CPP INVESTMENT BOARD

Public Meetings: Reporting to Canadians

CPP Investment Board

Remarks by

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and

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President and Chief Executive Officer

Canada Pension Plan Investment Board

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September and October 2004

Good morning. I am Gail Cook-Bennett, chair of the Canada Pension Plan Investment Board. I'm delighted to welcome you to this meeting, which is part of a series of public meetings with Canadians that we hold every other year.

With me this morning are John MacNaughton, our president and chief executive officer, and Ian Dale, our vice-president of communications.

These meetings are just one of the ways the CPP Investment Board stays in touch with Canadians. They are occasions when we can keep you informed about our work in managing the reserve assets of the Canada Pension Plan on your behalf.

Equally, they provide an opportunity to hear your questions and concerns.

Following my brief remarks, John will talk about the performance of the fund and some of the challenges of investing on behalf of 16-million Canadians.

Following our presentation, we'll open the floor for your questions and Ian will help manage this part of the meeting.

To put the last 6 years in context, let me highlight the key stages in the development of the Canada Pension Plan.

The Canada Pension Plan was established in 1966 to provide working Canadians with a foundation on which to build their retirement income. It was a joint creation of the federal government and all provinces except Quebec, which has a parallel plan of its own.

While the Canada Pension Plan is administered by the government of Canada, policy decisions are made by all 10 governments.

In 1996, it was clear that the Canada Pension Plan was unsustainable. Many of you are familiar with this part of the story. For example, in 1996 $11 billion in contributions came in, but $17 billion in benefits were paid out. At that time demographic projections indicated that there would be far fewer workers to support retirees in coming decades.

Ottawa and the provinces took action.

Following extensive federal/provincial consultation and discussions with Canadians in all participating provinces, reforms of the Canada Pension Plan were agreed upon.

Two major decisions were made. First, CPP contribution rates were to be raised in stages, reaching 9.9 per cent by 2003.

Second, the CPP Investment Board was created as a Crown corporation by the Canada Pension Plan Investment Board Act in 1997 and a board of directors was appointed in late 1998.

The CPP Investment Board's goal was to manage the Canada Pension Plan reserve fund to help ensure the long-term sustainability of your plan.

Our legislation outlined clear objectives. The CPP Investment Board was directed to invest in the best financial interests of Canada Pension Plan contributors and beneficiaries and to maximize investment returns without undue risk.

Importantly, legislation required us to limit ourselves to those two objectives.

Equally important, the federal and provincial governments created a strong governance structure that carefully balances the independence and the accountability of the CPP Investment Board. This structure was designed to ensure that we work at arm's length from governments, with investment professionals, not governments, making the investment decisions.

Oversight was to be provided by an independent board of directors. This board, not governments, approves investment policies and makes such critical operational decisions as the hiring of the chief executive officer.

A professional management team is accountable to the board and makes investment decisions consistent with board policies.

As a Crown corporation, the CPP Investment Board is accountable to Canadians and to the federal finance minister and provincial finance ministers who are responsible for the plan. This accountability is required to balance our arms length relationship from governments.

There are several ways in which we remain accountable to Canadians:
- Public meetings every two years in all participating provinces
- Triennial review by the federal and provincial finance ministers
- Special Examination--the federal finance minister, following consultation with the provinces, authorizes a special examination of our records, systems and practices every six years. This review has just been successfully completed

Special audit—if deemed necessary, the finance minister also has the power to appoint a firm of accountants to conduct such an audit

In an era when issues of corporate governance make headlines around the world, we are fortunate to be operating with a structure enshrined in legislation that has received international acclaim as a model for national pension plans.

The board of directors itself has worked to embrace the best practices of the private sector. We have, for example, a formal annual process to evaluate the effectiveness of the board and each director as well as the performance of management.

We have a conflict of interest policy, codes of conduct that apply to directors, officers and employees and an external Conduct Review Advisor.

We have a strong whistleblower policy requiring employees to report inconsistencies with policies, not just protecting them when they do so.

The Board is committed to transparency and gives this life through a strong disclosure policy that John will outline later.

We review and, sometimes improve, our policies regularly.
Our nomination and appointment process is also important because it ensures that directors will have the requisite expertise in investment, pensions, business and accounting. It is a balanced process that depends on a consensus among the 10 stewards of the Canada Pension Plan.

The significance of this mandated expertise is that the experience of the board of directors as a whole is aligned to the mission of the CPP Investment Board.

The board hires the president and chief executive who, in turn, hires and leads the management team. The CEO's performance objectives are set each year and are later reviewed by the board.

Senior executives are hired for their professional expertise and proven track record. Similarly, our external partners, who are engaged to make investments on the CPP Investment Board's behalf, are chosen on the basis of proven ability and performance.

That is a very brief summary of our history and governance structure.

Please welcome John MacNaughton.

Thank you Gail.

I would now like to talk to you about the progress we're making in building Canada Pension Plan assets, how we invest and some of the key policy considerations we take into account as we do so.

How will you know if our investment professionals and our board of directors are doing a good job on your behalf?

Our disclosure policy says the following: "Canadians have a right to know why, how and where we invest their Canada Pension Plan money, who makes the investment decisions, what assets are owned on their behalf, and how the investments are performing."

We provide as much information as we can, to tell our story, so that you can judge for yourself. (Leadership In Pension Fund Disclosure)

Consistent with our broad accountability, we provide a wide range of information to our government stewards and the public.

We release information about new investments and major developments affecting our investment activities as they happen. We publicize our quarterly and annual financial results and hold media conference calls which are webcast on the Internet. Full details of our investment portfolio are also available on our website, along with our proxy voting record.

Periodically, Gail Cook-Bennett, myself and other senior executives of the CPP Investment Board make speeches and presentations.

We produce research and discussion papers on matters of relevance to our work.
We also meet regularly with a wide range of groups that are interested in the CPP Investment Board.

In all, we disclose more information, more often, than any other pension fund in Canada. (www.cppib.ca)

I encourage you to visit our website – www.cppib.ca. There you will find information about virtually every aspect of the CPP Investment Board.

We are asked regularly if we apply social criteria in making our investment decisions. Recently, for example, we have heard concerns expressed about our holdings in companies that are part of the defense industry or make tobacco products.

Social investing means different things to different people. And while it might be easy for individuals or small groups of like-minded people to agree on criteria for including or excluding specific investments, the CPP Investment Board cannot reflect the divergent religious, economic, political or personal views of 16-million Canadians in its investment decisions.

Rather, our mandate is to invest in the financial best interests of all Canada Pension Plan contributors and beneficiaries and to maximize investment returns without undue risk. Our statutory mandate and fiduciary duty are based exclusively on investment considerations. For these reasons, we do not screen investments based on non-investment criteria.

However, we believe that responsible corporate behaviour in such matters as the environment, employee practices, human rights, respect for domestic and international laws and ethical conduct generally contributes to enhanced financial performance. As a result, markets take these matters into account in the pricing of securies.

We also actively promote good corporate governance through our proxy voting guidelines. We hold a significant number of shares in approximately 300 of Canada's largest companies as well as some 900 foreign companies. In voting these shares, we seek greater disclosure so that all investors will be able to make informed decisions.

Our guidelines, which were updated in February, are posted on our website along with the record of our voting.

Canadians have every reason to feel confident about the future of the Canada Pension Plan. Based on current contribution rates and expected investment returns, The Chief Actuary of the Canada Pension Plan has said that the plan is financially sound for the next 75 years and beyond. And as the CPP's legislation requires, every three years the federal and provincial finance ministers, as stewards, review the state of the Canada Pension Plan. After the most recent review, in January 2003, they declared that the plan was sound and on track. The next review takes place in 2005.

Equally important, the Canada Pension Plan is constructed in a way that protects the financial assets. Remember, the Canada Pension Plan is not just a federal program. The federal and provincial governments, represented by their finance ministers, are the stewards of the Canada Pension Plan, but there is no government funding. The plan is funded solely by Canadian workers and their employers. The only government financing in the plan is in the form of contributions that governments make as employers.

As a result, Canada Pension Plan contributions are not part of consolidated government revenues. The reserve fund is not a government asset and is protected by legal safeguards. It belongs to 16 million Canadians – you and me –through the promise of future pensions. CPP assets are held in a segregated fund and cannot be used for any purpose other than administering the plan, paying pension benefits or making investments.

The CPP Investment Board has been investing for only five-and-a-half years, but in that time it has built a strong foundation as it pursues the goal of building the reserve assets of the Canada Pension Plan

As you can see, total Canada Pension Plan assets have grown from $44 billion in 1999, the year we began operations, to slightly more than $73 billion at June 30, our latest reporting period.
In 1999, the entire CPP portfolio consisted of non-marketable, 20-year government bonds and short-term government securities. At June 30, bonds and short-term government securities amounted to slightly more than 49 per cent of the assets. The remaining 51 per cent consisted of publicly traded securities and other investments managed by the CPP Investment Board. I'll talk more about these assets and the ways we've diversified the CPP portfolio shortly.

(CPP Reserve Fund And Projected Assets)

The projected growth you see here is based on a combination of contributions over and above the amount required to pay current pensions as well as anticipated growth from investment returns. Canada Pension Plan assets are expected to reach approximately $190 billion in the next 10 years.

On this chart you can also see what's called the asset transition period. Following amendments to the Canada Pension Plan Act and our legislation that were agreed to by the provinces, the $36 billion in cash and bonds held by Ottawa are being transferred to our care over the period ending with the 2007 fiscal year.

The additional flow of funds due to contributions has important implications for us at the CPP Investment Board. Because contributions will exceed benefits, we have a 17-year window before we're required to supply investment income to pay pensions, we can afford to be patient investors.

Under our diversification strategy, it means we can invest not only in publicly traded stocks, but in less liquid, potentially higher yielding investments such as private equity, real estate, infrastructure and venture capital.

Why are we diversifying Canada Pension Plan assets? The reason is straightforward.

This illustrative risk-return chart helps to make the point. On the left vertical axis is rate of return. The higher up the higher the return. Across the bottom is risk. The further you go to the right, the greater the risk.

Let me draw your eye to the red line in the middle of this slide. It represents the 4 per cent rate of return above inflation required to sustain the CPP over the long term.

Bonds and short-term debt securities are in the lower left quadrant. They are low in risk and also low in return. But they fall below the four per cent line. They will not produce sufficiently high returns to sustain the plan.

Above the line, you see other types of investments, public and private equities as well as real return assets. They present relatively more risk, but they are capable of producing the higher returns needed for sustainability. We need to diversify into these types of assets and we are doing so by making prudent investment decisions in line with the comprehensive investment policies and risk management guidelines that we have developed.

Within these limits, we believe our long term rate of return will be 4.5 per cent above inflation. This is slightly above the 4 per cent minimum rate of return that the Chief Actuary said would be necessary to sustain the plan over the long term.

As you can see from this chart, we've already made considerable progress in diversifying CPP reserve funds. In 2000, bonds and cash accounted for 95 per cent of the total assets, with the remaining 5 per cent invested in publicly traded stocks.
As of this June, the picture was very different. Bonds and cash now form slightly less than one half of the assets with the bulk of the remainder consisting of publicly traded stocks and a small amount – roughly 4 per cent - invested in private equities, real estate and infrastructure.

The Canada Pension Plan reserve fund performed very well in fiscal 2004, which ended on March 31. The fund earned a 17.6 per cent rate of return, producing $10.3 billion in investment income.

Adding the $4.6 billion in contributions from workers and employers that were not needed to pay current pensions, the reserve fund grew by $14.9 billion to $70.5 billion.

I would caution, however, that while 17.6 is an exceptional rate of return, it is not one that we expect to earn every year. In fact it will occur only rarely.

Because we invest a significant proportion of assets in publicly traded stocks, we are naturally subject to the short-term volatility that affects equity markets. In fiscal 2003, when equity markets were weak, we recorded a $1.1 billion loss and a negative return of 1.5 per cent.

As you can see from this chart, quarterly returns in dollars can fluctuate as sharply as annual results. Note the dramatic change from the last quarter of fiscal 2004 to the first quarter of the current year. A net investment gain of some $2.3 billion is quickly replaced by a net investment loss of $227 million.

Clearly, short-term swings in capital markets have an immediate effect on the portfolio, but no impact on current pensions or our long term strategy to help ensure sustainability.

Similarly, percentage changes from quarter to quarter are dramatic, although less so than the swings in dollar amounts.

But while short-term results are volatile, over the medium term, they are producing the returns we expected. In the five years the CPP Investment Board has been in operation the returns on assets under our management have exceeded the 4 per cent above inflation required for CPP sustainability.

We are on track to achieve our long-term target of an average annual 4.5 per cent rate of return above inflation.

So while short-term results look worrisome, the long-term results will be strong.
We are focused on the long term, on building investments in assets that will offer superior rates of return, provided we are patient. Looking to that distant horizon, we believe that returns from publicly traded equities and private equities will be significantly greater than the return on bonds.

Bonds will remain an important component of the Canada Pension Plan reserve fund. In fact, the last of the non-marketable government bonds gradually being transferred to our care will not mature until 2033.
However, given the potentially higher returns from alternative investments, we will continue to diversify the portfolio to secure long-term growth.

While public equities will form the largest component, we will also expand investments in other types of assets. For example, we would like to invest as much as 20 per cent of total CPP assets in private equity, real estate and infrastructure – with a maximum 10 per cent allocation in any one of these asset classes.

Right now, these asset classes combined make up barely 4 per cent of total assets, so we have considerable room to grow. In the case of private equity, we have already committed more than $6 billion to more than 46 limited partnerships. In terms of actual investments, about $2 billion has been drawn down by our private equity partners and invested in hundred's of underlying companies.

As I mentioned, we like private equity because it can deliver higher long-term risk adjusted returns than public equities, even though it can take a few years before positive cash flows materialize. Again, however, we have the time to be patient.

Similarly, we believe it is wise to build a portfolio of real estate and infrastructure assets because they diversify the reserve fund and provide higher expected returns than bonds over the long term.

Because such assets also tend to rise in line with overall inflation, they tend to match any potential inflation in Canada Pension Plan liabilities.

While our goal in public equities is to earn higher returns than we could achieve with bonds alone, we are also focused on building an efficient, diversified portfolio with broad exposure to business sectors in Canada and abroad.

In addition to equities, our public market investments can include derivatives, treasury bills and other money market instruments, exchange-traded funds and real return bonds.

During our first four years, we built public equity holdings through traditional passive index investing. But because this approach can result in over-concentrations in individual stocks or sectors, and because the composition of indexes results in a portfolio that is not optimally correlated with our liabilities, we have shifted to a passive portfolio of our own design based on global economic sectors. This portfolio is better correlated with our liabilities.

We have also taken the first steps to introduce active management to a portion of our public equity portfolio, working with some of the world's most respected investment managers. We hope to expand this program, although it will remain small in relation to the overall passive equity portfolio.

It is also worth noting that, despite our brief operating history, we have also made an impact on the Canadian venture capital scene. Our total domestic venture capital program has committed more than $550 million to general partners investing in Canada. This makes the CPP Investment Board one of the largest pools of venture capital in Canada.

Our funds are invested principally in early-stage companies that are still developing their products and services. These companies have the prospect of generating revenues within a few years. We also invest in later-stage firms that are already generating revenues and may produce profits within a year or two.

Gail and I have covered a lot of ground in a short time and we hope this information is helpful in understanding the work of the CPP Investment Board. We are proud of what we've accomplished in a relatively short time. The board was blessed at the outset with a strong governance structure that balances independence and accountability. We've been fortunate to work within this structure to diversify and grow Canada Pension Plan assets on your behalf.

The question we hear most often is: will the money be there for me when I retire?

The answer to that is an emphatic yes. Canadians can count on the Canada Pension Plan. We literally do have time on our side and we're making the best use of it by applying sound, prudent practices as we make investment decisions that will help sustain the Canada Pension Plan for generations to come.

Thank you for coming out today. Gail and I would now like to open the floor to answer any questions you may have.