Public Confidence and the Pension Promise

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Remarks by

by

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It is a privilege to be your luncheon speaker at this conference on the challenges facing employer-sponsored pension plans.

Your focus is on private pension plan reform. The Canada Pension Plan is an essential calculation for defined benefit plans that integrate CPP benefits when your employees reach age 65.

Consequently, the Canada Pension Plan promise matters to worker confidence in your employer plans as well as to their confidence in the CPP itself.

That's what I want to talk about. Public confidence and pension promises.

Canadians are alarmed by reports of pension plans in jeopardy at companies like Stelco and Air Canada.

Investors are nervous about shareholder liability for plans that are underwater.

They are concerned about the overstatement of expected investment returns when the conventional view for the next several years is modest equity returns and a decline in fixed-income values as interest rates rise.

More unfunded liabilities are likely to emerge in the short term as losses being carried in smoothing reserves work their way through actuarial calculations. Many employees have difficulty sorting out short-term investment cycles within the longer-term perspective because so many of their judgments are about the near future ... when they retire.

Anxiety about the pension promise is likely to grow at a time of great demographic transformation.

The first of the baby boomers are starting to retire. The last will have done so by 2030. By then … just a quarter of a century away … Canada will have only three workers for every retiree … a dramatic change from seven to one when the Canada Pension Plan was launched in 1966.

As everyone in this room knows, a quarter of a century is short term in actuarial time. But not to the average worker.

The enormous pensioner population will be healthier and live longer than previous generations. Most retirees will live almost as many years on pension as they worked. They wonder if enough money will remain in the kitty to see them through.

Some will have contributed to an RRSP … although studies show that those most likely to save in this way are higher income earners already covered by an employer pension plan.

The millions of retired workers not covered by employer-sponsored plans … and who do not have an RRSP account … will rely on the Canada Pension Plan. Our own studies show that more than half expect to do so.

Currently, the maximum CPP pension is $9,770 a year. It is intended to replace about 25 per cent of a worker's earnings.

For those who do not contribute to the CPP … their next to last line of resort is Old Age Security, a basic pension paid to Canadians over 65. The last resort is the Guaranteed Income Supplement for those with little or no other income.

Few Canadians understand what awaits them financially when they quit work. With the large boomer generation heading for retirement, we are entering a period of the rude awakening. And they do not have positive views on the pension promise. Only 48 per cent have high confidence that their plan will be able to pay reasonable benefits when they retire.

For the Canada Pension Plan, the confidence level is just as bad. Only one-third of Canadians believe it will be there for them when they retire … while 52 per cent believe it will be out of money.

Under the shadow of so much anxiety … how can we build public confidence in the pension promise?

Part of the answer is, in one word, transparency.

Transparency is not a strategy that any organization embraces intuitively. Indeed, it is still very much a reluctant concept in the Canadian pension fund industry, with good reason.

Transparency can create risks subject to liability.

Transparency can expose embarrassments that might otherwise have been dealt with effectively in private.

Transparency provides information that many people do not understand … leading to confusion and worry.

Transparency gives your critics information they can interpret differently -- and use against you.

Transparency means higher costs, including executive time, that are not necessarily offset by improved investment returns as a result of transparency.

So is transparency worth all the bother? At the CPP Investment Board, we believe it is.

We accept as part of our fiduciary duty responsibility for building confidence in the Canada Pension Plan and in our role as its investment manager.

While our experience at the CPP Investment Board is different in many respects from the way you govern and manage your pension plan … I think there are sufficient parallels to engage you.

Transparency has many meanings. Basic to the concept is demystifying pension jargon. How many people know the difference between a defined benefit plan and a defined contribution plan? Or what is meant by actuarial adjusted net asset value? Or whether an unfunded liability is a real problem or just an actuary's view of the distant future?

We believe it is important to use plain language … to explain to Canadians what is going on and what it likely means to their retirement future. They must be prepared for the short-term volatility that invariably lies ahead. Whether they choose to listen is their choice and should not dilute the fiduciary obligation to communicate.

One of the key messages that we have communicated in recent years is that the Canada Pension Plan is financially sound.

This message comes from the experts. The chief actuary for the CPP has stated that the plan is sound … on the basis of a 9.9 per cent contribution rate and a reserve fund equivalent to 25 per cent of liabilities … for at least 75 years. His opinion is endorsed by a panel of independent actuaries.

This is good news for all of us.

We have also reminded people of important features of the Canada Pension Plan that are not well known.

First, the CPP is not a federal program. The stewards of the plan are the federal ***and*** provincial governments. Together, they set the funding policy, contribution rates and benefit levels.

Second, unlike the Old Age Security and Guaranteed Income Supplement … the CPP is not government financed. It is funded solely by workers and their employers. The only financial obligation on governments is to match the CPP contributions of their employees … like other employers.

Third, CPP reserves are not part of consolidated government revenues. They sit in a segregated fund and cannot be used for any purpose other than administering the plan, paying pension benefits and making investments.

Investing the CPP reserve fund is our sole business. But moving from an historical reserve fund of government bonds and cash to a diversified portfolio of assets like stocks and real estate is not something that all Canadians readily embrace.

Still, as we state in our disclosure policy, we believe they have the right to know what we do with their money … why and how we are diversifying assets … and what assets are owned on their behalf.

Even so, few Canadians know about the CPP Investment Board – although the media frequently report on our activities and report every quarter on our investment performance.

According to public opinion surveys, 86 per cent of Canadians say they have not heard of the CPP Investment Board. While only six per cent have. The rest are vague about it.

What matters to us is that those who are interested … the experts and ordinary Canadians … can access comprehensive information. In fact, 20 per cent of pre-retirement workers have high awareness of the CPP Investment Board … an impressive population by any measure.

We make a concerted effort to encourage public understanding of our investment activities and strategy. Just visit our web site. No pension fund discloses as much as we do – or as frequently.

A key message is that … because the CPP is partially funded by design … investment income will not drive the plan's sustainability.

Fertility rates and real-wage growth will have a greater influence in preventing contributions from rising above 9.9 per cent than will investment policy.

One implication of this is that we can afford to take greater investment risk than mature plans that must be fully funded and rely on investment income to meet current pension obligations.

So what are we doing?

We manage the CPP reserve fund in the context of the plan's liabilities. This is our investment framework. It includes our investment beliefs as well as concepts that define risk-return trade offs.

Our investment policies, strategies, guidelines and procedures are all developed within this framework.

For example, risk budgeting is an integral component of our investment framework and shapes the investment strategy. We examine risk-return tradeoffs between different asset classes measured against a minimum risk performance base.

To us, risk and is the starting point … not the assets we might invest in.

Our minimum risk portfolio is a real-return bond index that acts as a proxy for the growth of CPP liabilities. It enables us to track the value added to the CPP reserve fund as we seek full compensation for all risks assumed and investment costs incurred.

What is our risk tolerance? It is potentially higher than other public pension funds. With $6 billion to $8 billion a year in cash flow … and no need to help pay pension benefits until at least 2021 … time is on our side.

We have quantified the risk of different asset classes to estimate how they might perform over the long term relative to our minimum risk portfolio.

Our research suggests, for example, that equities will on average earn two percentage points more than government bonds. Consequently, we can afford to invest a high proportion of assets in equities and be patient about earning that premium.

Five years ago, CPP assets were exclusively federal and provincial government bonds and short-term government securities. We have already built a $30 billion portfolio of Canadian and foreign publicly traded stocks. These equities make up 43 per cent of all CPP assets today. Within the next two years, we expect they will represent 58 per cent.

This is quite a change in a short period of time that should add many billions of dollars of value in the decades ahead.

Asset diversification … premised on being compensated for any risks taken … should enable the CPP reserve fund to do better than the four per cent real rate of return required to help keep the Canada Pension Plan sustainable. We think we can earn a real return of 4.5 per cent over the long term. In our first five years, we have done better with a 4.7 per cent real return.

Our risk budgeting also anticipates moving from traditional passive investing to a more active portfolio management to earn higher returns than the market and better manage portfolio risks.

The $70.5 billion in assets currently available to the CPP are expected to exceed $190 billion within a decade.

Given our emerging size, we face a portfolio risk that Canadians need to understand – the foreign property rule. As you know, it restricts pension fund investing outside Canada to 30 per cent of assets at cost.

The Canadian investment universe of high quality and highly liquid stocks is small at perhaps 320 companies. That's less than three per cent of global market capitalization. Putting so many eggs in a tiny basket is a big risk.

These companies populate relatively few economic sectors compared with those available in the U.S. and Europe. Canada has a heavy weighting of publicly traded companies in financial services, natural resources and utilities. The market is also distorted by the dominance of Nortel.

Globally there are 12 major economic sectors. Canada is not represented fully or adequately in some of them, such as pharmaceuticals and technology.

How can we better manage portfolio risk and earn higher returns? By bringing improved economic sector balance to our public equity portfolio. The experts we have retained have begun to assist us with that challenge.

We would also like to invest as much as 20 per cent of total CPP assets in real estate, infrastructure, and private equity … with a maximum 10 per cent allocation in any of these asset classes.

Right now, these assets make up about three per cent of total CPP assets … so we have a lot of growth ahead of us.

In the case of private equity … we have already committed $6 billion to more than 40 limited partnerships and funds created with the CPP Investment Board as the sole investor.

These commitments include $500 million in venture capital … positioning the CPP Investment Board as one of Canada's largest venture capital pools.

In terms of actual investments, about $2 billion has been drawn down by our private equity partners and invested in more than 2,000 underlying companies.

We like private equity because it can deliver higher long-term risk-adjusted returns than public equities … although it can take two or three years for positive cash flows to materialize.

In all this diversification, we will maintain a large bond portfolio … largely because the portfolio we inherit is non-marketable.

Sharing all this investment information – the risks and the potential rewards – is what we mean by transparency.

Let me touch on another area where we believe transparency is crucial to our mission – governance.

While a federal Crown corporation … the CPP Investment Board is very much an independent investment organization. We operate like a private sector investment management company competing in capital markets.

We are governed by an expert board with directors experienced in investing, accounting, financial management, business leadership and pension funds.

Our management team is drawn from the private sector … we follow private sector best business practices … and our corporate culture is one of reward for results.

While we operate at arm's length from government … we have a demanding – and, I dare say, unparalleled -- level of accountability to parliament, the provinces and the public.

Public confidence in our governance model is strong. More than 60 per cent of Canadians agree that investment professionals should invest CPP assets and be accountable to a board of directors with the business and investment expertise I have outlined.

However, two-thirds of Canadians are worried that there may be political interference in the way CPP assets are managed. Needless to say, we will all have to be vigilant in protecting the integrity of an unusual Crown corporation.

Let me give a small example with big ramifications of how hard we try to do the right thing.

Once a year, our directors evaluate the effectiveness of the board of directors based on a wide range of topics. Among the issues they consider is the statement (and I quote) "there has been no inappropriate pressure brought to bear on the Board, any director or management in the investment, procurement or recruitment decisions of the CPP Investment Board."

The statement seems innocuous. It isn't. Obliging directors to deal with it formally is a sharp reminder that none in good faith can ignore.

Furthermore, the Board Chair, Gail Cook-Bennett, asks the directors if any federal or provincial politician has tried to influence them. She asks me the same question in front of the board.

In my almost five years in this job, I can tell you that neither I nor the organization has ever been subject to anything that remotely felt like an attempt at political influence.

Fortunately, our brief history confirms that the political independence of the CPP Investment Board is respected on all sides and in all quarters.

Let us not forget that the CPP Investment Board was created by the federal and provincial governments to manage many billions of dollars that belong solely to workers who contribute to the Canada Pension Plan. These funds sit in a segregated account … with no financial obligation on government … and deserve to be managed at arm's length from government by professional managers under the governance oversight of an expert board.

We are independent and accountable to government and ultimately to the 16-million Canadians who contribute to the CPP. We file our annual report in Parliament through the federal minister of finance … file quarterly financial statements with federal and provincial finance ministers … and hold widely advertised public meetings every two years in the nine provinces that participate in the Canada Pension Plan.

Our next public meetings will be held in September and October. The location and specific dates are available on our website. Our Chair and I will be there and we invite you to attend.

I hope that what I have shared with you confirms that transparency has served us well in developing an understanding with interested Canadians about what we do, why we do and what the future may hold. The benefits of transparency more than offset the risks.

Public interest and concern about the governance and performance of pension plans and pension funds will no doubt escalate in the years head. Under such a scenario, transparency is, in our view, a sound and prudent strategy to adopt.

Thank you.