Public Meetings Tour

CPP Investment Board

Remarks by

Gail Cook-Bennett, Chairperson and

John A. MacNaughton,

President and Chief Executive Officer

Canada Pension Plan Investment Board

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June 2002

Good morning, 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.

Bonjour, Mesdames et Messieurs. Je m'appelle Gail Cook-Bennett, présidente du conseil d'administration de l'Office d'investissement du RPC. J'ai le plaisir d'ouvrir la présente assemblée – et de vous souhaiter la bienvenue.

As you see from our title slide, we are here to talk about the future for millions of Canadians who will be turning to the Canada Pension Plan in the decades ahead to help provide financial comfort in their retirement years.

With me is John MacNaughton, our president and chief executive officer, whom I will introduce more fully in a few minutes.

Our legislation requires us to hold a public meeting every two years in each province that participates in the Canada Pension Plan.

This month we are visiting all nine participating provinces on our second cross-Canada tour.

As you can see here, the purpose of this meeting is spelled out in our legislation -- to discuss our recent annual report and give you an opportunity to comment on it.

And we have promoted this meeting through a series of newspaper ads as well as information distributed to the news media and posted on our web site.
Before Mr. MacNaughton reviews our financial performance and future direction, let me make a couple of observations on our governance.

The CPP Investment Board was created in 1997 to invest CPP funds in capital markets until they are required to pay future pensions and other benefits.

The federal and provincial governments envisaged an investment management company operating at arm's length from both levels of government.

We have been in business now for three full fiscal years … have so far invested $14 billion … and expect to be managing $160 billion within 10 years, including the CPP assets currently administered in Ottawa.

With professionals managing such large sums of public funds … strong governance is essential.

Our legislation provides that the board shall have a sufficient number of directors with proven financial ability or relevant work experience.

In other words, oversight expertise closely aligned with the investment mandate of the organization.

How are directors appointed?

The federal and provincial finance ministers appoint one member each to a nominating committee that consists of public and private sector representatives … and is chaired by a private sector CEO.

The committee identifies and recommends a list of qualified candidates to the federal finance minister.

The federal finance minister then appoints members from the list in consultation with the provincial finance ministers.

This process has produced a board of independently minded directors with investment, business and financial expertise that relates to the organization's responsibilities and provides knowledgeable oversight of management.

Canadians like this governance model. Earlier this year, we commissioned a public opinion survey of 2,500 Canadians. We wanted to gain the measure of their confidence in what we are doing … recognizing that public confidence is very much a priority for us. Incidentally, the results of the survey are on our web site.

Among other important findings … we learned that 75 per cent of Canadians have confidence in the long-term health of the CPP if the assets are managed by investment professionals.

Furthermore, 65 per cent have confidence in these professionals being accountable to a board of directors with business, financial and investment expertise.

We also commissioned an in-depth attitudinal study of key stakeholder groups. This document is also on our web site.

The study found that our key stakeholder groups like the arm's length relationship to governments. They approve of experienced directors providing oversight of management. They have confidence in professionals making the investment decisions.

These are extremely encouraging endorsements of our governance model.

However, our research also shows that many Canadians have doubts about our ability to maintain our independence from governments as our assets grow and we become a major force in Canadian capital markets.

What many Canadians do not know is that the federal and provincial governments were not only aware of the dangers of political interference – but did something about it. They sought expert governance advice on how to set up the organization to protect it from inappropriate pressure while still holding it accountable. They incorporated that advice in legislation and regulations.

Our board of directors serves with this understanding.

Let me share with you some aspects of our governance that illustrate how we differ from most other crown corporations in ways that should give you confidence in our governance model.

First, the board of directors – not government -- appoint the CEO. The CEO is accountable to the board … not to government.

Second, we are responsible for our own budgets and do not need government approval.

Third, we set our own compensation policies.

Fourth, we appoint our own auditor.

Fifth, we have a rigorous process for the board to evaluate itself … for each director to evaluate his or her own performance and that of colleagues … and for the directors to evaluate the CEO.

In addition to these important distinctions, we have the standard components of good governance in place … such as conflicts of interest procedures and codes of conduct for directors, officers and employees.

All this keeps the focus on best governance practices in the interests of stakeholders.

Now, having established that management is accountable to an experienced board of directors … who are we … the directors… accountable to?

As a federal crown corporation, we are accountable to Parliament through the federal minister of finance.

As an investment company, we are accountable to the federal and provincial finance ministers … who are responsible for the Canada Pension Plan.

And we are accountable to the public through meetings such as this one.

Accountability and reporting is a vital and continuous process. The directors share a fundamental belief in timely disclosure and proactive reporting to all Canadians.

We have taken a strong stand in favour of disclosure and hold management accountable for this. Their support of our position has shaped our new web site launched last month.

There you will see on our home page our bold disclosure policy that states: “Canadians have the 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.”

According to our research, this policy resonates with Canadians … who, like us … believe transparency is critical to confidence in our mission.

I think you will be surprised by the scope and depth of information on the new web site.

It includes board-approved policies …

a full list of public equities …

a summary of the CPP’s fixed-income securities …

a summary of private equity holdings …

a discussion of investment strategies … and much more.

The financial information and holdings are updated quarterly and new developments are posted as soon as possible.

Having said all that, we understand that a governance model, no matter how carefully constructed and maintained, cannot guarantee organizational success.

Something can … and no doubt will … occur that will put our governance and practices to the test.

We are determined to retain your confidence because what we do is important to the financial future of 16 million Canadians who contribute to or benefit from the Canada Pension Plan.

If you would like to know more about our governance … please do not hesitate to ask me during the question period.

In the meantime, I will now turn the podium over to our President and CEO John MacNaughton, who will discuss our recent performance and future direction.

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.

In the almost three years since he joined the CPP Investment Board, he has formed a management team with all the skills, knowledge and determination to carry our mandate forward successfully.

John, over to you.

Thank you Madame Chair – and a warm welcome to all of you.

In my presentation I am going to review our performance for the past fiscal year … share our plans for the near future ... and comment on the market outlook.

An important part of our progress during the past year was to continue building our management and support team. And a strong and dedicated team it is.

We are a lean and focused organization committed to controlling costs … developing investment and operating strategies … retaining outside specialists to implement these strategies … and producing returns that contribute to the financial strength of the Canada Pension Plan.
Last year, it cost $11.4 million to operate the CPP Investment Board. Let me assure you that we continue to be vigilant in managing costs with a view to maximizing investment returns net of costs, which is the ultimate measure of our performance.

For the next 20 years, the Plan will meet all its benefit obligations from monthly contributions by employees and employers.

After that, it will increasingly rely on invested assets to help pay benefits.

Currently, the Plan has nearly $54 billion in invested assets ... an increase of $4.5 billion in just the last year.

These assets consist of fixed-income securities held by the Canada Pension Plan and administered by the Department of Finance in Ottawa … and equities managed by the CPP Investment Board in Toronto.

Here's how these assets performed last year.

The fixed-income securities earned $2 billion with an estimated 5.0 per cent return.

The equities earned $316 million for a 3.4 per cent return.

On a consolidated basis, the total assets earned $2.3 billion last year for a 5.7 per cent rate of return.

Why is the overall return of 5.7 per cent higher than the returns for the component portfolios? The explanation is somewhat technical … but nonetheless important.

Basically it has to do with a shift in the asset mix to equities … from 14 per cent of total CPP assets at the start of the year to 27 per cent by year end.

In the first half of the year, equity returns were negative, while fixed income returns were positive. In the second half, however, equity returns were strongly positive while fixed-income returns were muted.

As a result … equities under-performed bonds in the first half when they were proportionately smaller … and over-performed bonds in the second half when equities were above their average exposure for the year.

The net effect of all this was that the asset mix shift increased the total return by about one percentage point.

The fixed-income assets consist of 20-year government bonds and a cash reserve. Some bonds matured during the year and the net proceeds were either used to pay pensions or transferred to us and invested in equities. This explains the decline in fixed-income assets during the year from $42 billion to $39 billion.

This smaller asset base earned $2 billion in fiscal 2002, compared with $3.8 billion in the prior year.

Now let's turn to the assets we manage at the CPP Investment Board – the equity portfolio.

We invest in equities to balance the large CPP fixed-income portfolio … and because we believe equities will produce superior returns for the risks incurred over the long term.

About 71 per cent of equity assets were invested in Canada

… 15 per cent in the U.S. …

and 14 per cent outside North America.

Considering the unsettled nature of stock markets, our equities did well. We earned $316 million for a 3.4 per cent return – a welcome change from the negative results in the prior year.

Those of you who follow the market know how volatile equities have been.

You see here our roller-coaster results quarter by quarter for the past three years.

In fiscal 2002, we began with a modest gain …

followed by a large loss …

followed by a strong gain …

followed by a further modest gain.

As our assets grow, the gains and losses will widen to a few billion dollars in some quarters.

Fortunately, Canadians understand market volatility. According to our research, there is a high level of tolerance for short-term losses.

In fact, 46 percent say they are not bothered by occasional short-term losses because they will be more than offset by gains over the next 20 years. That is almost twice the number of Canadians who are bothered by short-term losses.

About 97 per cent of our assets were invested in public equities and three per cent in private equities.

One way in which we measure performance is against benchmarks that blend the returns for stock indexes for public equities and internal targets for private equities.

You see the results here for Canadian equities, foreign equities and total equities. In all cases, we did better than the benchmarks. I won't dwell on the relative performance because in the end what matters most is making money for the Canada Pension Plan … not simply comparing our performance to markets and other large investors.

While we made money last year, over the past three years, we have incurred a $65 million loss. That is less than half-of-one-percent of the equity assets at the end of the recent fiscal year.

We are disappointed, of course, to have any loss. But considering the volatility of markets, it is not unexpected and will, we believe, be erased by gains in the decades ahead.

Let me share with you now a fuller understanding of what we are doing and where we are going.

The Chief Actuary for Canada recently concluded that the Canada Pension Plan is financially sound for the foreseeable future.

Contributions are projected to exceed benefits until at least 2021. After that, investment income will be needed to help pay benefits.

Consequently, we are investing excess CPP funds to help pay the pensions for today's younger workers when they retire in 20, 30 and 40 years' time.

As we go forward, the existing CPP bond portfolio will shrink as bonds mature … and the equity portfolio will expand.

By mid-2004, fixed-income securities and equities could be about 50 per cent each of total assets.

By early 2006 … four years from now … equities might reach 60 per cent of total CPP assets – the level for many large Canadian public sector pension funds today.

So, in the next year we will have to make basic decisions about the most appropriate mix for CPP assets.

This decision will be made in the context of a major announcement earlier this month by the federal finance minister on behalf of himself and provincial finance ministers.

The government plans to transfer management of the CPP's fixed-income assets from the department of finance to the CPP Investment Board.

If the legislation receives Parliamentary approval, we will manage the CPP cash reserve and bond portfolio.

The cash reserve will likely be transferred to us within the next 12 months.

When that occurs, we will be charged with providing the Canada Pension Plan with funds in a timely manner to pay current pensions.

The bond portfolio will be transferred to us over three years and we will receive a portion of it every month, starting sometime next year.

The transfer of all CPP assets to our care will focus our attention on the most effective investment strategy to secure the long-term health of the Canada Pension Plan.

In our first three years, we invested passively in public equities through externally managed funds.

You can find every stock we owned on March 31, 2002 on our web site just as you see them in these slides. The list will be updated every three months when we release our quarterly results. As our Chair said, we are committed to telling Canadians what assets are owned on their behalf.

Our publicly traded stocks are currently listed according to well-known stock indexes in Canada, the United States and outside North America.

During our first three years, we replicated these indexes. This was an efficient way to invest large sums of money quickly during our formative period.

We now have the executive leadership on staff to undertake a more active and better focused investment strategy than merely indexed investing.

Let me deal first with our private market investments before addressing our evolving strategy for public market investments.

We initiated our private equity program one year ago. Why are we investing in private equities? Because they offer the potential of higher returns than public equities over time. However, private equity investing requires considerable patience before those higher returns materialize. With our long investment horizon, we can afford to be patient.

We are investing in two types of private equity funds.

One channels capital into early-stage and later-stage companies that require venture capital to establish new businesses and then to achieve growth and profitability.

The other type flows capital into established what are called buyouts – such as firms undergoing restructuring, a change in leadership, or the adoption of a new growth strategy through expansion or acquisition.

Many of these investments will be in Canada … providing solid returns and contributing to our nation's economic growth, productivity and competitiveness. Others will be in the United States, Britain and Western Europe … where we can capitalize on opportunities that will help to secure the retirement income for Canadians.

What have we done so far? We have committed $3.5 billion to 24 limited partnerships managed by 20 private equity firms. To date, about half a billion dollars has been drawn down for investment.

It will take several years to achieve our target of investing

as much as 10 per cent of total assets in private equity … and up to 12 years for the initial investments to fully realize their expected returns.

We intend to expand our private market investments beyond equities. We are looking at opportunities in income-producing real estate, infrastructure, energy and natural resource assets.

We are prepared to commit as much as five per cent of our total portfolio to these types of assets if the right opportunities can be found.

All told, up to 15 per cent of our equity portfolio could eventually be invested in private market opportunities.

Let me turn now to our plans for public market investments.I can share with you a general outline of what we have in mind.

First, we are consolidating our existing public equity holdings into a single passive portfolio. It will be designed and managed internally by our own team of investment professionals. Our goal is to reduce costs and better manage risk.

Second, we introduce new transition management strategies to reduce the commission and market impact costs of putting our substantial cash flows into the market.

Third, our staff will focus on managing portfolio risk, rather than solely on beating our passive benchmark. Prudence in protecting the capital entrusted to us by hardworking Canadians is the companion to maximizing returns.

Fourth, we will introduce active management overlay strategies to our passive portfolio. These strategies will be innovative and add value by capitalizing on the capabilities of our internal team and leveraging it with the expertise available in the competitive marketplace in Canada and abroad. Further details on this important initiative will be published on our web site later this year.

Let me close by looking ahead – or rather looking back to get historical perspective on what the future might hold for us.

I want to show you quickly performance data for bonds and equities since 1970. We picked 1970 as a starting date because that is when reliable data on international investing became available.

Let's see what would have happened 30 years later if we had invested $14 billion in different assets. I am using $14 billion because that is our current asset size at the CPP Investment Board.

Here you see how government of Canada bonds have performed over the past 30 years. That $14 billion invested in 1970 would have grown to $289 billion today. I'm sure you're thinking – that's not bad at all.

Now you see how Canadian equities have done over the same period. A little better, to total $306 billion.

Let's look at foreign equities. That $14 billion invested in non-North American equities would have done very well – growing to $579 billion over three decades.

Finally, if we had invested solely in U.S. equities, the assets would have experience astonishing growth, they would be worth $722 billion 30 years later.

These numbers underscore why investing in equities … especially in foreign equities … is so important to the future strength of the Canada Pension Plan.

As we all know, it would be foolish to put all of our eggs in one investment basket.

What would have happened if we had applied our current geographic allocations and invested 70 per cent in Canada, 15 per cent in the U.S. and 15 per cent outside North America?

That $14 billion would have grown to about $416 billion over 30 years.

That's a theoretical look back to admire the miracle of compounded rates of return … and to appreciate that a commitment of CPP assets to Canadian and foreign equities makes sense.

Over the next several years, we expect equity returns will be below the levels of the past 30 years … although they should eventually revert closer to the historical norms.

We have 20 years before we are expected to contribute income to the Canada Pension Plan to help pay pensions. In that time, we believe equities will make a strong contribution to the overall investment performance of consolidated CPP assets.

Canadians, however, appear to have mixed feelings about the long-term performance of equities, with four out of 10 believing in the long-term power of equities … and similar number having doubts. Clearly we have a responsibility to share information with Canadians that will give them greater comfort in our strategies.

We are heartened that Canadians overwhelmingly believe that it's a good idea to have a mix of different types of investments to offset too much risk.

In conclusion, it has been a gratifying year.

We have built a capable team. We have established a solid asset base. We have performed well. And we are confident that in the years ahead we will make a meaningful contribution to the financial strength of the Canada Pension Plan.

Thank you very much.