performance of one pension fund with another. I'm not fond of this approach because of major differences … such as asset mix policy, risk tolerance and diversity of investments.

For example, we currently invest only in equities. Other funds also own assets such as bonds and real estate.

In addition, our year-end is March 31 while most funds report on a calendar year basis. The returns of large public sector pension funds that reported calendar 2000 returns ranged between 6.2 percent and 10.2 percent.

The CPP Investment Board's 12-month return for calendar 2000 was 12.2 percent. This return does not include the income of the Canada Pension Plan bond portfolio and cash reserves.

So on this basis we did better than most – and they still have to report on the recent market correction in this calendar year's results.

Overall, we are not concerned about annual losses from time to time. Volatility of annual returns is a reality of investing to maximize long-term returns. We believe that our focus on equities … and expansion this year into private market investments … is the right approach for a young organization with a financial obligation to younger Canadians over the coming decades.

And we will grow rapidly. Over the next 10 years … we will likely receive more than $80 billion in cash inflows from the Canada Pension Plan.

We expect to grow those cash inflows to at least $130 billion of assets under management by 2011.

Let me say in closing, that we are pleased with the vision of the federal and provincial governments in setting up the CPP Investment Board as an independent, professionally governed and professionally managed investment organization.

Second, we know that we have taken on an onerous challenge to make life a little more financially comfortable for a rapidly expanding pensioner population as this century progresses.

Third, we believe that our current investment strategy … with its emphasis on equities and eventually other asset classes will generate superior long-term risk-adjusted net returns to help keep the public pension promise to Canadians.

And finally we know that millions of Canadians are counting on us to do just that. I hope we can count on you to assure them that the CPP assets are in good hands and that their CPP benefits are secure.

Thank you, best wishes for the balance of your conference.