2005 Annual Report

THE PUBLIC SECTOR PENSION INVESTMENT BOARD

Investments

CORPORATE PROFILE

The Public Sector Pension Investment Board (PSP Investments) is a Crown corporation established to invest in capital markets the net contributions received after April 1, 2000 from the pension plans of the Federal Public Service, Canadian Forces and Royal Canadian Mounted Police. PSP Investments operates at arm's length from the federal government. Its statutory objectives are to manage the funds entrusted to it in the best interests of the contributors and beneficiaries of the Plans and to maximize investment returns without undue risk of loss.

Highlights – Fiscal Year 2005

- Consolidated net assets increase 36% to $19.4 billion
- Total portfolio return is 7.9%, compared to Policy Benchmark of 7.2%
- Policy Portfolio asset mix revised following strategic review
- Investments in additional new asset classes initiated
- New active-management policy and value-added activities implemented
- Robust Human Resources Policy put in place
- Team building continues-number of employees increases from 35 to 75

Contents

ANNUAL OBJECTIVES

The legislation governing PSP Investments requires the annual report to include its objectives for the fiscal year under review, indicating to what extent they were met, and to state its objectives for the new fiscal year. This information is summarized below.

Fiscal Year 2005 Objectives	Status*
• Implement changes to the Policy Portfolio following strategic review	√
• Complete extensive review of value-added activities and implement changes	√
• Ensure that operations can support these new activities	√
• Implement a strong human-resources process to support the growth of PSP Investments	√

* √ indicates objective was substantially or completely achieved

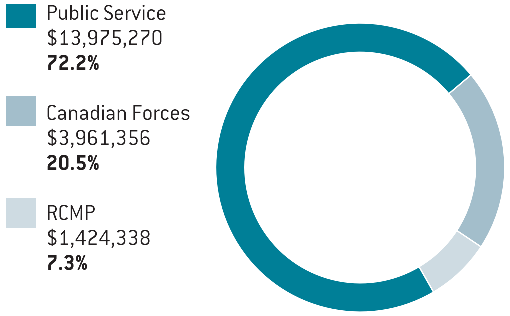
Key Objectives for Fiscal Year 2006

- Continue implementing investments in real estate, private equity and other new asset classes
- Further increase the level of active risk, within the authorized ceiling, in order to increase the level of returns
- Develop enhanced capabilities to manage private transactions
- Further strengthen infrastructure and support staff to keep pace with rapid growth of investment activities

Plan Accounts' Net Assets

(as of March 31, 2005)

($,000)
% of total net assets



Responding to a changing global investment climate

PSP Investments' response to a rapidly changing global economic and investment climate was reflected by the Board's adoption of a new vision statement and authorization of investments in a broader range of asset classes during fiscal 2005.

Objectives can and do change, as often as yearly. Strategies too are subject to periodic review and revision. But a vision should be more enduring. It should be a beacon that the organization can look to as it reviews its options and charts an appropriate course through a constantly evolving investment environment at home and abroad.

To that end, PSP Investments developed a vision statement that effectively bridges our legislative mandate and its strategy and objectives. The vision statement reads as follows:

We stand for superior investment performance aligned with our pension plans' financial obligations, and will look for it everywhere while upholding the highest ethical and professional standards.

Until now, we have invested primarily in stocks and bonds. But these are just parts of a much broader spectrum of opportunities available to us today. As you will see from the President's Report, PSP Investments already is moving forward with a considerably wider range of investments in real estate and private equity. Further down the road, we will be looking at still more asset classes, including infrastructure and natural resources/commodities. Moreover, we are increasingly seeking out investment opportunities in the broader global marketplace. As the vision statement implies, we are committed to exploring all appropriate avenues that will lead to superior investment performance.

Investments do not take place in a vacuum. So in addition to broadening our investment horizons, it is important to consider the major forces that are likely to impact the environment in which we invest.

One such force is the changing regulatory framework. For example, income trusts have emerged as major investment vehicles in Canada and recent legislative initiatives would protect investors from the risk of unlimited liability that made pension and mutual funds leery of these trusts. Now we can ask ourselves if income trusts offer good investment potential for us and act accordingly. In a similar vein, the federal government's proposal to set aside the 30% limit on foreign pension and retirement investments will allow PSP Investments to increase its direct exposure to non-Canadian opportunities.

We also need to consider our investments in the context of worldwide economic and market forces. Among them is the emergence of China and India as economic superpowers. With their enormous populations and rapidly expanding economies, these Asian giants have become low-cost venues of choice for the manufacturing of a wide range of consumer and industrial products, with voracious appetites for energy and raw materials. What will this mean for the global economy going forward – and how ought we to adjust PSP Investments' asset mix and geographic mix to take the anticipated impact into account?

As well, we must weigh opportunities abroad against economic and investment prospects closer to home, which carry their own measure of uncertainty. For instance, very sizeable trade and budgetary deficits in the United States – dominant partner in the North American Free Trade Agreement (NAFTA) – are the subject of increased scrutiny. Coupled with on-going security concerns and the NAFTA partners' differing policies on the Kyoto Accord, we see the makings of an unsettled investment environment. Of course, as investors we are not called on to formulate government policy on these issues. But we do have to make assessments of the potential impact of these various forces and factor those assessments into our investment decisions.

Complex though it may be, there is no doubt that today's global investment marketplace – characterized by increased investment options, a wealth of information sources and highly specialized expertise – offers attractive opportunities for sophisticated participants. However, we are conscious as well that seizing opportunities inevitably means taking risks. Accordingly, we are working diligently to build our risk-management skills as we build our portfolios, to ensure that PSP is, in fact, positioned among those sophisticated investors with the specialized expertise appropriate for today's market realities.

Paul Cantor
Chairperson

A governance role model

In keeping with the practice introduced during fiscal 2004, fellow Board members once again conducted their annual review of my performance as Board Chair. During fiscal 2006, we will institute a process of peer review for each Board member. Other governance-related undertakings during the course of the latest fiscal year included a review of our Human Resources Policy and the continuation of education and training sessions designed to ensure that Board members are kept up to date on relevant governance and investment issues. As well, the initial phase of the Special Examination of systems and practices was completed, in accordance with the legislation governing PSP Investments.

From the very outset, PSP Investments has been committed to best practices in corporate governance. So I am pleased to observe that our organization is serving as a model for some of the new rules being implemented by Ottawa for the governance of Crown corporations, such as the process whereby our CEO is selected and hired by the Board rather than through political appointment; as well as the arm's-length process used to identify qualified director candidates.

Proposed changes would alter framework

That being said, however, there is cause for concern about how proposed amendments to the *Public Sector Pension Investment Board Act* and the *Financial Administration Act* – as well as the government's stated intent to make PSP Investments subject to the *Access to Information Act* and the recently tabled *Conflict of Interest and Post-employment Code for Public Office Holders* – will alter the framework under which PSP Investments was established.

- Bill C-43 contains a proposed amendment to both the *Financial Administration Act* and the *Public Sector Pension Investment Board Act*. If Bill C-43 is adopted in its current form, the Governor in Council would be required to appoint the Auditor General of Canada as the auditor for PSP Investments, unless the Auditor General waives this requirement. Furthermore, the revised legislation would require that the Auditors' Reports on the financial statements of PSP Investments be submitted directly to the respective responsible Ministers. Currently, the Board of Directors appoints the external auditors and the Auditors' Reports are submitted to the Board of Directors, which forwards them to the Ministers.

- Currently, PSP Investments is not subject to the *Access to Information Act*. As part of the new rules relating to the governance of Crown corporations, it is the intention of the government to make PSP Investments subject to the *Access to Information Act* going forward. However, to ensure that vital commercial relationships with external investment managers are not compromised, the government is also formulating exemptions for PSP Investments from certain provisions of the *Access to Information Act*.
- Currently, directors are subject to PSP Investments' Conflict of Interest Policy. The recently tabled *Conflict of Interest and Post-employment Code for Public Office Holders* states that directors who are public office holders are required to arrange their private affairs in a manner that will prevent any actual or perceived conflict of interest even if permitted by law.

These changes may enhance transparency. At the same time, we believe that they will result in increased marketplace challenges.

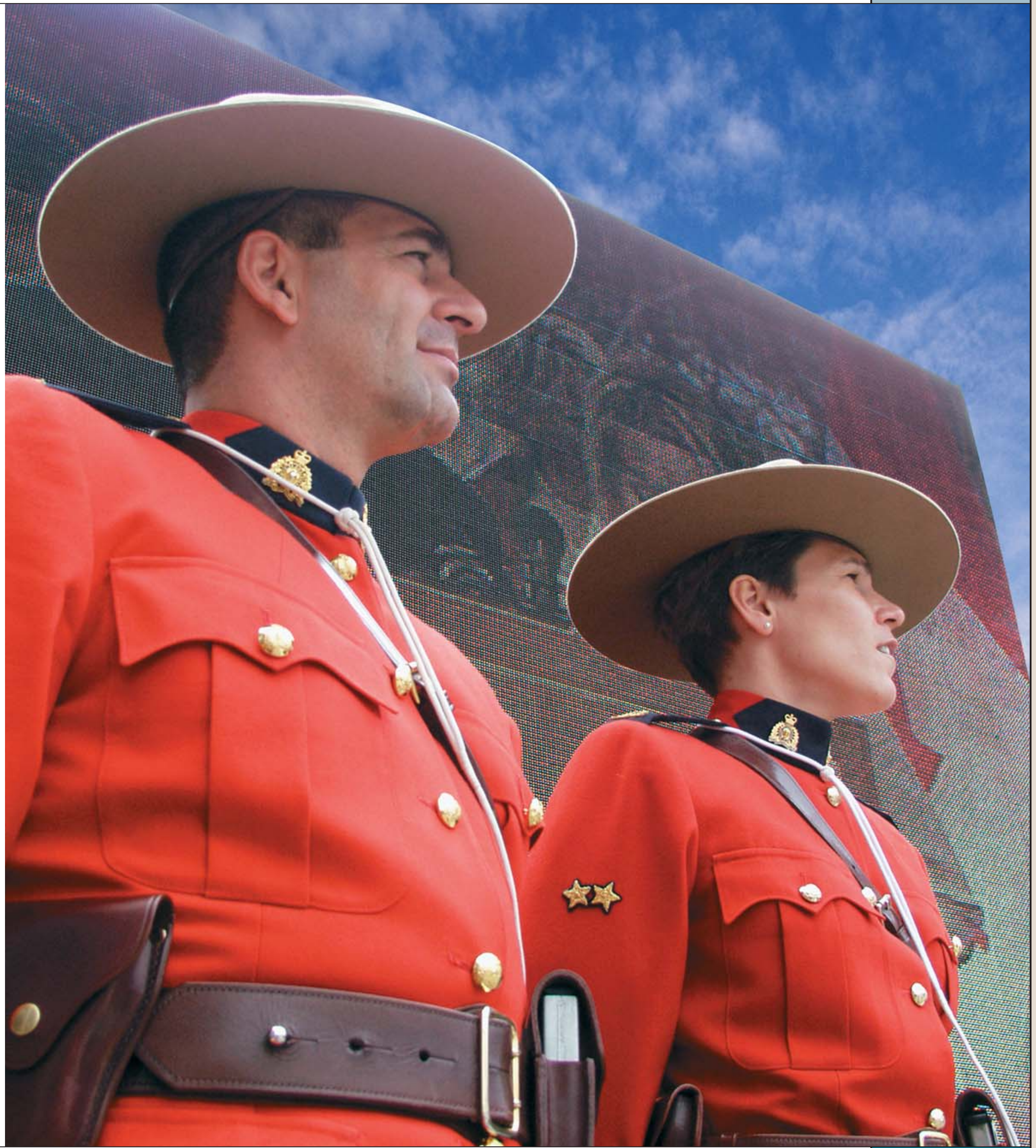
Enhanced liaison with plan representatives

In October 2004, President Gordon Fyfe and I met with representatives of the three pension plans to review events of the previous year and outline our plans and objectives for fiscal year 2006. In addition to this annual review, plan representatives have been invited to attend an off-site conference with Board members and the senior management team, scheduled for June 2005, where they will have an opportunity to participate in in-depth discussions of PSP Investments' affairs.

Acknowledgements

I would like to take this opportunity to congratulate Gordon and his colleagues for their achievements over the past year and to thank my fellow Board members for their counsel and support. We welcome Anil K. Rastogi, who joined our Board in October 2004. A seasoned executive, Mr. Rastogi is Chief Information Officer of McCain Foods Ltd. and brings to our boardroom a wealth of expertise in operations.

Paul Cantor
Chairperson



I am pleased to report that we made good on the commitments set out in last year's annual report: revisions to the Policy Portfolio asset mix, stemming from a strategic review, were initiated; we completed an analysis of value-added activities and introduced changes designed to enhance our performance in that regard; we strengthened our risk-management and operational capabilities; and we put in place a robust human-resources process. As well, we continued to build our team.

Focused on diversification and team building

To put the initiatives of the past year in perspective, consider that the mandate of PSP Investments is to (a) generate solid returns; and (b) develop the capabilities to effectively manage future growth and increased diversification of assets. I believe we made excellent progress on both those fronts.

People are the key assets in the management of money. Accordingly, my top priority as CEO in fiscal year 2005 was to continue building a strong team that has the depth and specialized expertise required to manage an expanding, increasingly diversified pool of assets within a growing organization. Noteworthy initiatives in that regard included the establishment of specialized units to manage our investments in real estate and private equity; assembly of an internal team for index and quantitative investments; creation of a department to oversee external, public-market investment managers; and initiation of a comprehensive risk-management process.

As I indicated above, we undertook a reorganization of the underlying Policy Portfolio during fiscal year 2005, allocating more funds to less-liquid asset classes such as private equity, small-cap equities and emerging markets. The changes are designed to enhance long-term returns by taking advantage of PSP Investments' unique liquidity, which is driven by net inflows of well over $3 billion a year in contributions. This exceptional level of liquidity provides us with a competitive advantage vis-à-vis other investors in capturing the return premiums offered on less-liquid investments.

Changes to the Policy Portfolio authorized by the Board of Directors in August 2004 included a reduction in the targeted allocation of assets to large-cap equities from approximately 65% to 43% – including 30% in Canadian equities, 5% in U.S. large-cap equities and 8% in international developed equities. The Board also authorized the targeted allocation of 5% of assets to U.S. small-cap equities, 7% to emerging-markets equities and 8% to private equity. The targeted allocation to debt has been reduced from 31.5% to 20%.

Other changes included approval of increased exposure to inflation-sensitive asset classes, in order to protect the portfolio against the prospect of higher inflation in the future. To that end, 10% has been allocated to real estate and 5% to "real-return" bonds whose value, contrary to ordinary bonds, rise with inflation.

By fiscal year-end, approximately $800 million had been committed to real estate – most of it to be invested directly by PSP Investments. The initial real-estate portfolio includes residential and commercial assets in Canada, the United States, Europe and Asia.

PRESIDENT'S REPORT

Our Private Equity team has so far committed approximately $30 million to external managers and we expect to commit up to $3 billion during fiscal 2006. Going forward, we intend to continue building the relationships and capabilities that will enable us to invest – directly and indirectly – in additional private-equity situations, as appropriate opportunities arise. Investments in private equity typically entail an eight-to-10-year cycle, with negative returns early on and positive returns harvested during the latter part of the cycle.

To complement our wider diversification, we also have been working to increase the proportion of assets that are actively managed in order to add more incremental value on top of the Policy Portfolio return. With that aim in mind, we issued more investment mandates over the course of the year, both externally and internally, while terminating some under-performing managers. As well, we are utilizing a broader spectrum of active management strategies, including instruments related to foreign exchange. These activities generated 0.7% in added value for PSP Investments during the fiscal year. Over all, the Consolidated Pension Plan Account produced a rate of return of 7.9% for the year.

At this writing, PSP Investments still is approximately 95% invested in public equities and bond markets. The goal over time is to see that proportion continue to decline as we further diversify our mix of investments in asset classes that play to PSP Investments' strengths in terms of size, growth and liquidity. In the future, we will be looking at other inflation-sensitive equity classes, such as natural resources/commodities – including timber – and infrastructure. On the non-equity side, we will give consideration to investing in certain less-liquid debt markets, such as mortgages, to increase returns in the portfolio.

However, public markets will continue to comprise 80%-90% of assets and account for virtually all of PSP Investments' returns over the next 12 months. The initial impact of the changes I have outlined will only be felt in fiscal 2007, when alternate asset classes, including real estate, begin to contribute meaningfully.

Turning to other areas of the organization, we significantly increased the number of employees in operations and support roles in fiscal 2005, building specialized Legal and Human Resources functions while strengthening our Finance and Information Technology teams. The head count at year's end reached 75, compared with 35 a year earlier.

The remuneration system for our investment personnel has been restructured. The annual incentive-compensation plan for investment-management professionals and the deferred incentive-compensation plan for key executives were both revised to ensure that the interests of management are closely aligned with those of PSP Investments' stakeholders. The plans are designed to reward participants for the achievement of superior investment performance and to ensure that we remain competitive in terms of being able to attract high-calibre employees. I should note, too, that our expanded Human Resources team currently is undertaking an enhancement of the performance-evaluation process for employees.

Gordon J. Fyfe
President and Chief
Executive Officer

Priorities for fiscal year 2006

Looking ahead to priorities for fiscal year 2006, we will of course be proceeding with the implementation of investments in real estate, private equity and other new asset classes. We also will be gearing up the organization to further increase the level of active risk – which is still below the ceiling authorized by the Board – in order to increase the level of returns at a rate in line with the organization's growing risk-management capabilities. Another priority on the investment side entails enhancing our capabilities to manage private transactions, i.e. mortgage and infrastructure portfolios. At the same time, we will focus on further strengthening PSP Investments' infrastructure and support staff to keep pace with the rapid growth of investment activities.

Acknowledgements

In conclusion, I would like to formally welcome those who joined our management team during the past year, including Guy Archambault, Vice President, Human Resources; Bernard Augustin, Vice President, Index and Quantitative Investments; Assunta DiLorenzo, First Vice President, General Counsel and Corporate Secretary; and John Valentini, First Vice President and Chief Financial Officer.

I also want to thank our employees, whose efforts are instrumental to the success of a fast-growing and dynamic organization. Thanks are due as well to former chief financial officer Danielle Morin for her contributions to PSP Investments during its formative years. Finally, I wish to express my appreciation to the Board for its continued support.

Gordon J. Fyfe
President and Chief Executive Officer

The Public Sector Pension Investment Board (PSP Investments) completed its fifth year of operation on March 31, 2005. During that period, it received $3.8 billion in net contributions from the Public Service, Canadian Forces and Royal Canadian Mounted Police pension funds. The market value of invested assets as of March 31, 2005 totaled $19.4 billion, compared with $14.2 billion a year earlier.

Market Performance

In general, financial markets went through two distinct phases during fiscal 2005. The first six months were sluggish, with uncertainties regarding the presidential election in the United States hanging over the markets. The next six months saw more movement.

Two main stories dominated financial headlines. The first was the resolve of the U.S. Federal Reserve Board to stifle any inflationary pressures. To that end, it raised U.S. interest rates seven times over the 12-month period. Investors watched the movements of currency markets with keen interest. The U.S. dollar continued a downward slide that had begun in the previous fiscal year, as investors worried about the "twin deficits" (fiscal and trade) in the U.S. economy. Over the course of fiscal 2005, the U.S. dollar fell by 8% against the Canadian dollar and 5% against the Euro. The U.S. deficits are currently being funded in large part by Asian investors, both public and private, who appear content to hold U.S. government and corporate bonds.

The U.S. economy continued to move forward, even in the face of the twin deficits, inflation fears, the decline of the U.S. dollar and rising interest rates. Once again, the engine of growth in the United States was the consumer, who translated earlier tax cuts into a surge in retail sales. The S&P 500 Index rose 7% for the year in U.S. dollar terms. (However, the decline of the U.S. currency meant that, in Canadian-dollar terms, the S&P effectively fell by 2%.)

The other major economic story from the past year was a spike in commodity prices. The price of oil rose 60%, closing the year at around US$55 per barrel. As well, commodity prices in general increased, reflecting investor sentiment about the current and anticipated demand for commodities in China.

The bull market in commodities and oil served to boost the Canadian equities market, which is heavily weighted towards energy and commodity issues. The S&P/TSX Composite Index rose 14% during the fiscal year.

European equity markets had a positive year despite a lack of encouraging news. Asian markets were mixed; a strong year for commodity-rich Australia was offset by a flat year for Japan, where the economy stagnated. Taken together, the MSCI EAFE Index rose 6% for the year in Canadian-dollar terms.

The Canadian bond market had another positive year. The Scotia Capital Universe Index rose 5%, as corporate-bond spreads tightened and the yield curve flattened.

Investment Results

In fiscal 2005, the Consolidated Pension Plan Account produced income of $1.35 billion, before expenses. This compares with income of $2.46 billion in fiscal 2004.

Performance Measurement and Evaluation

We use rigorous performance measurement as an essential tool for management to evaluate its investment strategies, as well as its internal and external managers.

FISCAL YEAR 2005 RESULTS

Benchmarks

- Each asset class has a benchmark defined in PSP Investments' Statement of Investment Policies, Standards and Procedures (SIP&P).
- The return for each asset class is compared against the relevant benchmark return.
- A combined Policy Benchmark has been created from the asset class benchmarks and the asset class weights established in the SIP&P.
- The Consolidated Pension Plan Account return is compared to the Policy Benchmark return.

Rates of Return on Consolidated Pension Plan Account (as of March 31, 2005)

	One year		Five-Year (annualized)		
	Portfolio Returns %	Benchmark Returns %	Portfolio Returns %	Benchmark Returns %	
Canadian Equities	15.7	13.9	3.4	3.5	S&P/TSX
Foreign Equities	1.7	1.5	-5.0	-4.9	Foreign Equity Benchmark[a]
Real Estate[b]	7.9	6.7	7.7	6.2	Real Estate Benchmark[c]
Fixed Income	5.0	4.7	7.7	7.6	Fixed income Benchmark[d]
Cash Equivalents	2.9	2.2	3.4	2.9	SC 91-Day T-Bill
Total Return	**7.9**	**7.2**	**3.0**	**2.9**	

These are time-weighted rates of return, before fees and expenses, for the consolidation of the three pension plan acounts. They are calculated in accordance with the methodology recommended by the CFA Institute, and are audited as such. Total Consolidated Pension Plan Assets include an initial investment in Private Equity.

[a] A combination of S&P 500, MSCI EAFE, and MSCI Emerging Markets Free

[b] Real Estate Investments commenced in fiscal year 2004.

[c] Canadian Consumer Price Index + 5.5% per annum.

[d] A combination of Scotia Capital Universe, Scotia Capital Short Term Federal Bond, and Scotial Capital Real Return Bond

Rate of Return

The rate of return for the Consolidated Pension Plan Account was 7.9%. The account outperformed its Policy Benchmark-which returned 7.2%-by 0.7%.

During fiscal 2005, PSP Investments aggressively took steps to further diversify the sources of both absolute performance (i.e. the asset classes in the Policy Portfolio) and relative performance (i.e. the active strategies and managers employed). Performance-enhancing initiatives were spread across a wider range of asset classes and active strategies. This trend will continue in fiscal 2006, as PSP Investments continues to work towards achieving its objectives. Further details can be found in the Investment Policy and Strategy section of this report.

Changes in Net Assets

The Consolidated Pension Plan Account began fiscal 2005 with net assets of $14.2 billion at market value. Consolidated net contributions during the year added $3.8 billion. After factoring in the net income from investment, consolidated net assets as of the fiscal 2005 year-end were $19.4 billion at market value.

Expenses

The cost of operating PSP Investments during fiscal year 2005 totaled $35.1 million, compared to $21.1 million in fiscal year 2004. The total expenses are comprised of operating expenses ($20.8 million in fiscal year 2005 versus $12.1 million in 2004) and external investment management fees ($14.3 million in fiscal year 2005 versus $9.0 million in fiscal year 2004). The higher costs can be attributed mainly to the growth in assets under management, the hiring of additional staff to implement and support our investment strategies and the increase of activities in our real-estate and private-equity operations.

Total expenses amounted to 0.211% of average assets – or 0.125% of average assets, when external investment management fees are excluded. External investment management fees increased because of the significant growth in assets (36%) and the high proportion of those assets allocated to external managers.

Expenses will continue to increase in fiscal year 2006. External investment management fees will rise as a consequence of the expected growth in PSP Investments' assets and the high proportion that will again be allocated to external active managers. There will also be a substantial increase in operating expenses, reflecting the hiring of additional staff to support the implementation of more internally managed and active investment strategies, the continued development of specialty asset classes, such as private equity, real estate and infrastructure, indexed and quantitative investments and the continued amortization of investment in major new technology systems.

We remain vigilant about expenses and are committed to maintaining tight financial controls. Also, on a long-term basis, PSP Investments will increase its portion of investments managed internally and therefore lower the ratio of external management fees to average assets.

This section summarizes the statutory investment objectives of the Public Sector Pension Investment Board (PSP Investments) as well as the policy and strategy being used to achieve these objectives. A complete review of investment strategy during fiscal 2005 led to the development of a revised asset-mix policy, which includes allocating more money to asset classes that are less liquid and provide greater protection against inflation. Concurrently, management developed a new active-management policy. This focuses on the efficient utilization of active risk, in order to generate returns in excess of those of the Policy Portfolio.

Investment Objectives

The mission of PSP Investments is set out in section 4 of the Act:

- to manage funds in the best interests of contributors and beneficiaries under the Plans; and
- to maximize returns without undue risk of loss.

Based on these statutory objectives, the following investment objectives were established:

1. ***Absolute Performance:*** Achieving a return (net of expenses) at least equal to the actuarial rate of return as determined by the Chief Actuary of Canada; and
2. ***Relative Performance:*** Achieving a return exceeding the Policy Benchmark return by 0.50% (with a minimum value-added component equal to expenses).

These two objectives were met in fiscal 2005.

Asset-mix Policy

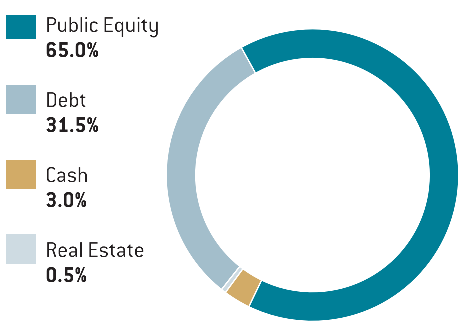
In fiscal 2005, PSP Investments conducted a complete review of its investment strategy. The main goal of this exercise was to determine the asset-mix policy that is best suited to achieving PSP's mission, as set out in the Act. Within this context, another goal was to emphasize "alternative" asset classes that provide a premium for lower liquidity as well as protection against inflation.

The outcome of the review was a new asset-mix policy that was approved by the Board of Directors in August 2004. The major changes are:

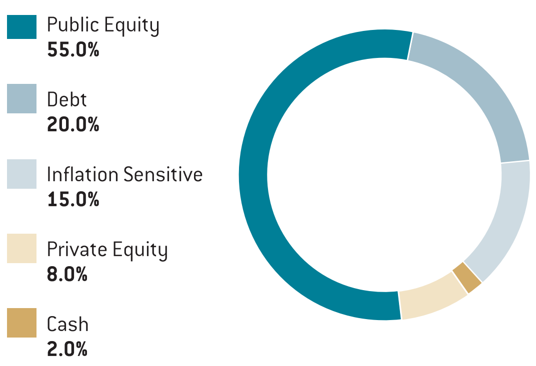
- A decrease in targeted allocations to global, large-cap public equity markets, in favour of less-liquid markets such as small-cap equities, private equities and emerging markets.
- A decrease in targeted allocation to liquid government debt (namely conventional government bonds), in favour of inflation-sensitive asset classes such as real-return bonds and real estate.

Evolution of the Asset-Mix Policy

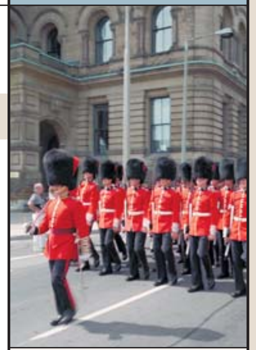
March 31, 2004



Approved August, 2004



INVESTMENT POLICY AND STRATEGY



The revised Policy Portfolio calls for the assets to be invested as follows:

Public Equities	**55%**
Canadian Equities	30%
Large Cap U.S. Equities	5%
Small Cap U.S. Equities	5%
International Developed Market Equities	8%
Emerging Market Equities	7%
Private Equities	**8%**
Debt	**20%**
Inflation-Sensitive	**15%**
Real Estate	10%
Real Return Bonds	5%
Cash Equivalents	**2%**

The process of reallocating assets to match the asset-mix policy is ongoing and should be substantially completed by the end of fiscal 2006.

Active Management Strategy

In addition to refining the asset-mix policy, PSP also adopted a more sophisticated approach to seeking added value on top of the Policy Portfolio. The Board has approved a "risk budget" that management can allocate to active strategies. Within this framework, management works to optimize its "roster" of active strategies, in order to meet the value-added objectives set out above.

In the past, the only active-management activities undertaken were within the asset classes of the Policy Portfolio (for example, as part of the allocation to Canadian Equities, a manager would be hired with a mandate to add value over the Toronto Stock Exchange's S&P/TSX Composite Index). Such activities remain an important element of PSP's approach, but the universe has been expanded: the asset classes of the Policy Portfolio are no longer a limiting factor in the search for added value. Mandates have been awarded to managers in other spheres, such as currency management and tactical asset allocation across countries and asset classes.

Over the course of fiscal 2005, PSP awarded a number of active mandates to internal and external managers. A number of managers were terminated during the year as well. Finally, an internal team has been assembled that will look to add value through quantitative management in equities and fixed income.

Investment Risk Management

A critical aspect of the revised asset-mix policy and active-management strategy is PSP's focus on measuring and managing investment risk. A fundamental law in investing is that the search for returns necessarily involves taking on some level of risk. In this context, risk is not something to be avoided. Rather, it is something to be *managed*, intelligently and efficiently, in the quest for superior investment performance.

The risk-management philosophy at PSP has evolved constantly since the organization's inception. Today, a rigorous process is in place, overseen by a dedicated team of professionals and supported by the appropriate systems. Risk is measured at all levels, from individual stocks up to total PSP assets. The diversification benefits of investment in different asset classes and investment styles also can be quantified.

The main benefit of the process is that new opportunities – in terms of asset classes, investment styles and individual managers – can be evaluated with regard to the additional risk they entail and the potential rewards and/or diversification benefits they offer.

Ultimately, by following the risk-management process, PSP can optimize its investment structure, with a view to maximizing returns for a given level of risk.

GOVERNANCE

Effective governance is essential in order to safeguard the capital entrusted to the Public Sector Pension Investment Board (PSP Investments) and to ensure that appropriate objectives are pursued and achieved in line with the fulfillment of its legislated mandate. This section of the annual report presents pertinent information on PSP Investments' mandate, the roles of the Board of Directors and Board Committees and key policies designed to guide the organization's activities and behaviour.

Legislated Mandate

The legislated mandate of the Public Sector Pension Investment Board (PSP Investments) is:

- To manage funds received "in the best interests of the contributors and beneficiaries" of the three Plans; and
- To invest "with a view to achieving a maximum rate of return without undue risk of loss, having regard to the funding, policies and requirements of the Plans... and the ability of those Plans to meet their financial obligations."

The legislation states that PSP Investments shall not, directly or indirectly, carry on any business or activity or exercise any power inconsistent with these objectives.

Relationship to Pension Plans

Effective April 1, 2000, the federal government created three new pension funds – one each for the existing Public Service, Canadian Forces and Royal Canadian Mounted Police (RCMP) pension plans. These pension funds receive the employer and employee contributions in respect of each plan to provide for liabilities for service after April 1, 2000. The balances (that is, contributions after payment of benefits accrued since April 1, 2000 and after plan administration expenses) are transferred to separate accounts at PSP Investments, to be invested in accordance with the approved investment policy and strategy.

The government is the sponsor and administrator of the Plans. The President of the Treasury Board is responsible for the Public Service Plan, the Minister of National Defence for the Canadian Forces Plan, and the Solicitor General of Canada for the RCMP Plan.

The President and CEO and the Chairperson meet once a year with the Advisory Committees of the Plans. On-going communication also is in place with the Chief Actuary of Canada.

Accountability and Reporting

PSP Investments' President and CEO is appointed by and reports to the Board of Directors. The Board of Directors reports to Parliament through the President of the Treasury Board, who is responsible for PSP Investments' legislation and is required to table its annual report in Parliament. PSP Investments is required to provide quarterly financial statements and the annual report to the President of the Treasury Board, the Minister of National Defence and the Minister of Public Safety and Emergency Preparedness.

Annual meetings with the Advisory Committees of the Plans are also part of PSP Investments' reporting requirements.

Selection of Directors

A Board of Directors comprised of 12 members, including the Chairperson, governs PSP Investments. At March 31, 2005, 11 board positions were occupied and the nominating process had been initiated to fill current and anticipated vacancies. The Governor in Council appoints all members on the recommendation of the President of the Treasury Board. Qualified candidates for directorship are selected and recommended to the President of the Treasury Board by an eight-member nominating committee that operates at arm's length from the government. PSP Investments' legislation disqualifies as directors members of the Senate, the House of Commons and provincial legislatures, federal government employees and those entitled to benefits from the three Plans. (The list of current Directors may be found on page 67.)

Biographical information about each of the Directors may also be viewed on PSP Investments' Web site: www.investpsp.ca under About Us – Board of Directors.

Duties of Directors

In order to ensure that legislated and regulatory objectives are met, the Board of Directors has defined its role to include, among other responsibilities, the following:

- Appointment of the President and Chief Executive Officer (CEO);
- Approval of a written Statement of Investment Policies, Standards and Procedures;
- Approval of strategies for achieving investment performance objectives;
- Adoption of appropriate policies for the proper conduct and management of PSP Investments, including a Code of Conduct, Conflict of Interest Procedures and risk-management policy;
- Approval of human-resources and compensation policies;
- Establishment of appropriate performance evaluation processes for the Board of Directors, the President and CEO and other members of senior management;
- Preparation and approval of quarterly and annual financial statements for each underlying pension plan account and for PSP Investments as a whole.

Board Committees

The Board of Directors has established the following four standing committees to assist in the fulfillment of its obligations:

- Investment Committee;
- Audit and Conflicts Committee;
- Governance Committee; and
- Human Resources and Compensation Committee.

Recommendations of Board committees are subject to the approval of the full Board. The Investment Committee includes all the members of the Board. The composition of the other committees is set out on page 67 of this report.

Further information relative to PSP Investments' committees, including their specific terms of reference, may be viewed on PSP Investments' Website: www.investpsp.ca under Governance – Duties & Responsibilities.

Directors' Compensation

The approach to director remuneration adopted by the Board, on the recommendation of the Governance Committee, reflects key requirements of the Act, which state that: (a) the Board should include: a "sufficient number of directors with proven financial ability or relevant work experience such that the Board will be able to effectively achieve its objectives"; and (b) that directors' compensation should be set "having regard to the remuneration received by persons having similar responsibilities and engaged in similar activities".

The Board reviews directors' compensation once every two years and considers whatever changes may be warranted based on a report and recommendations provided by the Governance Committee. The most recent review was conducted in fiscal year 2004. As of April 1, 2004, each director receives an annual retainer of $20,000 and meeting fees of $1,500 for each Board of Directors' meeting and $1,000 for each committee meeting. However, only a single fee is paid when Board and Investment Committee meetings are held concurrently. In recognition of the significant additional time and responsibility demanded of the chairs of Board committees, committee chairs receive an additional retainer of $7,500 per year.

The Board Chairperson – who is responsible for the effective overall operation of the Board and its activities, as well as for the relationship between the Board and management, and for PSP Investments' reporting relationship to its stakeholders – is paid a total of $98,000 per annum in recognition of those services, while foregoing all other retainers and meeting fees.

The Board met nine times during fiscal year 2005 and its Committees held 25 meetings. In recognition of the added impact on Board members who are not from central Canada, an additional fee of $1,000 is paid to directors who attend a meeting in person if their primary residence is not in Quebec or Ontario.

The compensation paid to directors during fiscal year 2005 is summarized in Note 7(a) to the financial statements of PSP Investments. The Terms of Reference for the Board Chairperson and for the Board of Directors may be viewed in their entirety on PSP Investments' Web site: www.investpsp.ca under Governance – Duties & Responsibilities.

Conflict of Interest Procedures

The Conflict of Interest Procedures for Directors are intended to provide a workable process for identifying, minimizing and resolving potential conflicts of interest. They help ensure that directors have a full understanding and appreciation of PSP Investments' principles and values to assist them in determining appropriate business practices and behaviour.

The Conflict of Interest Procedures for Directors sets out in detail the statutory and fiduciary duties of the directors relating to conflicts of interest. The Conflict of Interest Procedures include a requirement for the provision of written notice by directors to the Board of Directors of the nature and extent of the directors' interest in a transaction or proposed transaction; prohibit directors from voting on a resolution or participating in a discussion relating to any transaction involving their interests; require the disclosure of any other business activity which, directly or indirectly, affects the activities of, or is in competition with, PSP Investments; require the abstention from voting and the physical absence from discussions relating to any resolution if the director is also a director, employee or consultant of the bidder, has more than a 10% financial interest, when the investment represents more than 5% of the director's financial worth or an associate of the director's household is a director or employee of the bidder. The Audit and Conflicts Committee of the Board of Directors is responsible for monitoring the application of these procedures.

The Conflict of Interest Procedures may be viewed in their entirety on PSP Investments' Web site: www.investpsp.ca under Governance – Conflict of Interest Policy.

GOVERNANCE

Assessment of Board Performance

The regulations adopted under PSP Investments' governing legislation require that the Board of Directors set out in the annual report the procedures in place for the assessment of its own performance. A formal performance evaluation policy, adopted in accordance with those requirements, focuses on procedures designed to encourage frank and confidential discussions between the Chairperson and individual directors, as well as between the Chairperson and the President and CEO of PSP Investments.

To facilitate the assessment process, guidelines for evaluating the performance of the Chairperson and of the Board as a whole are distributed once a year to every director as well as to the President and CEO. The guidelines take the form of a questionnaire. Directors submit their completed questionnaires to the Chair of the Governance Committee, who summarizes the information and presents it to the Board of Directors. The discussion focuses on concerns and opportunities for improvement, what is working properly or has improved since previous assessments. In fiscal 2006, board members will also conduct peer reviews of their performance.

Code of Conduct

In accordance with its governing legislation, PSP Investments has a Code of Conduct for officers and employees. As well as ensuring stringent compliance with the relevant statutory requirements, the Code serves as a framework that provides officers and employees with a full understanding of the organization's corporate principles and values to assist them in determining appropriate business practices and behaviour. It includes a "whistle-blowing" provision, designed to encourage officers and employees to step forward and report any questionable practices.

Among other things, the Code deals with honesty and integrity; compliance with the law; use of confidential information; reporting of personal investment transactions; receiving or giving entertainment, membership in and public representation of nonprofit and professional associations; and personal use of PSP Investments' resources, assets and facilities. As well, PSP Investments maintains a restricted list of securities in respect of which the organization has confidential knowledge. Officers and employees are prohibited from trading in securities on the restricted list.

The Audit and Conflicts Committee is responsible for monitoring the implementation and enforcement of the Code.

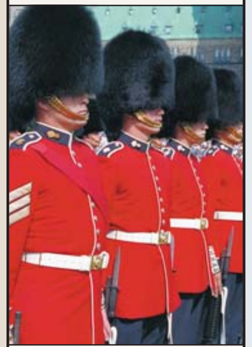
The Code of Conduct may be viewed on PSP Investments' Web site: www.investpsp.ca under Governance – Code of Conduct.

Proxy Voting Guidelines

The Proxy Voting Guidelines are designed to ensure that shares beneficially owned by PSP Investments will be voted in accordance with its investment policy and objectives.

The Guidelines stipulate that PSP Investments will be mindful of best corporate governance principles when considering the merits of an issue and will exercise its voting rights with a view to maximizing the value of its shareholdings. The Guidelines focus on four areas considered crucial in terms of their potential impact on performance:

- the independence, size and effectiveness of a company's board of directors;
- management and directors' compensation, including stock options and incentive compensation plans;
- takeover protection; and
- shareholder rights.



The Guidelines apply equally to securities managed internally and those held in portfolios managed for PSP Investments by external managers.

The Proxy Voting Guidelines may be viewed on PSP Investments' Web site: www.investpsp.ca under Investments – Proxy Voting Guidelines.

Policy on Social and Environmental Responsibility

The primary responsibility of PSP Investments is to provide for the financial benefit of contributors and beneficiaries of the Plans from which it receives funds and to support the fulfillment of the pension promise explicit in those plans. That responsibility notwithstanding, the Policy on Social and Environmental Responsibility states that "the environmental and social impact of the behaviour of corporations may be one of a number of factors that our investment professionals would wish to take into account in making investment decisions for the Plans".

The Policy on Social and Environmental Responsibility may be viewed on PSP Investments' Web site: www.investpsp.ca under Investments – Policy on Social & Environmental Responsibility.

Special Examination

As provided in subsection 44(1) of the *Public Sector Pension Investment Board Act*, the President of the Treasury Board is required to cause a Special Examination to be carried out at least once every six years in respect of PSP Investments and its subsidiaries.

This is not an audit in the conventional sense. Rather, the purpose of the Special Examination is to determine if the financial and management control and information systems and management practices, referred to in paragraph 35(1)(b) the Act, "were... being maintained in a manner that provided reasonable assurance that they met the requirements of paragraphs 35(2)(a) and (c)" of the Act. Further information relative to these requirements may be viewed on PSP Investments' Web site: www.investpsp.ca under About Us – Mandate. Click on the link to the Public Sector Pension Investment Board Act

There are three phases to the Special Examination process: Phase I, completed in fiscal 2005, entailed the definition of focus areas; Phase II, scheduled for the first half of fiscal 2006, entails carrying out the actual examination; and Phase III entails reporting the findings.

A

Act
The Public Sector Pension Investment Board Act is the legislation which governs PSP Investments.

Active Investment Management
The application of manager skill in selecting investments, with the goal of earning higher returns than the general market.

Active Risk
The probability of investment losses-relative to a benchmark – from active investment management.

Annual Report
A publication that includes the audited financial statements of an organization as well as management's discussion and analysis (MD&A) of its financial results and operations. PSP Investments' annual report must be issued within 90 days of its March 31 year-end and tabled by the President of the Treasury Board in the House of Commons.

Annualized Rate of Return
A rate of return expressed over one year, although the actual rates of return being annualized are for periods longer or shorter than one year.

Asset Mix
The proportion of assets invested in cash, fixed income securities, equities and other asset classes. Asset mix should reflect an investor's investment goals and risk tolerance.

Asset Mix Policy
Policy setting the guidelines for the management of the asset mix needed to achieve an expected level of investment returns. Pension funds set their asset mix policy to ensure that investment returns plus plan member contributions are sufficient to pay all current and future pension benefits. In making our investment decisions, we take into consideration the financial obligations of the three public sector pension funds for which PSP Investments invest money.

B

Basis Point
One-hundredth of a percentage point. The difference between 5.25 per cent and 5.50 per cent is 25 basis points.

Benchmark
A standard against which rates of return can be measured, such as stock and bond market indexes developed by stock exchanges and investment dealers.

Business Resumption Plan
Corporate plan to ensure the maintenance of essential business operations while recovering from a significant disruption. The Business Resumption Plan and the Disaster Recovery Plan combined ensure that the corporation maintains its essential activities while rebuilding the infrastructure of the corporation.

C

CFA Institute
The CFA Institute (CFAI) is an international, nonprofit organization of more than 70,000 investment practitioners and educators in over 100 countries. The investment performance standards of CFA details methodology and guidelines that promote uniformity in reporting investment performance.

Cash Equivalents
Short-term, highly liquid securities (e.g. commercial papers, treasury bills, demand notes) with a term to maturity of less than one year from the date of issue. These investments are relatively easy to convert into cash.

Cost Value (or Book Value)
The purchase price, or original cost, of an investment.

Custodian
An independent organization entrusted with holding investments on behalf of the owner. The custodian maintains the financial records for the investments and may perform other services for the owner as well.

D

Derivatives
Financial contracts that derive their value from an underlying asset or index, such as an interest rate or foreign currency exchange rate. For example, a derivative contract based on the S&P 500 Index of large U.S. stocks fluctuates in value with the index, but involves buying one contract rather than each stock in the index. Derivatives can be less expensive and easier to acquire than the underlying assets. They can be used to manage risk, reduce cost and enhance returns. Some common derivatives are forwards, futures, swaps and options.

Disaster Recovery Plan
Corporate plan to address information technology disruption by identifying, documenting and testing processes aiming to facilitate recovery of technology capabilities.

Diversification
A strategy to spread investment risk among different asset classes (stocks and bonds), different types of assets (public and private equities), among securities (different stocks), among economic sectors (financial services and natural resources) and among different countries.

E

Equities (or Stocks)
Financial instruments that represent an ownership interest in a corporation, as well as a claim to proportionate shares of that corporation's assets and earnings.

F

Fair Value (or Market Value)
The most recent price at which a security transaction took place.

Fiscal Year
A company's accounting or financial reporting year. Our fiscal year commences April 1 and ends March 31.

Fixed Income Securities
Securities, such as bonds, mortgages, debentures and preferred shares, that generate a predictable stream of interest by paying a fixed rate of return until a specific date, maturity or redemption.

Foreign Currency Risk
The risk that an investment's value will be affected by changes in exchange rates. International investments cause investors to face the risk of currency fluctuations.

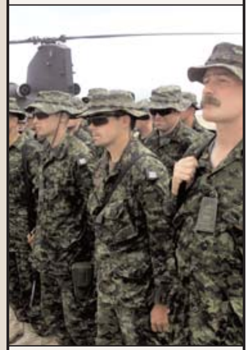
I

Index
A broad-based measurement of a general market trend. Called an index because it is designed to reflect not only price changes, but value changes as well.

Index Fund
An investment fund that closely replicates the return of a market index.

Infrastructure
Long duration assets – like highways, utilities, transportation, and pipelines – expected to produce low-volatility returns with a cash component similar to that of the fixed income markets.

Investment Management Fee
An annual fee paid to an investment manager for its services. The fee can be based on the level of assets under management, or on the performance of the portfolio.



M

Market Risk
Market risk is the risk that the value of an investment will fluctuate as a result of changes in market prices, whether those changes are caused by factors specific to the individual investment, or factor affecting all securities traded in the market.

MSCI EAFE Index
A stock index created by Morgan Stanley Capital Inc. (MSCI) to measure the returns of investments in Europe, Australia and the Far East. It contains stocks from 21 countries, including Japan, Australia, Hong Kong, New Zealand, Singapore, the U.K. and the Euro zone countries.

O

Option
A derivative contract that grants the owner the right, but not the obligation, either to buy or sell a specified quantity of an asset at a fixed price on or before a specific date.

P

Passive Investment Management
A strategy designed to replicate a market index return by gaining exposure to individual securities in proportions that closely resemble their composition in an underlying index.

Pension Plan Account (or Plan Account)
Separate account established by PSP Investments for each of the pension plan funds to receive the pension fund's net contributions as well as the allocation of its investments and the results of its operations. There are three (3) pension plan accounts, one for each pension plan fund.

Pension Plan Fund
Created effective April 1, 2000 by the federal government to receive the employer and employee contributions in respect of the pension plans to provide for liabilities for service after April 1, 2000. There are three (3) pension plan funds, one for each of the Public Service Pension Plan; the Canadian Forces Pension Plan and the Royal Canadian Mounted Police (RCMP) Pension Plan.

Pension Plans (or Plans)
The pension plans of the federal Public Service, the Canadian Forces and the Royal Canadian Mounted Police.

Plan Liabilities
Plan liabilities represent the financial obligations of a pension plan relative to the benefits earned by the plan participants. The liabilities correspond to the value calculated by the pension actuary of all future benefits accrued as of the date of valuation.

Policy Portfolio
The asset mix, set by the Board of Directors, identifying how the funds managed should be allocated between different asset classes (example: cash, fixed income securities, equities, real estate, ...)

Portfolio
A group of investments, such as equities and bonds and possibly financial instruments such as derivatives grouped for investment purposes.

Private Equity
Ownership interest in assets that do not trade on public exchanges or over the counter.

Proxy Voting Rights
Written authorization by a shareholder for someone else to represent them and vote their shares at a shareholders' meeting, generally under stipulated guidelines or conditions.

R

Return (or Rate of Return)
The percentage change in assets in a particular period, consisting of income (such as interest, dividends or rent), plus realized and unrealized capital gains or capital losses.

Risk
The probability of investment losses, either in absolute terms, or versus a benchmark.

Risk-Adjusted Return
A measure of investment return adjusted to reflect the risk that was assumed to produce that return.

S

Scotia Capital Debt Market Indices
A series of indices created and maintained by Scotia Capital to measure the performance of Canadian bond and money markets. The Universe Index includes all marketable Canadian bonds with a term to maturity greater than one year, and is a broad measure of the performance of the Canadian bond market. The 91-Day T-Bill Index is one of a number of money market indices maintained by Scotia Capital.

Social Investing
An investment process that uses screens to select or avoid investing in certain companies or industries to reflect religious, economic, political, social or personal priorities.

S&P/TSX Composite Index
The most diversified Canadian market index representing almost 90 percent of the capitalization of Canadian-based companies listed on the TSX. A committee of the Toronto Stock Exchange and Standard and Poor's selects companies for inclusion in the S&P/TSX Composite Index.

Standard and Poor's 500 Composite Index (S&P 500 Index)
A U.S. index consisting of 500 stocks chosen for market size, liquidity and industry group representation. It is a market-value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The Standard & Poor's company selects stocks for inclusion in the index.

Statement of Investment Policies, Standards and Procedures (or Investment Policy)
A written investment policy approved by the Board of Directors, and reviewed at least annually, relating to each pension plan fund. This is a requirement under paragraph 7(2) (a) of the Act. It addresses matter such as categories of investments; use of derivative products; asset diversification and expected investment returns; management of credit, market and other financial risks; liquidity of investments; lending of cash and securities; evaluation of investments that are not regularly traded on a public exchange; and the exercise of any voting rights that PSP Investments has through its investments.

T

Time-Weighted Rate of Return
A return calculation methodology that eliminates the impact of cash flows into (or out of) a portfolio. This methodology recognizes the fact that managers have no control over the size and timing of cash flows.

V

Volatility
Generally refers to variability (in frequency and magnitude) of returns around an average or reference point over a period of time.

Head Office

50 O'Connor Street
Suite 1500
Ottawa, Ontario
K1P 6L2
Tel: 613-782-3095
Fax: 613-782-6864

Principal Business Office

1250 René Lévesque Blvd West
Suite 2030
Montreal, Quebec
H3B 4W8
Tel: 514-937-2772
Fax: 514-937-3155

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