CPP INVESTMENT BOARD

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# Turning a Distinctive Experiment into a Canadian Advantage

by

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It's a great pleasure to be back in Atlantic Canada and especially to be here with you today in Halifax.

I'd like to begin my remarks today by paying homage to Mr. Ernest Ackerman of Cleveland, Ohio.

Now I'm sure many of you are asking yourselves, who on earth was Ernest Ackerman? Well, he was actually the first beneficiary of the United States Social Security system, having paid in a nickel on its first day of operation in January 1937 only to receive the very next day the sum of 17 cents on the occasion of his retirement.

Now that's an enviable rate of return for Mr. Ackerman, to be sure, but hardly the way to build a sustainable public pension system.

Canada was in no better position in 1996, when the Canada Pension Plan paid out $17 billion in benefits, but took in only $11 billion in contributions. As in Mr. Ackerman's day, hardly the way to build a sustainable pay-as-you-go public pension system.

The difference is that in 1996, something quite remarkable happened. Canadian political leaders looked into the future, saw the demographic wave coming, and did something about it. And not just anything. They – and here I'm referring to the Federal and provincial governments – consulted with Canadians, collaborated with each other and embarked on what can fairly be called a bold and uniquely Canadian experiment.

Hinged on joint federal-provincial cooperation, this experiment included the creation of a new kind of entity – the Canada Pension Plan Investment Board, an organization competing in the private sector, but with elements of public sector accountability. At stake: the pension security of 16 million Canadians and the solvency of one of Canada's most important social programs.

Over the next 20 minutes or so, I hope to share with you some of the distinctive characteristics of that experiment, the real and powerful advantages it confers on Canada and the Canadian business sector, as well as some background about the CPP Investment Board.

But before I dive headlong into a discussion of our governance model, the challenges of managing a $100 billion start-up, and what I'm calling the "Canadian Advantage," let me begin by asking a simple question:

Other than the fact that a portion of your annual paycheck goes into the CPP reserve fund, why should you care?

I'll offer a few reasons:

- The Canada Pension Plan is one of Canada's most important social programs.

- It helps support the retirement needs of 16 million Canadians, and, along with Old Age Security, represents almost the entirety of annual income for as many as 5.4 million Canadians.

- For many other Canadians, it backstops their corporate pension plans, some of which, as you well know, are less than robust.

- The CPP Investment Board has billions of dollars invested in Canada -- in 600 publicly-traded companies, in private equity, government bonds, venture capital, real estate, and – where the investment conditions are right – we will invest in much-needed infrastructure.

- Similar to some other large Canadian institutional investment organizations with a longer history than us, we are building a world-class institutional investment organization by investing in people and fostering innovative thinking about risk management and investment strategies.

- Finally, as one of Canada's largest investors, we probably own between 2 and 5% of every major company in the country.

So, who are we? What is the CPP Investment Board? And how did we get here?

We are an investment management organization that manages the CPP reserve fund. These are the assets of the Canada Pension Plan not needed to pay current benefits.

In 2000, the reserve fund had assets of $44.5 billion. By the end of our most recent fiscal year March 31st, 2006, the CPP reserve fund had more that doubled to $98 billion.

And by 2016, Canada's Chief Actuary projects the reserve fund will have approximately $250 billion in assets under management, making it not only one of the fastest-growing, but also one of the **largest** single-purpose pools of investment capital anywhere in the world.

So for those of you still concerned about your Canada Pension Plan benefit, YES, the money will be there for you when you retire.

## A Bold Experiment

Now, how did we get here?

In 1996, the Federal and Provincial governments worked together to address the long-term challenge of securing the CPP. In doing so, they took what have to be regarded as several significant risks.

Number one, they took a political risk by raising contribution rates from 6 to 9.9 percent over 6 years to solve a problem that, while absolutely real and serious, still lay way off in the future. That took foresight and courage, and resulted in much greater intergenerational fairness in terms of CPP contributions paid and benefits received.

Number two; in order to help pre-fund the Plan, they committed to build a substantial reserve fund to be managed by professional investment managers.

Number three, having heard Canadians' concerns about the potential for government interference in the investment of CPP funds, they created the CPP Investment Board; with an innovative governance model that provides far greater public accountability and disclosure than any other Crown corporation in Canada, yet equally ensures that we are able to operate at arms-length from government.

This was something new and untested in Canada – or elsewhere, for that matter -- and it is now recognized globally as a best practice model for other national pension funds. That took care and creativity.

Our Chairperson, Gail Cook-Bennett and I recently attended a reception for former U.S. President Bill Clinton. In discussing the CPP Investment Board, he told us how much he had wanted to create something like the CPP reserve fund model to help secure the promises of Social Security, the US national pension system. But the idea never got off the ground, he told us, because of staunch resistance from no less than Federal Reserve Board chairman Alan Greenspan. Although he acknowledged the merits of the approach, Mr. Greenspan believed the temptation for politicians to interfere in investment decisions was simply too great and could not be cured.

Greenspan wasn't alone in this. The CPP reformers had the same concern, but to their credit, they also had the ingenuity and commitment to engineer a solution.

That solution could be the subject of an entire talk, so I will have to be very brief on this point and focus on two key elements.

First, they created protections for the reserve fund and how it is managed.

- They crafted a simple but bold mandate – maximize investment returns without undue risk of loss – and incorporated it in legislation that can only be changed by the consent of the Federal government plus two-thirds of the provinces representing two-thirds of the population. Essentially – this is the same as the constitutional amending formula.

- The money in the reserve fund is invested on behalf of Canadians and is not part of general revenues. As such, by law, it cannot be used for any purpose other than to pay benefits, invest the reserve fund and administer the Canada Pension Plan.

Second, was the creation of the CPP Investment Board as a professional investment organization that would operate at arms-length from government but be accountable to the federal and provincial finance ministers, who act as stewards of the plan.

On that score, let me take a minute to describe our governance model – designed with a carefully crafted balance between being arms-length and accountable.

This carefully crafted governance model was designed in 1997 after extensive consultations with Canadians and reflects their desire to see investment decisions made at arms-length from governments.

Our public opinion polling has consistently shown that almost 70 percent of Canadians are concerned about the potential for political interference in the investment decisions related to an asset pool of this size, or that the funds may be used by governments for some other purpose than helping to sustain pensions.

But our governance model and related safeguards were designed to ensure that this does not happen.

Our arms-length status from governments manifests itself in a number of different ways. The CPP Investment Board is governed by an independent Board of Directors comprised of qualified professionals with investment or financial expertise. Board members are appointed through a nominating process that itself balances government's legitimate role in selecting directors with private sector input, expertise and independence. In investing and managing the portfolio and operating the Investment Board, management is accountable only to the Board of Directors – not to government.

On the other hand, we have a variety of accountability measures to the 10 finance ministers who act as stewards of the plan. For instance the CPP is subject to a formal review every three years by the federal and provincial finance ministers, we undergo a special exam by an external audit firm every six years, and the Federal Finance Minister can call a special audit of the CPP Investment Board at any time.

As part of our accountability framework, we disclose more information than any other pension fund in Canada. Our website contains 1,200 pages of information about how we operate and how and where the reserve fund is invested. We disclose our investment results quarterly on our website and through press releases, we make available our annual report to any Canadian who requests a copy, and every two years we hold open meetings -- like the one we are hosting tonight at the Westin Hotel -- in each of the nine participating provinces where anyone can come to hear how we have invested their funds and ask us any questions they might have.

All in all, this was a novel experiment to say the least, and it has worked magnificently. The proof can be seen in a variety of ways.

While the CPP Investment Board continues to enjoy a relatively low profile at home, the World Bank has cited it as a model for other national pension plans. In fact, recently established national investment funds for New Zealand and Ireland were modeled very directly on our Canadian blueprint. And we have a steady stream of visitors from national pension funds around the world coming here to learn about how we operate.

In the stewards to whom we are accountable – in other words, the federal and provincial finance ministers -- we have found true partners who have consistently protected and reinforced our governance model and have never attempted to influence our investment activities.
And in practice as in principle, we have been given a free hand to build our organization, to make investment decisions and to hire the best people we can find. Our human resources policies, including our compensation system, are comparable to and competitive with private sector investment organizations. And we are implementing a long-term investment strategy of our own devising, free of the kind of political interference Alan Greenspan and others worried so much about.

So while we are still at a relatively early stage in our development, the experiment is definitely working and working well.

## **A Distinctive Canadian Advantage**

Let me now turn to what this all means for Canada.

The Canada Pension Plan is essentially a defined benefit plan for working Canadians. As such, it provides a measure of security that should help strengthen the social safety net and keep our workforce productive for years to come.

And just last week, rating agency Standard and Poor's, singled out Canada as being on track over the next few decades to have one of the strongest fiscal positions amongst 32 industrialized nations, in significant part because of the successful reforms to our national pension system.

A strong national pension system is an important consideration for immigration and foreign investment -- and that's an advantage we can expect to continue building upon, particularly in light of the relatively weak financial condition of the national pension plans in many countries around the world.

As we all know, in the US the Bush administration has been unsuccessful in implementing reforms to address what they have identified as a future crisis in the US Social Security system.

And Britain recently announced plans to slowly increase its retirement age to 68 as one of the prescriptions for an ailing pension plan.

The unfunded liabilities of pay-as-you-go pension programs are more than 150% of GDP in Germany and over 200% of GDP in France and Italy. This issue is so dire that the European Commission recently stated that "There is a risk of unsustainable public finances in some half of the EU countries. Belgium, Germany, Greece, Spain, France, Italy, Austria and Portugal are on this black list." If it goes unchecked, some believe the pay-as-you-go systems could turn out to be one of the gravest threats to the EURO.

One way or another, the piper will get paid in these countries. And corporations, who rightly fear that they will be among those asked to pay the piper through higher payroll taxes, will increasingly look at this as a factor in where to locate their operations.

Now in Canada, we have already paid up front, and rather than be forced to confront a national pension funding crisis at some later date, we should be in a position to invest our political energies and financial resources elsewhere – and THAT can only be to our collective benefit.

Unfortunately, the majority of Canadians are unaware that our national pension system has been successfully reformed. For example, only 26 percent of Canadians are even aware that a pool of assets is being built to help sustain future CPP pensions for millions of Canadians.

A strong CPP benefits Canadians in other ways as well.

Many of you will be aware that traditional private – or corporate – defined benefit plans are also nearing a state of crisis. Early this year, even the mighty IBM announced plans to “freeze” its defined benefit plan for US employees. Other major US companies, like Motorola and Verizon, have announced similar plans. The trend hasn’t hit Canada yet, but it appears to be coming.

A recent study of 92 firms by benefit consultants Watson Wyatt found that the funding gap grew to a total of $18 billion at the end of 2005, up from $15 billion in 2004. Additionally, due to accounting rules that allow for the gradual recognition of such deficits, the study found those same companies have a total of $27 billion in unrecognized losses that have yet to be brought on to their balance sheets.

David Dodge, Governor of the Bank of Canada, put the issue in stark terms in a recent speech and I quote:

> …one important part of our pension system—defined-benefit plans—has been in relative decline. This relative decline represents a transfer of return risk and longevity risk to individuals, who are less able to bear or manage them. This transfer has a negative impact on overall economic efficiency and could ultimately represent a significant threat to the ability of pension funds to finance the long-term investments that will maximize our economy's future potential growth.

Now, I think that we all appreciate that the CPP benefit in dollar terms, is not designed to be enough on its own to sustain an individual or family through retirement. However, its relative security is of considerable and increasing value to Canadians, especially given the uncertainty around their other sources of pension income in a time when many private defined benefit plans are being phased out, restricted to existing participants, or facing growing funding deficits.

A recent paper about Canada's retirement system from the Center for Retirement Research at Boston College put it this way: "…the predictability of public benefits provides a secure retirement income floor. This helps workers plan their retirement and allows them to take more risk in their supplemental plans."

And why is more risk good? Because risk, if managed wisely, can bring enhanced investment returns.

On that note, I will take the last few minutes of my remarks to speak briefly about some elements of our investment strategy. I will cover two elements this afternoon because, as we kick-off our national tour of public meetings tonight in Halifax, these are topics that we are often asked about by Canadians.

According to Canada's Chief Actuary, we need a long-term real rate of return of 4.2% -- that's 4.2% after inflation – to sustain the plan at the current contribution rate. Our own goal is to do better than this minimum requirement and I am pleased to confirm that we have done so over the last 3 and 5 year periods.

Now as everyone here would appreciate, there is no way to fully guarantee a real return of at least 4.2%, but we are confident that through our portfolio design activities and by exploiting our comparative investment advantages, we will be able to do so over a long investment horizon.

One of our comparative investment advantages is that CPP contributions are expected to exceed benefits paid until 2022, providing a 16-year period before the first dollar of investment income is needed to help pay CPP benefits. And even then, the reserve fund is expected to continue growing as only a relatively small portion of investment income is needed to help pay benefits. So with no need for near-term liquidity, we are uniquely well-positioned as a patient investor in private equity, real estate, infrastructure and other illiquid asset classes that trade off short term liquidity for the prospect of higher long term returns.

While the size of global private market investment opportunities in real estate, private equity, private debt and infrastructure vastly exceeds those available in public markets, accessing those opportunities requires both specialized skill and, importantly, local knowledge and presence.

Given this, we believe that the best way for us to access these private markets, in the scale required for our portfolio, is to forge aligned strategic relationships with organizations that have demonstrated that specialized skill and knowledge in all major markets around the world.

This is something we have been able to do with many of the world's leading specialty asset management firms, including KKR, Blackstone, Brookfield, Macquarie Bank, Celtic House and others.

Our long time horizon provides another kind of advantage in our investment activities as well In the active management of equities, we see the vast majority of research and investment focus placed on short horizon factors that have equally fleeting impact on valuations of stocks. We are beginning to incorporate longer horizon factors into our investment process that we think are under analyzed and have not been fully reflected in company valuations. One example of this is the potential impact that environmental, social and governance, or ESG factors can have on financial performance of companies over quite long-term horizons and this was one of the underlying factors in the Policy on Responsible Investing we adopted last Fall.

We were also involved in the formulation of and are one of the first signatories to the United Nations' recently launched "Principles of Responsible Investing," endorsed by institutional investors and pension funds around the world that collectively manage more than US$2 trillion. We are the first Canadian member of the Enhanced Analytics Initiative, a partnership of global institutional investors with more than $1 trillion in combined assets aimed at spurring the development of investment research that considers the impact of extra-financial issues on long-term company performance. And we have joined the Carbon Disclosure Project. All of these are designed to improve the development of research, tools and methodologies that will help us incorporate ESG factors into our investment process.

This is a very different kind of approach to what some people call “socially responsible investing” that you may otherwise be familiar with.  But as is evidenced by the signatories to the UN agreement and the $1 trillion of managed capital lined up behind the Enhanced Analytics Initiative, we believe it is the direction of the future, as major institutional investors like the CPP Investment Board apply a fiduciary investment framework to environmental, social and governance factors.  This framework means that we won’t screen out stocks – but we will be a leader in the development of tools and methodologies for incorporating E, S and G factors into the investment process, and we will proactively engage companies where we believe their attention to improved corporate conduct or disclosure could reduce risk or enhance corporate performance.

So these are just a few of many elements within our investment strategy, which has, as its foundation, a comprehensive risk/return framework that will allow us to manage one of the largest single-purpose pools of capital in the world and generate the long term investment returns needed to help ensure the future pensions of 16 million Canadians.

So, to sum up, back in 1997 the CPP reformers got it right.

They created a strategy and a governance model to help secure the Canada Pension Plan for future generations.  We are working very hard to fulfill our part of that mission by building a world-class investment management organization and a portfolio designed to generate the kind of long-term results needed to help sustain the plan.

So far, so good. The reserve fund is strong, increasingly well-diversified, and growing.  We are on track to where we need to be.

The experiment is working, and Canada – and Canadians – are much better for it.

Thank you once again for being here today, and if time permits I would be happy to take any questions.