Public Meeting Tour

CPP Investment Board

Remarks by

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President and Chief Executive Officer

Canada Pension Plan Investment Board

Public Meetings Tour

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INTRODUCTION

Good afternoon, ladies and gentlemen. I am Gail Cook-Bennett, Chair of the CPP Investment Board. It is my pleasure to call this meeting to order and welcome you to our first round of public meetings across Canada.

We are delighted to be here today. We had the opportunity to meet earlier with your local media and others interested in the CPP Investment Board. We now look forward to this public session.

To give you an idea of what to expect, I will make some opening comments and then John MacNaughton, our Chief Executive Officer will speak to our investment challenges and programs.

The CPP Investment Board Act requires that we hold a public meeting at least once every two years in each province that participates in the Canada Pension Plan. That is, all provinces except Quebec, which has its own pension plan.

These public meetings are one way in which our legislation holds us accountable to Canadians, a task we take very seriously.

TABLE NOTICE

The first order of business is to table the notice calling this meeting.

Our legislation requires the notice to be published at least 10 days in advance of each meeting in a daily newspaper in each province. We published three local newspaper notices in English and one in French for this meeting.

In addition, public service announcements and press releases were distributed to the news media and we devoted a page on our Web site to information about the public meetings.

PURPOSE

The purpose of this meeting is to discuss the CPP Investment Board's annual report for the fiscal year ended March 31, 2000.

DIVISION OF RESPONSIBILITIES

Before we do that, let me clarify the division of responsibilities between the Canada Pension Plan and the Canada Pension Plan Investment Board.

We at the CPP Investment Board are not responsible for the Plan's funding policy, financial viability, contribution rates or benefit levels. These are the joint responsibility of the federal and provincial governments.

However, we anticipated that some of you may have come with questions about your own CPP benefits. We asked the CPP specialists with Human Resources Development Canada to be available today.

They are located in the (Name of Room). If you have any personal questions, I suggest you visit with them after this meeting. They can access your personal file through their laptop computers.

With these preliminaries behind us, let us turn to the business of the CPP Investment Board.

BACKGROUND

First, by way of background, the Canada Pension Plan itself was created in 1966 as a pay-as-you go pension 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 in 2003.

As a result of increases in the contribution rate so far, more money is flowing into the plan than is needed to pay current pensions.

The question the federal and provincial ministers had to address was – what should we do with the excess funds until they are needed to pay future pensions?

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.

And that is why the CPP Investment Board was created by an Act of Parliament in December 1997. The directors were appointed in October 1998, making our organization a little over two years old.

WHAT WE DO

Let us turn now to what the CPP Investment Board does.

Our legislation requires us to invest cash transferred to us from the Canada Pension Plan in the best interests of CPP contributors and beneficiaries, a very clear and focused objective.

We are to invest this cash with a view to achieving a maximum rate of return, without undue risk of loss.

It is important once again to emphasize that we are separate from and independent of the Canada Pension Plan.

Although we do have sole responsibility for day-to-day investment decisions, we are not involved in the administration of Canada Pension Plan policies, contribution rates and benefits.

In short, we are an independent organization building a diversified portfolio of assets to help deliver the long-term pension promise to Canadians.

THE BOARD OF DIRECTORS

Let me tell you a little bit about our board of directors and what it does.

First, directors are selected for their expertise in investment and related matters. Indeed, this requirement is enshrined in our legislation. As a result, the board consists of individuals with expertise in such areas as accounting, economics, actuarial science, investing, banking and business generally.

Second, the federal and provincial governments instituted a significantly different way of selecting directors for this Crown corporation.

The process began with the federal and provincial finance ministers naming one member each to a nominating committee. The committee consists of business executives and government officials and the chair comes from the private sector.

The nominating committee identified who fulfilled the criteria set out in advance by the governments and submitted its short list to the federal finance minister.

The federal finance minister made the appointments after discussion with the provincial finance ministers.

All of this was an innovative attempt to position the CPP Investment Board as much as possible at arm's length from governments.

The board of directors' responsibility is to represent the best interests of the 16 million people who contribute to and benefit from the Canada Pension Plan.

The directors do not manage the CPP Investment Board on a day-to-day basis. We are required to hold management accountable for the operating and investment strategies, the annual business plan and budgets, and risk management policies and controls, just as it would be in a private sector organization.

Our goal is to make sure that the CPP Investment Board is managed competently, that the organization acts with integrity, and that all efforts are focused on building long-term value to help pay future CPP pensions.

SUMMARY

Let me summarize:

We are an organization focused on maximizing investment returns.

We operate at arm's length from the federal and provincial governments.

We have no administrative or policy responsibility for the Canada Pension Plan.

We are committed to attaining the highest standards of governance.

And we embrace our responsibility to report to the Canadian public through these public meetings and many other avenues.

Our President and CEO John MacNaughton will now share with you the nature of the task we face. Before he does, let me tell you a little bit about him.

INTRODUCING JOHN MACNAUGHTON

John has more than 30 years experience as an investment banker and senior executive of investment firms in Canada and the United States. He retired as President of Nesbitt Burns in 1999.

John had hoped to take a long sabbatical – until our board of directors offered him a challenge he could not refuse.

We believe his knowledge, experience and vision are tailor-made for carrying out our mandate in the best interests of Canadians.

Moreover, John's integrity and values are those essential to the leadership of this important new organization.

John, over to you.

Thank you Madame Chair – and a warm welcome to all of you for being here this afternoon.

I am honoured to be the founding President and Chief Executive Officer of the CPP Investment Board where we have the opportunity to do great things over time that will make a difference to the financial future of millions of Canadians.

My colleagues and I are mindful of the important responsibilities we have been asked to undertake. With the support and wise counsel of our board of directors we are determined to discharge them in an exemplary manner. We know that Canadians are counting on us.

Like other nations, Canada has wrestled with the issue of how a state-run pension plan responds to the needs of an aging population. Let me show you in practical terms what this means.

INTRODUCTION

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 and challenging implications for those of us charged with managing the CPP assets.

Our job is to make money over the coming decades through prudent and productive investing. Our success will ease the financial burden on a worker population that is declining in proportion to the pensioner population.

To help you understand how we will do that I am going to address three items.

First, I will tell you about our current investment policy and performance.

Second, I will describe the type of organization we are building.

And third, I will share with you our priorities and current thinking on our future investment strategy.

CURRENT INVESTMENT POLICY AND PERFORMANCE

Let's start with our current investment policy.

As our Chair has noted, our legislation requires us to maximize investment returns without incurring undue risk of loss.

This is an appropriately balanced pair of objectives. On the one hand mandating us to pursue superior investment returns but on the other hand cautioning us that this should only be done within the bounds of prudent risk taking.

However, designing and implementing an investment strategy based on these countervailing objectives is not as straightforward as it may at first appear.

Some questions will serve to highlight the inherent complexities. For example: What is a maximized return? How high should it be? Compared with what? And over what period of time?

What distinguishes acceptable risk from undue risk? Should risk tolerance or risk aversion change with the passage of time or different circumstances?

These are critical questions. They require well-considered answers that will lead to clear policies and strategies to achieve our legislated objectives.

The first step in pursuing these objectives is to decide what is called asset mix policy. The basic asset mix choice for any investor and especially for pension fund investors is to decide the proportions of stocks and bonds in the portfolio.

The asset mix policy one chooses affects the long-term investment returns that can be expected as well as the risks involved in pursuing them. By most studies, it is the major determinant of total portfolio performance.

In developing our asset mix policy, we took into consideration the $30 billion bond portfolio the Canada Pension Plan already owns. This portfolio is administered by the federal finance department and consists primarily of long-term loans to the provinces.

To offset the dominance of the CPP bond portfolio and in pursuit of higher returns we are investing all cash flows in stocks. This is bringing about a gradual change in the asset mix of the consolidated assets of the Canada Pension Plan and the CPP Investment Board.

Stocks can be highly volatile in the short-term as we have all seen in recent months and even produce negative returns. But history tells us that stocks gain value over the long term despite short-term market downturns.

Let’s put this statement to the test. If you had invested $100 in the Toronto stock market in 1966 the year the Canada Pension Plan was founded it would have grown to almost $4,000 today.

Our investment horizon is very much long term spanning three decades rather than three months. So we can afford to be patient through the market peaks and valleys.

Historically, the returns on stocks are much better than those on most traditional investment assets, such as bonds or treasury bills. In other words, over the long haul, stocks are the place to be.

During our start-up phase, we have been investing in stocks through funds that mirror the indices of major markets.

Of the assets we managed last fiscal year, we invested 80 cents of every dollar in a fund that substantially replicated the TSE 300 index of major Canadian companies trading on the Toronto Stock Exchange.

We invested 10 cents of every dollar in a fund of large companies in the United States and another 10 cents in a fund of about 1,000 companies in Europe, Australasia and the Far East.

Let's go back to the asset mix I was talking about a moment ago. We showed an asset base of exclusively bonds owned by the Canada Pension Plan.

Our investment activities in fiscal 2000 brought about a small but significant shift. By March 31 last year 93 percent of the combined assets were bonds and 7 percent were stocks.

How have we performed so far? Let's look at the growth in our assets during our last fiscal year.

During fiscal 2000 we invested excess CPP funds as we received them and ended the year with approximately $2.4 billion of assets at market value.

The growth in assets reflected both our cash flows and the performance of markets where our assets were invested.

As I mentioned, we invested the bulk of our assets in a fund that replicated the TSE 300 Index, which was among the world's top performing markets in the 12 months ended last March.

The remaining funds were invested in two foreign equity funds that also did well.

The total fund earned a 40.1 percent return or $463 million of investment income after deducting investment expenses.

We measure the performance of individual portfolios against market benchmarks. One would expect a stock index fund to do almost as well as the index itself after deducting transaction costs.

In our case, we did slightly better than our total fund benchmark last year.

Let me point out that to earn high long-term returns one has to tolerate large positive or negative swings in quarterly and annual performance.

To show you what I mean let's look at the returns for Canadian stocks since 1966.

Nominal investment returns include inflation. Annual returns are highly volatile from year to year.

The TSE 300 Index exceeded 40 percent on only three occasions over the past 34 years.

The market was also negative on six occasions and lost 11.3 percent as recently as 1999.

Those are the nominal returns. What happens when we exclude inflation to measure real rate returns?

This is essential to know because the federal Chief Actuary has estimated that the CPP funds entrusted to us need to earn a real rate of return of 4 percent per annum over the long term. That is a return of 4 percent annually on top of inflation.

Since 1966, the Canadian market has produced an average real return above 4 percent. But it did so only half the time and fell below that level just as often.

Like the Chief Actuary, we believe that a 4 percent real return is a prudent basis for future long-term expectations.

We are now well into our second full year and you might well ask how we are doing. The answer is that we had good performance in the first two quarters that is from April to September 2000.

The results for the third quarter from October to December will be released in mid-February so I cannot share them with you today. What I can tell you is that we expect a negative quarter because most markets around the world were negative.

To help put quarterly statistics into perspective, I draw to your attention that in fiscal 2000 when we produced a 40 percent total fund return we experienced one quarter of negative returns.

We regard the recent sell off in stocks as a welcome opportunity to put our steady cash flows to work at substantially lower prices.

And considering the volatile character of the stock markets who knows how the first three months of this year, which are the last three months of our current fiscal year, will turn out?

As I said earlier, we are long-term investors. Remember, our focus is on three decades, not three months.

Now let's switch to the costs of running the CPP Investment Board.

Last year we spent just under $500,000 on investment services and just over $3 million on operating expenses, salaries and benefits, and professional and consulting fees.

Total expenditures of about $3.7 million worked out to 32 cents for every $100 of average assets under management.

We continue to be vigilant in managing costs with a view to maximizing net investment returns, which is the ultimate measure of our performance.

Let me move on from performance to comment on the type of organization we are building.

TYPE OF ORGANIZATION WE ARE BUILDING

Instead of the traditional corporate model we want to stay small and lean.

We call our organizational model a virtual corporation.

Under this model, our small team of senior executives creates effective strategies and then accesses and leverages external expertise to manage assets and increase their long-term value.

By following this approach, we will have broad exposure to ideas and deal flow.

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 through partner-like relationships, our senior team will be accountable for all aspects of our investment and business performance as well as for compliance and control.

We believe that the virtual corporation model will focus our energies on high value-added activities provide access to and flexibility in choosing specialized skills and capabilities generate potentially better results at less cost and provide risk management and diversification benefits.

In other words, we can take full tactical advantage of the talents already flourishing in the competitive marketplace.

Let me turn now to our future strategy and priorities.

PRIORITIES AND CURRENT THINKING ON FUTURE INVESTMENT STRATEGY

We have five priorities for the current fiscal year.

1. To complete the recruitment of the senior management team.

2. To develop a risk management framework.

3. To review our asset allocation policy and develop strategic alternatives.

4. To improve how we measure performance.

5. To complete our program of public meetings across Canada.

We are making progress on all these priorities. I'd like to elaborate on the third one – the development of a diversified investment strategy.

Our assets are growing rapidly. Within the decade, we expect to have more than $100 billion under management.

That will put us in the league of the world's leading pension funds managing a large pool of capital belonging to you, your family, your neighbours and friends across Canada.

Consequently, we have to look at investing these funds broadly to spread the risk.

This will involve looking at the benefits of passive and active investing in equity and debt securities, merchant banking and private equity opportunities, private/public infrastructure projects, venture capital opportunities, real estate investments, real rate bonds and the prudent use of derivative products, such as swaps and options.

What do I mean by passive versus active investing?

Passive investing means replicating an index, such as the TSE 300. You buy assets in the exact proportion they are represented in the index. Your returns should mirror the index, less transaction costs.

To date, our investing has been substantially done passively, and the strategy has served us well.

Active investing means picking individual investments based on research and analysis. Considerable professional judgment is involved and the goal is to earn higher returns than the relevant benchmark.

Active investing enables fund managers to attempt to add value above market returns – and thus maximize overall fund returns. It also enables them to better manage risk by diversifying fund exposure among a broader choice of public and private investment opportunities.

We look forward to diversifying into various active management strategies in the months and years ahead, even though I believe passive investing will remain a core strategy for the foreseeable future.

SUMMARY

I have covered a lot of ground today in a short period of time. I hope that my report has been informative and I look forward to your questions. Before turning the meeting back to the Chair, let me summarize my key points:

1. First, we had unusually high investment returns in our first full year thanks to our current policy of investing only in stocks. We do not expect to achieve such dizzy heights again and we do expect years where we will report losses. Be patient. Our investments will pay off over the long term.

2. Second, we are building a virtual corporation to minimize overhead costs and maximize investment returns by capitalizing on a small expert professional team that will tap into talents across Canada and around the world through partner-like relationships.

3. Third, we will broaden our investments into new areas now that our executive team is largely in place.

A lot has been accomplished and we have much to do. As we move forward, we will listen to Canadians and communicate extensively so that there is a broad understanding of how we are helping to keep the public pension promise.

I am honoured to have this opportunity to lead the CPP Investment Board and to work with my colleagues in helping to secure the retirement future of our fellow Canadians. We look forward with enthusiasm and purpose to discharging the important responsibilities that have been entrusted to us.

Thank you very much.