CPP INVESTMENT BOARD

Past Present and Future

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Canada Pension Plan Investment Board:

Past, Present and Future

Presentation by

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It’s a pleasure to be your breakfast guest. To start your day, I want to share with you the role of the CPP Investment Board in helping to keep the long-term pension promise to Canadians.

If there are messages that you leave with today, I hope that one of them is that our job at the CPP Investment Board is to invest funds today to pay pensions much later in this century. Our investment horizon is at least 20 years. And it is the long distance of this investment horizon that very much influences what we do and why we do it.

And the second is we have the legislative framework, the strategy and the people necessary to discharge our responsibilities professionally and productively, and free of political interference.

I have been asked to discuss the past, present and future of the CPP Investment Board.

So let me begin with the past, with some background on the Canada Pension Plan and why the CPP Investment Board was created.

Then I will deal with the present, namely, how we are organized, our governance policies and practices and our investment policies and performance.

And, before entertaining your questions and comments, I will review our future plans and thinking.

So first, the past.

The Canada Pension Plan is the joint responsibility of the federal government and nine provinces. The tenth province, Quebec, has it own plan.

The Canada Pension Plan was created by the federal and provincial governments in 1966 as a pay-as-you-go scheme that is indexed to inflation. It is a mandatory plan. All employees and their employers must contribute.

It needs to be said that the Canada Pension Plan was not designed to be fully funded. Instead, the idea was that each generation would pay the pensions of the previous generation.

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.

Over the next 30 years, the Canada Pension Plan worked fairly well. Substantially more money flowed in than flowed out to provide all working Canadians with retirement income, as well as financial help to their families should the breadwinner die or became disabled.

Let’s fast-forward 30 years to the mid-90s.

By 1996, more money was going out than was coming in. In that year alone, $17 billion was paid out in benefits, but only $11 billion was collected in contributions, leaving a one-year deficit of $6 billion.

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. The burden on future generations would be enormous.

Particularly worrisome was the changing ratio of seniors to workers.

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.

The impending pension crisis sparked an extensive review by the federal and provincial governments and 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 separate from the plan itself to manage the reserve assets.

Let's look at the changing financial structure of the plan.

Over a 20-year period, the plan will move from being exclusively a pay-as-you-go scheme to a partially funded plan.

The goal is to build its financial viability to the level where assets should represent 20 percent of liabilities and five years of pension benefits. That's projected to happen by 2017.

Considering that assets represented only 8 percent of liabilities in 1996, when the plan was experiencing annual shortfalls, this is a big step back from the edge of a fiscal abyss.

A good part of this transformation is being accomplished by gradual increases in the contribution rate until it reaches 9.9 percent of the employee's pensionable earnings by 2003. After that, the contribution rate will be held steady indefinitely.

So what is emerging gradually is a partially funded defined benefit plan.

As a result of the contribution increases already implemented, more money is flowing into the Canada Pension Plan than is needed to pay pensions, a situation that is expected to continue for at least another 20 years.

Back in 1996, the federal and provincial governments debated what to do with the excess funds until they are needed to pay benefits.

The first part of their answer was 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 corporation is the CPP Investment Board, which commenced operations in October 1998.

The Canada Pension Plan and the CPP Investment Board are two related, but quite separate and distinct entities.

The Canada Pension Plan is the exclusive responsibility of our federal and provincial governments. They are responsible for its design, administration and funding policy. For example, they set contribution rates and determine benefits and the federal government actually collects contributions and pays entitlements.

The CPP Investment Board is a crown corporation that has one job – to invest the funds transferred from the plan. We have no policy or administrative responsibilities for the plan.

The CPP Investment Board is not only governed and managed independently of the Canada Pension Plan. It is also governed and managed independently of governments.

We have our own board of directors and professional management team, each with clearly delineated responsibilities and accountabilities.

So much for the past. Let's move to the present, beginning with our investment mandate and activities.

Legislation sets out two objectives. First, we are to manage the cash transferred to us in the best interests of the Canada Pension Plan's contributors and beneficiaries. That means we must invest in the best interests of currently about 16 million people.

Second, our legislation directs us to maximize investment returns without incurring undue risk.

Furthermore, we are not allowed to conduct any business that is inconsistent with these two objectives of furthering the financial interests of Canadians and maximizing returns without assuming undue risk.

In other words, we do not invest according to the public policy objectives of any government other than to help keep the public pension promise.

That is a worthy social objective on its own. It deserves a focused investment mandate that is not diluted or distracted by other public policy goals or social causes.

In estimating the funding need of the Canada Pension Plan , the federal Chief Actuary provided some guidance on what is expected from investing in capital markets.

In the Chief Actuary's view in 1997, the cash flows not currently needed to pay pensions are expected to earn a 4 percent real rate of return or 7 percent assuming a 3 percent inflation rate.

Earning a 4 percent real return is tough to do continuously. For example, if all Canada Pension Plan assets had been invested in Canadian equities since 1966, they would have exceeded a 4 percent real return only half the time.

We have taken up the challenge by first investing solely in equities and second investing 30 percent of cash flow outside Canada.

Let me elaborate on both points.

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

The plan directly owns a large portfolio of federal and provincial bonds. Most of these bonds are 20-year loans to the provinces, territories and federal government at preferential rates.

Under the new financial structure for the Canada Pension Plan, each province can renew its bonds when they mature for one further 20-year term. However, they must do so at market rates. The federal government, by the way, cannot roll over its maturities.

The proceeds of matured and redeemed bonds flow through to the CPP Investment Board.

Eventually, when the last of any renewed bonds mature, the cash proceeds of the entire portfolio will have flowed through to the CPP Investment Board. That will happen no later than March 1, 2033.

In the meantime, we are required to take these fixed-income assets into consideration in developing our investment strategy. Their existence is one reason why we invest solely in equities.

On June 30 of this year, our equity holdings were $11 billion. That is about 20 percent of the total assets available to the Canada Pension Plan.

Within three years our equity holdings will reach 50 percent of assets available to the plan. This will be close to the allocation of large public sector pension funds in Canada and the United States. They typically have between 55 and 65 percent of assets invested in equities.

So our decision to invest in equities can be seen first as an attempt to balance the enormous CPP bond portfolio.

A second key reason why we decided to invest in equities is because the returns are attractive for the risks incurred over long periods of time.

According to the Chief Actuary, contributions to the Canada Pension Plan will exceed benefit payments until at least 2021. So we have a long investment horizon to earn the expected higher returns that equities can generate.

We also invest in foreign equities. Foreign investing by pension funds, as well as your personal investments in registered retirement savings plans, are federally regulated.

During the past couple of years, the federal government has increased the level of assets at cost that a pension fund or RRSP can own outside Canada and remain tax exempt. The limit is currently 30 percent at cost. We invest outside Canada to the maximum permitted by law to better diversify our asset base.

In Canada, virtually all of our current investing is in equity funds based on the TSE 300 Composite Index on the Toronto Stock Exchange.

Outside Canada, we currently invest in the Standard & Poor's 500 Index of large U.S. companies and the EAFE Index developed by Morgan Stanley Capital International of about 1,000 European and Asian firms. Each of these foreign funds holds about 15 percent of our total assets.

Investing globally is critical to our mission of maximizing returns and avoiding undue risk. Canada represents about 2 percent of the world's stock market capitalization. It would be foolish for us to put all our eggs in such a small basket.

As it is, we are investing large sums of cash at a time when stock markets are in the most severe correction in over 30 years.

Here you see the rapid growth in our assets, which totaled almost $11 billion by June 30 of this year,

Our rates of return have been highly volatile, as you can see here, from 40 percent in fiscal 2000 to a negative return of 9.4 percent last year on a larger asset base. The net effect is that we lost money last year.

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

Things picked up in the first quarter of the current fiscal year. We earned net income of $58.1 million.

The rate of return for the first quarter was 2.0 percent, versus 1.1 percent for the total portfolio benchmark, which is a proxy for the markets in which we invest.

Given market performance to September 30, it is reasonable to expect a further loss for the first half of the current fiscal year.

However, on a consolidated basis, the total fixed-income and equity assets available to the Canada Pension Plan produced positive investment returns last year. It is premature to comment on this year's results. We will do so in mid-November when we issue our quarterly financial statement and a commentary.

The important point to note in this stage of the CPP Investment Board's evolution as an equity investor is that we are cash rich and in the fortunate position to be able to buy stocks at much reduced prices, believing that they will be valued at substantially higher prices in coming years.

So in a real sense, this is the classic case of short-term pain for long-term gain. We are building a broader asset base for the future.

Over the next 10 years, we expect our assets under management to exceed $130 billion as contributions continue to pour in, the proceeds and income of the government bond portfolio flow through and we enhance the value of invested assets.

As you can tell, we are fully confident that our policy of investing in equities will more than compensate for the risks incurred and deliver real returns above the 4 percent minimum requirement over the long-term.

To carry out our investment mandate, we are building the CPP Investment Board as a small virtual corporation.

The management team is drawn from the private sector and supported by other professionals and staff who also have private sector experience.

Key executives and several managers are already on board. Our staff of 18 will grow to approximately 30 over the next year. In other words, we are not building a bureaucracy.

Our operating and investment strategies are being implemented 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.

Furthermore, we operate from Toronto, Canada's financial capital, rather than Ottawa.

You should also know that we have made a special effort to follow best governance practices.

Effective governance defines the responsibilities and accountabilities of the key groups in an organization. The board of directors represents the stakeholders, reviews and approves policies and strategies, provides oversight of management and compensates management according to its performance.

Management, on the other hand, is responsible for developing policies, strategies, and annual business plans and budgets for board approval and for all aspects of the ongoing operation of the organization within the approved policies, strategies, plans and budgets.

In terms of accountability, the board of directors reports to the stakeholders and management reports to the board.

Our primary stakeholders are the federal and provincial governments and the 16 million Canadians who contribute to, or benefit from, the Canada Pension Plan.

The twelve members of our board were selected for their expertise in such areas as economics, accounting, actuarial science, finance, investing, banking and business generally. The requirement for relevant expertise and experience is set out in our legislation.

This is a critical check in our system and the foundation on which much of our governance structure is built.

How our directors are nominated is very much a Canadian innovation.

First, the federal finance minister and the finance ministers for the nine participating provinces appoint a nominating committee. Each government names one committee member. The federal finance minister chooses the committee chair and has selected the chief executive officer of a private sector company to fill that position.

The committee identifies qualified prospective candidates from across Canada, bearing in mind that they must find individuals with the expertise and experience relevant to our investment mandate that I described a moment ago.

The committee agrees upon a list of qualified candidates and refers the list to the federal finance minister.

The federal finance minister consults with his provincial counterparts on the proposed names and then appoints directors from the list of nominees recommended by the arm's length committee. Once appointed, directors serve for up to three terms of three years each.

The federal finance minister also appoints the chair of the board, again, in consultation with his provincial counterparts and also in consultation with the directors already appointed.

I'm sure you will agree this is an arm's length process that reconciles the responsibilities of the federal and provincial governments with the desire to de-politicize appointments.

Here's another important point. The board of directors, not the politicians, recruits and appoints the President and Chief Executive Officer.

I am honored to serve as the first incumbent. I report to the board of directors, not to politicians. Our board sets my compensation and performance objectives and I in turn do the same for the senior executives I recruit.

The most essential aspect of this process for the public to understand is that full-time experienced investment professionals make all investment decisions.

Political leaders and government officials cannot and do not tell us how to invest.

There are many other aspects of our governance that protect the integrity of the organization, such as codes of conduct and conflicts of interest policies for directors and employees.

A key element that I want to mention is our commitment to public transparency and reporting.

Like other pension funds, we publish an annual report. Our legislation and regulations specify what must be disclosed – including our objectives for the past year and how they were met , as well as our objectives for the coming year.

And we must disclose the total compensation of the top five officers as well as the total compensation of the directors and executive officers.

We also accept our obligation to explain our quarterly and annual financial results to Canadians and recently instituted a policy of holding a conference call with the news media to discuss our year-end results.

We publish all this information on our Web site.

Another worthwhile aspect of our governance and reporting is that we are required to hold a public meeting once every two years in each participating province. Its purpose is to discuss our most recent annual report and to give interested persons an opportunity to comment on it.

We held our first series of public meetings last January and went further than the law requires. We met with select stakeholder groups, such as poverty activists, union leaders, pension fund managers, pensioners, business students, business leaders and personal financial planners.

And I appeared on several radio shows and talked to the television and print media at every stop.

What this amounted to was a broad dialogue and reporting campaign with Canadians throughout our vast country.

What about the future?

We realize that continuing to invest in publicly traded equities through index funds is not the best way to maximize returns without undue risk of loss.

Now that we have recruited our executive team, we are beginning to actively manage a portion of our assets in both public and private markets.

Recently, through external fund managers, we began to invest in private equity through early-stage companies and new technologies, established firms seeking private expansion and growth capital and corporate buyouts and acquisitions that result in stronger and more profitable companies.

We are positioning ourselves as a preferred investor for the top private equity managers and merchant banks in Canada and around the world.

We are also considering other private market investments, such as real estate, infrastructure projects, electrical power projects, and natural resources.

We have approved the commitment of up to 15 percent of total assets to private market alternatives, although the percentage could go higher.

We are currently in the process of developing as strategy for active investing in public markets.

During our first two years, federal regulation restricted our domestic equity investing to index funds. In the third year, the regulation was relaxed, allowing us to invest up to 50 percent of capital actively in domestic equities.

In the next few weeks, we expect this restriction to be removed entirely. Then we will be able to invest actively as much of our domestic equity as we choose, just as other funds can.

Active investing in both public and private markets, at home and abroad, should enable us to add value above the returns that markets will produce on their own.

And, as I noted earlier, we will implement our strategies through investment partners around the world.

However, it will take many years before a sizeable portion of total assets are invested in actively managed portfolios. Index investing will remain a cornerstone of total assets, as it is for other public sector pension funds.

But I repeat again that we are confident that our emphasis on equity investing, to balance the existing large government bond portfolio, will earn the level of real returns expected of us over the next 20 years.

Our legislation is in place, an experienced board of directors has been appointed; an outstanding management team has been recruited; assets under our management are growing rapidly. We are at work to play our role in helping to keep the pension promise to Canadians, not just for current beneficiaries and contributors, but for generations of Canadians yet to be born.

Thank you for listening. And I now look forward to your questions and comments.