The Challenge of Investing CPP Assets

CPP Investment Board

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Presentation

by

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Profile

Created in December 1997, the CPP Investment Board is a crown corporation that invests funds not needed by the Canada Pension Plan to pay current pensions.

Cash flows are invested in equities and real estate to balance the bond portfolio owned by the Canada Pension Plan. By increasing the long-term value of funds, the CPP Investment Board will help the Canada Pension Plan to keep its pension promise to Canadians.

Located in Toronto, the CPP Investment Board is governed and managed independently of the Canada Pension Plan and at arm's length from governments.

For more information on the CPP Investment Board, visit www.cppib.ca.

Good morning, ladies and gentlemen. Thank you for inviting me to speak to you today.

In 1902, an immigrant Scot named Robert Chambers Edwards began to publish a newspaper in this city called the Calgary Eye Opener. It was a newspaper that was both original and witty, that made a habit of lampooning society's foibles and, in particular, the ways of politicians.

"Calgary Bob," as he became known, was a true original, and at his death in 1922, he left behind a wealth of humourous but illuminating observations. One of my favorites, which turns a skeptical old proverb on its head, goes like this: "The path to success is paved with good intentions that were carried out."

This aptly describes what we are trying to do at the Canada Pension Plan Investment Board. As stewards who have been given a public trust, we are working to carry out the good intentions inscribed in our mandate to help assure the retirement future of the 16 million Canadians who contribute to and benefit from the Canada Pension Plan.

With the conviction that good designs and intentions can and do produce good results then, I would like to speak to you about the origin, the current position and the future direction of the CPP Investment Board and how we're helping to secure the pension promise for Canadians.

The CPP Investment Board is part of a solution to a severe under-funding problem that became apparent at the CPP in the mid-1990s. Conceived by nine provinces and the federal government as a Crown corporation that would employ professional investment managers to manage the reserve assets of the CPP, the CPP Investment Board was given a clear mandate: to maximize returns without undue risk. Importantly, we were also given a governance structure that would ensure independence from the political process yet hold us accountable to the people of Canada.

Our history is brief: we were created by Act of Parliament less than seven years ago and, as of this March, it will have been exactly five years since we began investing CPP assets. In this short time, we have made significant progress in diversifying and building the CPP reserve fund – the excess funds not needed to pay current pensions.
We have worked to balance the plan's traditional holdings in government bonds and cash with investments in a broad range of assets such as publicly traded stocks, real estate, and with private equities, including venture capital and infrastructure projects.

As of our last reporting date in September, the reserve fund of the CPP is $64.4 billion and growing – by our estimates, to roughly $80 billion by 2007 and to as much as $160 billion within a decade. This will not be a straight-line progression. As we continue to diversify and build this portfolio, we fully expect there will be short-term ups and downs. But we are equally confident in the overall direction and long-term success of our strategy.

We are experienced investment professionals who are totally committed to doing our job of helping ensure the long-term retirement needs of Canadians.

I would now like to talk a bit more about why we were created, where we are today and what we are doing to keep our pension promise to you, your children and your grandchildren. I hope to demonstrate that the road to retirement security can, in fact, be paved with good intentions well fulfilled.

Afterwards, I welcome any questions you may have.

Past

I said initially that the creation of the CPP Investment Board was a federal-provincial response to the funding problem of the CPP in 1996. Some background here might be helpful.

At its inception in 1966, the Canada Pension Plan was designed as a pay-as-you-go system. The idea was that each generation would pay the pensions of the previous generation. That made sense in the 1960s because the number of retired Canadians was small relative to the working population.

For 30 years, the CPP worked fairly well. Substantially more money flowed in than out, providing working Canadians with retirement income, as well as financial help should a breadwinner die or become disabled.

By 1996, however, $17 billion was paid out in benefits while only $11 billion was collected in contributions. The plan was headed for serious trouble, particularly considering the worsening ratio of workers to retired persons. In 1966, there were seven workers for each pensioner. Today the ratio is five to one, and by 2030, it is estimated there will be only three workers for every retiree.

Like other industrialized countries, Canada was sitting on a demographic time bomb. Unless reforms were made, the CPP was not going to be viable for future generations.

Fortunately, the federal and provincial finance ministers, as stewards of the plan, realized the severity of the problem and acted. One of their key reforms was to increase contribution rates from 6 per cent in 1997 to 9.9 percent today.

The second major change was the creation of the CPP Investment Board as an independent organization, separate from the plan itself, to manage and grow the reserve assets of the CPP.

As the CPP Investment Board was being developed, there was extensive consultation, not only among the participating provincial governments and Ottawa, but also with the people of Canada through a series of coast-to-coast public meetings. It was through this process, in fact, that it was decided that reserve assets should be entrusted to a corporation that would operate with private sector discipline and expertise, and remain operationally independent of government.

Collectively, the changes have meant that the Canada Pension Plan is moving from a pay-as-you-go scheme to being partially funded.

I said earlier that our legislated mandate is to invest in the best interests of CPP contributors and beneficiaries and to maximize long-term investment returns without undue risk of loss.

“Long-term,” for us is much longer than it is for most other pension funds. Corporate and public pension plans are of necessity forward looking, but our horizon is measured in decades rather than months, quarters or even years.

Thanks to the foresight, indeed, the courage, of the provincial and federal finance ministers who designed our governance structure, we are able to focus exclusively on our mandate. Our governance model balances independence from government with rigorous public accounting and responsibility to Parliament, the provinces and the people of Canada.

This balance is achieved in a number of ways. One is through the composition of our board. Our legislation requires us to have “directors with proven financial ability or relevant work experience.” Until recently, the idea of mandating competency was radical. In doing so, our legislation was visionary.

We also benefit from a director appointment process unlike that of other Crown corporations. In our case, a committee appointed by the federal and provincial finance ministers nominates candidates who are then selected by the federal finance minister in consultation with the provinces. As a result, our board consists of experienced professionals with backgrounds in accounting, economics, actuarial science and investment banking – from both the public and private sectors. Candidates are drawn from all of Canada. They are able, knowledgeable and independently minded.

As well, our legislation gives the board powers that reinforce the buffer zone between governments and our investment professionals. The board, for example, appoints the chief executive officer and approves major policies free of any political involvement.

Above all, CPP pension reserves are segregated from general government revenue. These assets belong to 16 million Canadians through the promise of future pensions.

The result is that our investment professionals are free to make long-term investment decisions and meet their fiduciary responsibilities to Canadian workers without fear of political interference. That has been a problem for other national pension plans. We have avoided it.

For all our independence, however, we are accountable. The federal and provincial governments and citizens at large have ample ability to see what we're doing with Canadians' money. As our disclosure policy states: "Canadians have the right to know, why, how and where we invest their CPP money, who makes the investment decisions, what assets are owned on their behalf, and how the assets are performing." Consequently, we disclose comprehensive and timely information about our investments, our performance, our policies and our practices.

Where has this reform gotten us so far? What is the proof in the pudding? In 1997, the Canada Pension Plan ran a deficit of $6 billion. Today, as I mentioned earlier, the reserve fund of the CPP has grown to more than $64.4 billion. Thanks to higher contribution rates and investment income from CPP assets, the funding problem is behind us.

The design of the CPP Investment Board is a model that is gaining international acclaim. After examining our governance and practices, the World Bank cited us as a best practice model among national pension plans, precisely because we have an independent board and an investment decision-making process free from political influence. And a key feature of our model is the checks and balances that result from the involvement of both the federal and provincial governments.

Present

I would now like to look at the present state of the CPP Investment Board and how we're diversifying the portfolio in order to build the reserve fund.

In the five years since the CPP Investment Board began investing, we have built an organization well suited to the task of managing CPP assets. In summary, we have:

- Developed a strong and experienced board of directors and set a new standard for independence and good governance;
- Defined investment policies and guidelines that reflect the CPP Investment Board's distinctive mandate;

- Grown to a core team of 48 people with deep investment expertise and a strong commitment to fulfilling our duty to Canadians;

- Hired a group of world-class external investment partners to assist in the management of our growing private equity portfolio;

- Kept our promise to tell Canadians fully and faithfully about our activities through regular disclosure, press releases and public meetings, and by posting our investment strategy and policies, our investment beliefs, details of our investments, proxy voting guidelines, and other materials on our website.

These are the ways we have built a strong institution. Now let me speak of what we have done to manage the portfolio.

When we began operations in October 1998, CPP assets were solely 20-year government bonds and liquid, short-term government securities. As of our last reporting date, bonds and cash form $37 billion or 57 per cent of CPP assets. The remaining 43 per cent, slightly more than $27 billion, is managed by the CPP Investment Board and is being invested in a broad range of assets to diversify the portfolio.

The reason for this is straightforward. Government bonds alone are not expected to achieve sufficient returns over the long term to sustain the plan. Over the long term, bond yields would likely fall short of the 4 percent real rate of return the Chief Actuary for Canada has said is the minimum threshold necessary to sustain the plan.

In other words, what some people might regard as a very “safe” or “conservative” portfolio would almost certainly leave the plan short of the returns it needs to be truly sustainable. Given this reality, what might feel safe in the short-term would indeed be quite risky for the long-term.

The solution is to diversify into other asset classes with higher return potential over time. And we are doing it through prudent investment decisions in line with comprehensive investment policies and within strict risk/reward parameters.

From the beginning, we have attempted to structure a well-diversified portfolio with holdings in a variety of asset classes, including public and private equities, real estate and infrastructure.

As you would expect, the equity portion of the portfolio attracts the most attention. We expect that equities will pay a premium over the long term compared to bonds, but this, of course, means weathering short-term market volatility. Volatility generates headlines, but it has little impact on the long-term performance of the plan. As I said at the outset, long term for us means 18 years rather than 18 months.

This is why we don’t get too excited when we have a great quarter, and not too glum when we don’t.

We are also diversifying the portfolio geographically and by industry sectors. In line with the foreign property rule, 70 percent of CPP assets are invested broadly throughout the Canadian economy. The rest is invested abroad.

To date, we have committed approximately $5.5 billion to private equity and venture capital investments. As an asset class, private equity enables us to put large sums of capital to work in investments that can generate attractive risk-adjusted returns over longer-time periods, typically 8-12 years.

And last month, we announced our first infrastructure investment commitment to a fund that will invest in North American infrastructure assets, including pipelines, electricity generation and transmission networks, located primarily in Canada. Infrastructure investments provide an effective means of ensuring our returns keep pace with inflation.

What all this means is that the future security of the Canada Pension Plan will rest on a strong and well-diversified asset base.

Many Canadians are unaware that we are now building the Canada Pension Plan's reserve assets. They are still concerned that money may not be there for them when they retire… a myth promulgated during RSP time.

Given the high profile news of the Canada Pension Plan's crisis back in 1996, perhaps it isn't surprising that many Canadians are still concerned that the CPP won't be there for them.

The question I am asked most frequently is: "Will the money be there when I retire?" The answer is yes, the money will be there. We will contribute our share of Canadians' retirement incomes.

As you know, the CPP is a national pension scheme intended as a building block of the total retirement income of Canadians that includes employer-sponsored pensions and registered retirement savings.

Today I am calling on the financial services industry to help us dispel the unsettling myth that the CPP may not be there for Canadians. As financial planners and investment advisors to millions of Canadians, they're ideally positioned to deliver this important message.

In fact, we are now in the fortunate position that, by maintaining the current contribution rate and growing the reserve fund, the CPP is on track to be sustainable for generations.

Last year, the Chief Actuary for Canada, who reviews the health of the plan every three years, said that the CPP, as currently constituted, is sound for at least 75 years.

Future

Which brings me to the future…

I have described the history of the CPP Investment Board, the evolutionary strategy we have followed and the nature of CPP assets today, but what does the future look like?

Earlier I noted that, given the impact of the reforms in the 1990s, establishing the higher contribution rate and the creation of our board, it's reasonable to expect that the reserve fund of the Canada Pension Plan will grow to some $80 billion by 2007 and to as much as $160 billion within a decade.

Before I describe how we will invest these funds, it's important to note how we are different from other pension plans. The single biggest difference is that our investment horizon is extraordinarily distant. The reserve fund we are building is not expected to contribute to the payment of benefits for approximately 17 years – and it will continue to grow for decades beyond that start date.

In short, we have a long-term obligation to help assure Canadians' retirement incomes and we have some distinctive and important advantages that will help us succeed doing this.

At the current contribution rate, more money will flow into the Canada Pension Plan than is needed to pay pensions until 2021. That means we have a much greater ability to structure a portfolio able to generate increased returns than a pension fund that needs income to pay pension benefits today.

Therefore, we can invest in less liquid assets that may generate proportionately higher returns over a longer time frame. Private equity, real estate and infrastructure assets are good examples. We can also take on a greater percentage of publicly traded equities with less risk than a fund that must rely on current investment income to pay out current benefits.

After five years we are poised to move to the next level. We will continue to build our internal team and to expand partnerships with world-class investment managers. We now have relationships with some 50 external partners in Canada and globally and all are best in class.

What will we invest in? In some respects, past is prologue. Bonds will remain an important component of the portfolio. While they may decrease as a percentage, we expect to continue to hold well in excess of $30 billion of government bonds.

We will continue to diversify the portfolio from that foundation into the different asset classes I have spoken of.

I cannot begin to predict the short-term ebbs and flows we may face in the different markets where we have investments, but I can say two things with certainty. We will fulfill our responsibilities as shareholders of publicly traded companies, and we will fulfill our fiduciary responsibilities to the millions of Canadians who are counting on the CPP to help ensure their retirement security.

In part, this will mean using our influence as one of the largest shareholders in Canada to encourage the good governance of corporations we invest in.

The most obvious way is to vote our shares and raise our voice in support of governance practices that we believe will contribute to long-term value creation.

We believe proxies have real economic value in that we can exercise them on your behalf to encourage improved disclosure and governance practices with shareholder interests at heart. Incidentally, I would invite all of you to visit our website and see for yourselves what our proxy voting policies and guidelines are and how we have voted.

When I say we intend to be a long-term owner, it means we do not intend to sell our shares every time we feel companies are not acting in the best interests of all shareholders. Rather, through our proxy voting principles and guidelines, we intend to provide guidance on what we regard as good governance.

As to our fiduciary responsibilities, we operate with the knowledge that we help fulfill a pension promise to the 16 million Canadians who contribute and benefit from the Canada Pension Plan. We believe our diversification strategy is a prudent way to build CPP assets to help ensure the long-term health of the plan.

No investment strategy is – or should be -- written in stone, and undoubtedly further adjustments will take place over time in line with shifting market conditions and portfolio needs. For now, we are proud of what we have accomplished, and we are confident we can meet Canadians' expectations, fulfill our mandate, and keep our promise.

Conclusion

Past, present and a sampling of the future are a lot to contemplate so early in the day. But if there are three things I hope stay with you, they would be the following: CPP assets are owned by 16 million Canadians through the promise of future pensions; we are investing those assets in a way that is accountable but ensures we are politically independent; and lastly, CPP money will be there for you when you need it.

The CPP Investment Board was born as part of a solution to a very real problem. It was carefully conceived and structured by Alberta and the other provinces and the federal government to help address the funding problems of the 1990s.

Those problems are behind us. Better still, the reforms that were taken, including the creation of the CPP Investment Board, have allowed us to make significant progress. We have seen growth in Canada Pension Plan assets and it is clear we will see more over time.

I am confident that the CPP Investment Board's careful balancing of independence and accountability, coupled with a thoughtful strategy to build the reserve assets of the Canada Pension Plan, will do much to help assure the long-term retirement needs of Canadians.

That is something of which we can all be proud. I now welcome any questions you may have.