An Emerging Presence

CPP Investment Board

Canada Pension Plan Investment Board:

An Emerging Presence

Remarks by

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Thank you. It is a pleasure for me to have this opportunity to talk about the Canada Pension Plan Investment Board … what it is … where it is going … and what it might mean to capital markets and Corporate Canada.

Let me say right off the bat that the Investment Board … which I am privileged to lead … will emerge rapidly as a major presence in Canadian capital markets.

Within 10 years … we should have at least $88 billion of assets under management. Over 10 million contributors … both employers and employees … as well as almost three million beneficiaries … have an interest in how these assets are managed.

The emergence of this large capital pool … with a huge and diversified stakeholder base … will inevitably attract public scrutiny right across Canada. As it should.

Those of you who work for publicly traded companies know the onerous responsibilities of public disclosure and accountability.

In our case, they will be intense.

Like you … we must also publish an annual report and quarterly reports. But instead of a single annual shareholders' meeting … we are required to hold a public meeting at least once every two years in every province. That's equivalent to at least five annual meetings per year.

With so much accountability … we need to develop a widespread and hopefully accurate understanding of our mandate … which is why I am glad to be here this morning.

I would like to discuss three topics.

First, a quick history of the Canada Pension Plan … and why the Investment Board exists.

Second, our progress and near-term agenda.

And third, the role we will inevitably play as we emerge as a presence in Corporate Canada and capital markets.

Let's start with a review not of our Investment Board, but of the Canada Pension Plan itself.

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 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 about 3 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 the Federal and provincial governments … which led to important changes in 1997.

The two most important changes for purposes of our discussion were … first, an attempt to put the Canada Pension Plan on a firmer financial footing by increasing contribution rates and improving plan administration … and second, the creation of an independent organization, the CPP Investment Board, to manage the reserve assets.

From the financial perspective … the Canada Pension Plan is moving 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 between 17 and 20 percent of liabilities … a significant change … and a big step back from the edge of the fiscal abyss.

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

The Investment Board was created by an Act of Parliament … and commenced operations in October 1998 with the appointment of a board of directors, including a non-executive Chair. We at the Investment Board operate independently 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 plan assets … we will ultimately help it to meet its pension obligations.

But just what is our investment mandate?

The Act which created our organization set out 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.

Under the new financial structure approved by the federal and provincial ministers of finance … the federal actuary assumed that cash flows not needed to pay pensions would have to earn a 4 percent real rate of return.

There is some debate among actuaries about the viability of the plan under its new financial structure. That is not our debate at the Investment Board. Our job is to achieve a 4 percent real rate of return over the long haul … and, if we can, to do better than that without putting your hard-earned contributions at 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 being managed by the Department of Finance. This portfolio presently forms the bulk of CPP assets.

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

However, shifting the asset mix from exclusively bonds to a blend of bonds and equities will take time.

For instance, by investing all cash flows in equities … the combined assets of the Canada Pension Plan and the Investment Board will still be only one-third equities by the end of 2001.

Under our interim policy, we are investing in stock indices through two external fund managers. One is investing at least 80% of our cash flow in the Toronto Stock Exchange 300 Composite Index. The other is investing the balance in the Standard & Poor's 500 Index of large companies in the United States … and the EAFE Index of 1,000 companies in Europe, Australia and the Far East.

What have we accomplished so far?

During our first seven months of operations, we have received about $1 billion from the Canada Pension Plan … and put all of it to work in the market. So the process of shifting the asset mix from exclusively government bonds to both stocks and bonds is underway … and

we will report on our most recent quarter … for the period ended September … in mid-November.

As the assets under our management grow … setting a longer-term asset mix policy will become a priority. At the same time… we must make other decisions that will shape our investment and operating strategy and style.

Basically, we must address three key issues – passive versus active investing … asset classes beyond traditional stocks and bonds … and external versus internal fund management.

For obvious reasons … coming to grips with these issues is a logical first item on the decision tree for me and our board of directors. So this is where I am spending the majority of my time.

I expect to have our business plan approved and in place by this February. At that stage the early planning phase will have been completed and the implementation phase will begin in ernest.

Finally, I want to share a few comments with you on the role we will play as an emerging presence in Corporate Canada and capital markets.

When I look back to the early years of my career as an investment dealer … over 30 years ago … public sector pension funds were almost 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 fixed income securities.

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. Private mutual fund companies 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 derivative traders. Several are prominent in international markets.

The migration of public sector pension assets to capital markets will be complete next April when 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. That's in addition to the several billion that we will have to put to work year after year for the foreseeable future.

So the Canada Pension Plan Investment Board is very much part of a trend that has been underway for some time.

How important is all this public sector pension money to capital markets?

In 1998 … the top 100 pension funds in Canada had combined invested assets of $432 billion. Of them, 56 were public sector plans holding 77% of the "big 100" assets. Of the 10 largest funds … eight were public sector … each with more than $10 billion in assets.

Within the decade … the CPP Investment Board and the Public Sector Pension Investment Board will join the ranks of the top 10 funds, and no corporate funds are likely to be in the top 10 category.

As is evident in these statistics … pension assets have grown rapidly during the boom markets of the 1990s and they will continue to grow in the years ahead. And not only in size. Inevitably they will grow in influence as well. Increasingly these funds, including the CPP Investment Board, will be committed to securities in both public and private companies. As a result, pension funds are becoming leading owners of Corporate Canada.

For the directors and management teams of 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 become unhappy with a company's performance or prospects.

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 … especially public sector funds … take a keen interest in the governance practices of boards of directors … and the long term plans of management for enhancing shareholder value.

At the present time we are exercising our voting rights through our fund managers whose policies generally reflect our views. Going forward I expect we will develop our own proxy voting policies and become proactive where we believe circumstances warrant.

Happily we do not have to be preoccupied with the quarterly performance sweepstakes. We are long-term investors.

As a result we can be patient and we can support companies during adverse periods if they have strong boards of directors that effectively discharge their governance responsibilities and managements that are convincing that they have sound long term plans, and the resolve and resources to implement them.

Just as pension funds have become increasingly important owners of Corporate Canada they have also become increasingly significant forces in Canadian capital markets … and as a result even more important to financial intermediaries and service professionals.

Here too pension funds realize that their size, when combined with their determination to fulfill their fiduciary obligations, leads to strength.

This strength has been used to persuade the Street to deliver more and better products and services … at lower costs. The pressure … for more and better for less and less … will continue … and I expect intensify in the years ahead.

We plan to be highly focused on implementation costs. At the same time we want to be seen as a highly professional and responsible client. It is in our long term best interests that we have a viable and flourishing financial services industry in Canada. While we will seek win-win relationships with the Street and will reward value-adding innovation and service excellence, we will be relentlessly price sensitive.

All of that will help us to achieve our ultimate goal – the maximization of investment returns.

Consequently, anything we can do … and you can do … to encourage greater efficiency in capital markets … and better financial performance by Canadian companies … is in the best interests of all Canadians who contribute to and benefit from the Canada Pension Plan.

In closing, I like to think that ours is a noble quest at the CPP Investment Board – to help deliver the pension promise to Canadians. Our challenges are many, but I am confident that our efforts will make retirement more comfortable and secure for the millions of people who are counting on us.

Thank you for inviting me to be with you this morning. I now look forward to your comments and questions.