The Public Sector Pension Investment Board

2004 Annual Report

PSP 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 (Plans). 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 2004

- Consolidated net assets increase 76% to $14.2 billion
- Total portfolio return is 26.1% compared to the Policy Benchmark return of 25.4% for the year
- Gordon J. Fyfe is appointed President and CEO
- Investments in new asset classes initiated
- Key security-related systems for disaster recovery and business resumption put in place
- Number of employees increases from 29 to 35

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 2004 Objectives	Status
• Ensure continuity during the transition to a new CEO.	√
• Develop strategies for investments in new asset classes.	Began investing in derivatives, real estate and small- and mid-cap U.S. equities
• Establish a comprehensive risk management process.	Development under way with full implementation in fiscal year 2005

√ indicates objective was substantially or completely achieved

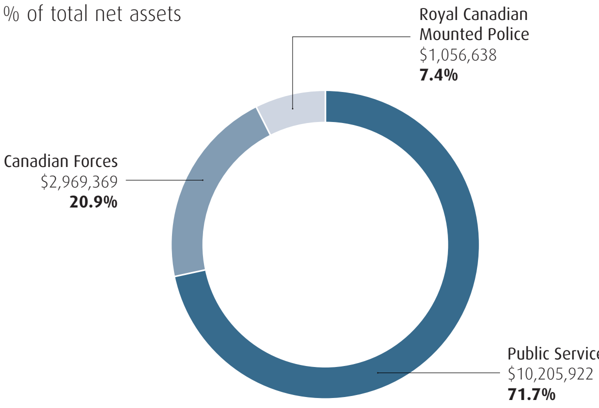
Key Objectives for Fiscal Year 2005

- Implement changes (asset classes and weights) to the Policy Portfolio following strategic review.
- Complete extensive review of value-added activities and implement changes.
- Ensure that the operations can support these new activities while maintaining quality, efficiency and risk control.
- Implement a strong human resources process to support the growth of PSP Investments' team.

Plan Accounts' Net Assets

(as of March 31, 2004)

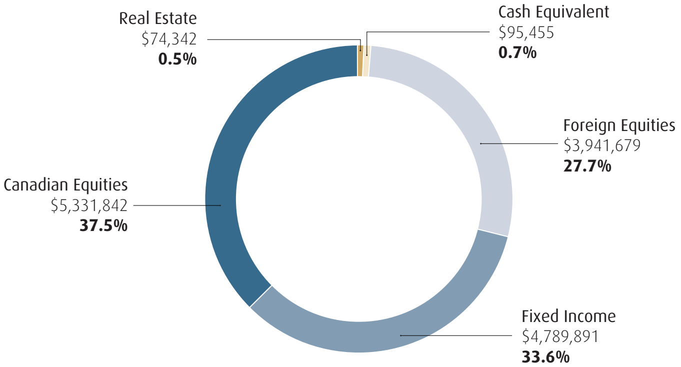
($,000)
% of total net assets



Asset Allocation

(as of March 31, 2004)

($,000)
% of asset classes



Chairperson's Report

Paul Cantor, *Chairperson*

New President and Chief Executive Officer in Place

Amongst all of the duties of the Board, our greatest single responsibility is to have effective leadership in place. Therefore, I am pleased to formally welcome Gordon J. Fyfe, who was named President and Chief Executive Officer of PSP Investments, effective October 15, 2003.

Mr. Fyfe brings to our organization solid experience gained during more than 20 years in the fields of finance and investment in both the private and public sectors. Before joining PSP Investments, he was President of CDP Capital, World Markets, and First Vice-President of CDP Capital in Montreal. Prior to that, he was a Principal at TAL Global Asset Management. He also worked in New York and London for J.P. Morgan, one of the world's great financial institutions. The Board invited Mr. Fyfe to lead PSP Investments because we believe he is an individual with the vision, management skills and financial expertise needed to guide PSP Investments.

I know I speak for my fellow Board members as well when I say that we look forward to working with Mr. Fyfe and his colleagues on the PSP Investments' management team.

Effective Governance Advanced

Effective governance is another important obligation of the Board of Directors.

From the outset, our Board has emphasized the development of – and adherence to – policies and procedures that reflect current best governance standards and practices.

The success of our efforts in that regard was confirmed in a recent review conducted by outside consultants who specialize in board governance matters. After scrutinizing our Board's governance practices, the consultants commended PSP Investments for standards they consider to be among the highest in the industry – an achievement that is particularly significant considering how recently we were established.

Those findings are also noteworthy in the context of today's intensified focus on governance issues. This was driven initially by a wave of corporate scandals, particularly in the United States, and followed more recently by increasing expectations of Crown Corporations in Canada concerning governance matters. A number of controversies that have arisen in our own sector, investment management, have made it clear that we, too, must remain vigilant with regard to effective governance.

Governance-related initiatives during fiscal year 2004 included the establishment of an orientation program for new Board members and the initiation of on-going formal training for directors to keep them abreast of changes related to our industry. The training program is linked to the rollout of our revised investment strategy. As well, PSP Investments' internal control procedures were further enhanced at the Board's behest. We also reviewed and formalized a Directors' Expense Policy and revised the Directors' Compensation Policy.

Nominating Process Reflects Stringent Focus on Qualifications

Of course, good governance involves much more than written procedures and adherence to them. It requires a culture of governance that starts at the very top of an organization, with qualified directors who are committed to the highest standards of ethical and business conduct. Our legislation calls for PSP Investments' Board to have "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". In order to fulfill this mandate, we need to identify, attract and retain directors with expertise that spans a wide range of discipline – publicly-traded marketable securities; alternative investment markets such as private equities and real estate; finance, including accounting, controls, corporate finance and actuarial science; risk management; human resources; and public and government relations.

Obviously, no one individual possesses all those qualifications. Therefore, we seek to build a board whose membership collectively encompasses the relevant knowledge and experience, utilizing a governance process designed with that specific goal in mind.

We regularly review the competencies of current Board members – taking into account the length of each member's remaining term – in order to identify areas of expertise where gaps exist or are likely to arise. This information is conveyed to a Board Member Nominating Committee, which is independent from PSP Investments' Board. The committee is chaired by Claude Lamoureux, President and CEO of the Ontario Teachers Pension Plan, who is widely acknowledged as a leading practitioner of investment management. Current and retired Federal public service employees representing the three pension plans also sit on this committee.

The Nominating Committee retains an executive search firm to seek out potential Board candidates. Nominations from all sources, including any that come through political channels, are first reviewed by the executive search firm and then placed before the Committee. The Nominating Committee ranks the candidates, based on an assessment of their strengths compared with the current needs of PSP Investments' Board, and then forwards the list to the President of the Treasury Board who after review, submits it to the Privy Council Office for consideration and appointment.

This comprehensive process has enabled PSP Investments to recruit directors of the highest caliber, fully capable of discharging the responsibilities placed upon them. It is clear to me that there is direct linkage between the excellence of our nominating process and the quality of our Board. Accordingly, I wish to express my thanks to the Board Member Nominating Committee for its outstanding work.

Successful Meeting with Plan Representatives

Good communications are also key to effective governance. In November 2003, Mr. Fyfe and I had a very successful meeting with representatives of the three Pension Plans, at which we reviewed the events of the previous year and outlined our plans and objectives for fiscal year 2005.

Acknowledgements

I would like to take this opportunity to thank my fellow Board members for their wise counsel and support over the course of the past year. Particular thanks are due to two directors who have left our ranks, Paul Haggis and Barbara Bender. Their contributions are greatly appreciated. I also wish to extend a formal welcome to Jean Lefebvre of Montreal, who joined our Board in August 2003. Mr. Lefebvre has been an asset management consultant and is a Fellow of the Canadian Institute of Actuaries.

We are also grateful to Danielle Morin, First Vice-President and Chief Financial Officer, who served as interim CEO for several months prior to Mr. Fyfe's appointment.

As PSP Investments enters its fifth year of operation, the Board intends to continue its focus on strong governance, while overseeing the on-going development and implementation of strategies for investments in new asset classes designed to enhance returns.

Paul Cantor
Chairperson

Gordon J. Fyfe, *President and Chief Executive Officer*

President's Report

I welcome the opportunity to serve as President and Chief Executive Officer of the Public Sector Pension Investment Board (PSP Investments) and I am excited about PSP Investments' prospects.

We will build a management team that will enable PSP Investments to properly manage its growth and become a leading pension investment organization – with assets of $100 billion projected within the decade – while providing excellence in terms of performance, controls and governance, in what is expected to be an increasingly challenging investment environment.

PSP Investments was established to manage the cash contributions accumulated by the three Pension Plans after April 1, 2000, in a manner designed to maximize returns without undue risk and provide investment returns sufficient to minimize the need for increased contributions from the government or employees going forward. The Chief Actuary of Canada determines what level of return is required to meet plan liabilities and it is PSP Investments' role to determine how best to achieve the requisite returns without assuming undue risks – and then to deliver from a performance standpoint.

To that end, PSP Investments is undertaking a thorough analysis and assessment of the organization's capabilities in all areas – systems, investment products, personnel and skills sets, as well as outside partners – to ensure that we have the necessary tools to meet PSP Investments' commitments.

Upon joining PSP Investments in October 2003, one of my first priorities was to review PSP Investments' "total portfolio" approach – that is the combination of market risks and active management risks considered most appropriate to achieving our objectives. PSP Investments is seeking to improve the mix of assets that comprise our Policy Portfolio, in terms of inherent market risks and returns, as well as our investment approach to adding value.

Increased Diversification Key to Reduced Volatility

PSP Investments will further diversify its mix of investment asset classes – which up to now has been focused on public equities and Canadian fixed income vehicles – in recognition of the fact that different economic conditions will favor different asset classes *(See page 1).* In other words, if we wish to manage risks and reduce the volatility of returns, we must ensure that PSP Investments has a sufficiently wide and diversified range of investments so that at any given point in time there will be a balanced portfolio performance.

In addition, PSP Investments can take advantage of its long-term, positive net cash-inflow position (projected at 25 years) by allocating an appropriate portion of the total investment portfolio to alternative investment classes such as Real Estate, Private Equities and Infrastructure that provide diversification, inflation hedges and premium returns, notwithstanding their long-term and less liquid investment characteristics.

A Look Back at Fiscal Year 2004

Before elaborating further on PSP Investments' strategy for the future, I would like to provide an overview of our investment performance for fiscal year 2004. PSP Investments produced a net gain of $2.15 billion and a rate of return of 26.1% for fiscal year 2004, which is 0.7% above the Policy Benchmark return of 25.4%. These results reflect generally favourable market conditions as well as the successful efforts of our investment managers, who deserve congratulations for a job well done.

We initiated in fiscal year 2004 the development of strategies for investments in two new asset classes, Private Equities and Real Estate, which had been approved by the Board of Directors in November 2002. We made our first investment in real estate in October 2003, through two pooled funds.

We also began managing our currency exposures in fiscal year 2004, which had a positive impact on our results. As well, there was an allocation made to small- and mid-cap U.S. equities. We initiated a securities lending program designed to generate additional revenues, which incorporates stringent provisions to minimize any risk of potential defaults.

A number of noteworthy initiatives were undertaken to further enhance PSP Investments' capabilities with regard to administration, systems and controls. In the vital area of corporate risk, we implemented more stringent security measures to safeguard information and electronic data, while instituting formalized disaster recovery and business resumption plans. In addition, we reviewed our disclosure procedures and controls to ensure that they are in full compliance with recent changes to Canadian reporting and regulatory requirements, and completed planning for a "special examination" of systems and practices that will be initiated during fiscal year 2005 in accordance with the legislation governing PSP Investments. It is mandatory that such an examination be carried out at least once every six years.

The Path Ahead

As I indicated above, our aim going forward is to further diversify PSP Investments' portfolio and expand its pool of expertise so that we will be able to exceed performance norms even when the investment climate is less favorable.

Subsequent to the fiscal year-end, we completed a comprehensive review of the asset mix, including testing the sensitivity of the liabilities to different scenarios, with the aim of achieving additional portfolio diversification. Results of this review will provide guidance not only in terms of which alternate asset classes to invest in, but also how they will contribute to overall portfolio performance and help minimize volatility. We will provide recommendations for the Board's consideration regarding requisite amendments to the Statement of Investment Policies, Standards and Procedures that may be required in this regard. We also are rethinking our exposure to active management risks and how we add incremental value to PSP Investments' Policy Portfolio. We want to be less dependent on the direction of financial markets for generating added value. As well, we wish to reduce our dependence on those public equity and bond markets which are exhaustively analyzed and extremely efficient, looking instead to extract value from less efficient markets.

The active portion of PSP Investments' portfolio will be managed in a manner designed to maximize risk-adjusted returns, within established risk parameters and policy guidelines. This means we must be able to quantify the expected risks, decide how much of each risk we are willing to assume and take steps to ensure that we will be adequately rewarded for the level of risk involved.

Accordingly, we are incorporating a modern risk management and risk budgeting process into the management of the funds, which will enable us to better understand and oversee potential downside risks.

Team Building

We continue to assemble our team: Mr. Pierre Malo joined PSP Investments in December 2003 as Vice President, Investments. Mr. Derek Murphy was appointed First Vice President, Private Equity effective March 31, 2004, and Mr. André Collin will join us as First Vice President, Real Estate Investments on May 17, 2004. We also have retained an external investment manager for enhanced indexed Canadian equities.

Our policy is to be highly selective – to seek out, attract and retain the very best people, wherever they might be, both in terms of PSP Investments staff and outside investment managers. If we are to succeed in that regard, we must provide employees with a stimulating, rewarding work environment and see that they are appropriately compensated. That said, I want to note that we are committed to ensuring that the incentive portion of the investment managers' remuneration is properly aligned with the interests of PSP Investments – and that it is based on performance over a sufficiently long period to reflect the consistency of results achieved.

Our aim is to foster a PSP Investments' culture that is opportunistic and open to fresh ideas, as befits a dynamic and fast-growing organization, while adhering to the very highest governance and ethical standards. It is vital for us – not just as individuals, but as a team – to be receptive to new approaches and willing to put forth the efforts required to understand and apply them.

Acknowledgements

In conclusion, I would like to take this opportunity to thank the Board for its support, which made settling into a challenging new job easier than it might otherwise have been. I would also like to thank our employees and partners for their hard work and contributions to a successful year. Finally, I wish to reiterate PSP Investments' commitment to work diligently to achieve the sustained high-level performance that I am confident we are capable of delivering and which plan participants have every right to expect.

Gordon J. Fyfe
President and Chief Executive Officer

Fiscal Year 2004 Results

The Public Sector Pension Investment Board (PSP Investments) completed its fourth year of operation on March 31, 2004. During that period, it received $3.7 billion in net contributions from the Public Service, Canadian Forces and Royal Canadian Mounted Police pension funds. Cash inflows of varying amounts were received several times a month and invested as soon as possible in a policy neutral manner. On a consolidated basis at the fiscal 2004 year-end, 37.5% of assets were invested in Canadian equities, 27.7% in foreign equities, 34.3% in Canadian fixed income securities, and 0.5% in real estate. The market value of invested assets as of March 31, 2004 totaled $14.2 billion, compared with $8.1 billion a year earlier.

Market Performance

Fiscal year 2004 was a buoyant period for financial markets. Investor confidence was restored by a stronger than expected recovery of the U.S. economy combined with the U.S. Federal Reserve's accommodative monetary policy. A sharp rise in corporate profits was driven by the productivity efforts made during the downturn. The corporate financial situation has considerably improved thanks to the strong cash flows and the control of capital spending. The risk aversion of financial participants that prevailed in prior years has evaporated, as illustrated by a sharp decrease in corporate bond spreads.

Canadian equity markets, strongly weighted in resources companies, clearly benefited from the bout of fever in raw material and gold prices. European equity markets were caught in the uptrend, although economic conditions deteriorated in the euro zone. Hopes of a Japanese economic recovery following its prolonged weakness also stimulated equity markets.

On the interest rate front, the U.S. Federal Reserve has remained concerned about the risk of seeing disinflation turn into deflation. Its discount rate was reduced to an historic low of 1%. The Bank of Canada and European central banks followed suit. Nevertheless, money and bond markets reflected greater tension in the face of a massive injection of liquidity into the world economy as well as the expansion of budget deficits and inflation of raw material prices. Bond interest rates clearly found a bottom in 2003, while the yield curve steepened.

The U.S. dollar continued to depreciate over the course of the year under the influence of the reflation orchestrated by the U.S. Federal Reserve and the worries created by the worsening U.S. current account deficit. The U.S. dollar decreased by 10.7% against the Canadian dollar and by 11.2% against the euro.

The Canadian equity market ended the fiscal year with a 37.7% return for the S&P/TSX Composite index. During the same period, foreign market returns (in Canadian dollars) were 20.7% for the Standard and Poor's 500 index and 40.8% for the MSCI EAFE index. The Canadian fixed income market generated positive returns as evidenced by the 10.8% return for the Scotia Capital Universe index.

Investment Results

In fiscal year 2004, the consolidated plan account produced income of $2.462 billion, before expenses. This compares with a loss of $920 million in fiscal year 2003.

Performance Measurement and Evaluation

We use rigorous performance measurement as an essential tool for management to evaluate its internal and external managers. It is also the tool used by the Board of Directors and other stakeholders to evaluate the performance of PSP Investments.

Benchmarks

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

Rates of Return on Consolidated Pension Plan Account (as of March 31, 2004)

	One-Year		*Four-Year (annualized)*		
	Portfolio Returns %	*Benchmark Returns %*	*Portfolio Returns %*	*Benchmark Returns %*	
Canadian Equities	36.1	37.7	0.5	1.1	S&P/TSX
Foreign Equities	30.7	28.8	(6.6)	(6.5)	S&P500 & MSCI EAFE*
Real Estate	3.6**	2.5**	—	—	CPI + 4%
Fixed Income	10.9	10.8	8.5	8.3	SC Bond Universe
Cash Equivalents	3.2	3.0	3.5	3.1	SC 91 day T-bill
Total Return ***	26.1	25.4	1.8	1.9	Policy Benchmark****

These are time-weighted rates of return, before fees and expenses, for the consolidation of the three pension plan accounts. They are calculated in accordance with the mandatory requirements set forth by AIMR***** and audited as such.

* In Canadian dollars, weighted by market capitalization.

** Started in fiscal year 2004.

*** Includes the impact of the currency overlay activities.

**** Based on weights in the Investment Policy. See Page 11.

***** Association for Investment Management and Research.

Rate of Return

The rate of return for the consolidated pension plan account in fiscal year 2004 was 26.1%. This reflected a 36.1% rate of return for Canadian equities, a 30.7% rate of return for foreign equities, a 10.9% rate of return for fixed income, a 3.6% rate of return for real estate, a 3.2% rate of return for cash equivalents and the impact of our currency overlay activities.

This compares to a rate of return of 25.4% for PSP Investments' Policy Benchmark (see Benchmarks–Page 9) and a (13.5)% rate of return recorded by PSP Investments in fiscal year 2003.

The performance of the currency overlay program was the biggest factor in the overall outperformance of the Consolidated Pension Plan Account. In April 2003, the decision was made to partly hedge exposure to the U.S. dollar. A subsequent drop in the value of the U.S. dollar led to significant added value for the Account.

The underperformance in Canadian Equities was generally attributable to managers holding higher-quality securities in their portfolios, whereas the market was led by rising prices of more speculative securities.

Returns and benchmarks for each pension plan account are presented in the Notes to their respective financial statements.

Changes in Net Assets

The Consolidated Pension Plan Account began fiscal year 2004 with net assets of $8.1 billion at market value. Consolidated net contributions during the fiscal year added $3.7 billion. After factoring in the net income from operations, consolidated net assets as of the fiscal 2004 year-end were $14.2 billion at market value.

Expenses

The cost of operating PSP Investments during fiscal year 2004 totaled $21.1 million, compared to $13.0 million in fiscal year 2003. The total expenses are comprised of operating expenses ($12.1 million in fiscal year 2004 versus $9.0 million in 2003) and external investment management fees ($9.0 million in fiscal year 2004 versus $4.0 million in fiscal year 2003). The higher costs can be attributed mainly to the growth in assets under management, the undertaking of several significant information-technology related projects and the hiring of senior individuals.

Total expenses amounted to 0.186% of average assets or 0.107% of average assets, when external investment management fees are excluded.

External investment management fees increased because of the significant growth in assets (76%) and the high proportion of those assets allocated to external managers.

Expenses will continue to increase in fiscal year 2005. 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 new investment strategies, the entry into specialty asset classes such as private equities and real estate and the amortization of investment in major new technology systems.

We remain vigilant about expenses and are committed to maintaining tight financial controls. PSP Investments' longer-term plan targets a lower ratio of expenses to average assets, excluding external investment management fees. The magnitude of future fees and costs will depend on the nature of the new asset classes in which PSP Investments will invest.

Investment Policy and Strategy

This section summarizes the statutory investment objectives of the Public Sector Pension Investment Board (PSP Investments) as well as the policy and strategy being utilized to achieve those objectives. The policy remained unchanged during fiscal year 2004 but some strategies were implemented during the year, which resulted in investments being made in real estate, small- and mid-cap U.S. equities, enhanced indexing of Canadian equities and derivatives for a total of $1.214 billion at fair value. A review of our strategy, taking into account liability sensitivity testing, was completed at the end of the fiscal year and is likely to lead to revisions to the investment policy and strategies in fiscal year 2005.

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. 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. Achieving a return exceeding the Policy Benchmark return by 0.50% (with a minimum value-added component equal to expenses).

These two objectives were achieved in fiscal year 2004.

Asset Mix Policy at Market Value (for fiscal year 2004)

	Target %	*Range* %	
Canadian Equities	35.0	30 – 40	S&P/TSX
Foreign Equities	30.0	25 – 35*	Customized**
Real Estate ***	0.5	0 – 5	CPI + 4%
Fixed Income	31.5	27 – 37	SC Bond Universe
Cash Equivalents	3.0	0 – 10	SC 91-day T-bill

* Foreign equity exposure cannot exceed 30% at book value, but can be higher at market value.

** S&P 500 and EAFE indices weighted according to market capitalization. Emerging markets will be included in the benchmark when investments are made in those markets. (EAFE is the MSCI Europe, Australasia and Far East Index).

*** Investments in real estate assets reduce the portion of asset invested in fixed income assets. Over time, real estate will represent up to 5% of total assets.

Asset Mix Policy

PSP Investments' assets are managed in accordance with the Long-Term Asset Mix Policy. The policy currently provides for the assets to be invested as follows: 35% in Canadian equities; 30% in foreign equities (the maximum allowed pension funds under the *Income Tax Act*); 34.5% in Canadian fixed-income vehicles and cash equivalents and 0.5% in real estate investment. In fiscal year 2003, the Board authorized a broadening of the total portfolio to include new asset classes, including private equities and real estate.

Balance Between Active and Passive Investment Management

Passive investment management entails replicating recognized market indices by purchasing shares and/or investing in Index funds that purchase shares – or other securities, as the case may be – in the same proportion they are represented in the relevant index. With active management, investment professionals can increase or reduce exposure to certain securities based on the perceived risk/return profile. The aim is to outperform the relevant market indices and thereby enhance PSP Investments' ability to maximize returns over time, without undue risk of loss.

Over the first three years of its history, PSP Investments shifted from being 100% in passive investment management to 51.5% at the beginning of fiscal year 2004 and 54% as at March 31, 2004.

During the course of the latest fiscal year, the split between actively and passively managed investments did not change substantially. The overall percentage of actively managed assets went from 48.5% at the beginning of the year to 46% at the end of fiscal year 2004. However, there were changes within both actively and passively managed asset groups.

On the indexed side, for example, 17% of the total Canadian – Equity portfolio is now managed with an enhanced mandate. Furthermore, we started investing in small- and mid-cap U.S. equities.

On the active side, we commenced investing in real estate assets and currency options, part of a broader strategy of managing currency. A smaller portion of our U.S. equities portfolio is managed actively.

Investment Risk Management

Investment risk is managed by a multi-faceted system of checks and balances to limit the risks inherent in PSP Investments' activities, as well as by a risk measuring activity.

The first set of activities entails controlling and monitoring both the overall percentage of assets allocated to active management and the amounts entrusted to individual managers to reflect the degree of risk associated with the individual managers' styles. Policies to manage credit, market and financial risks have been in place since PSP Investments began operating. For instance, the credit risk of bonds and cash equivalent securities is managed by controlling the percentage held in lower rated securities, as measured by an external credit rating agency. Interest rate risks associated with fixed income investing are managed through diversification strategies. The currency option activity is monitored by means of a stop-loss program.

The second set of activities – risk measuring – involves a process supported by the appropriate information and technology tools, and which measures and reports on the specific risks associated with each investment portfolio. This activity enables the examination of various measures of absolute and relative risks at both the portfolio and total fund levels.

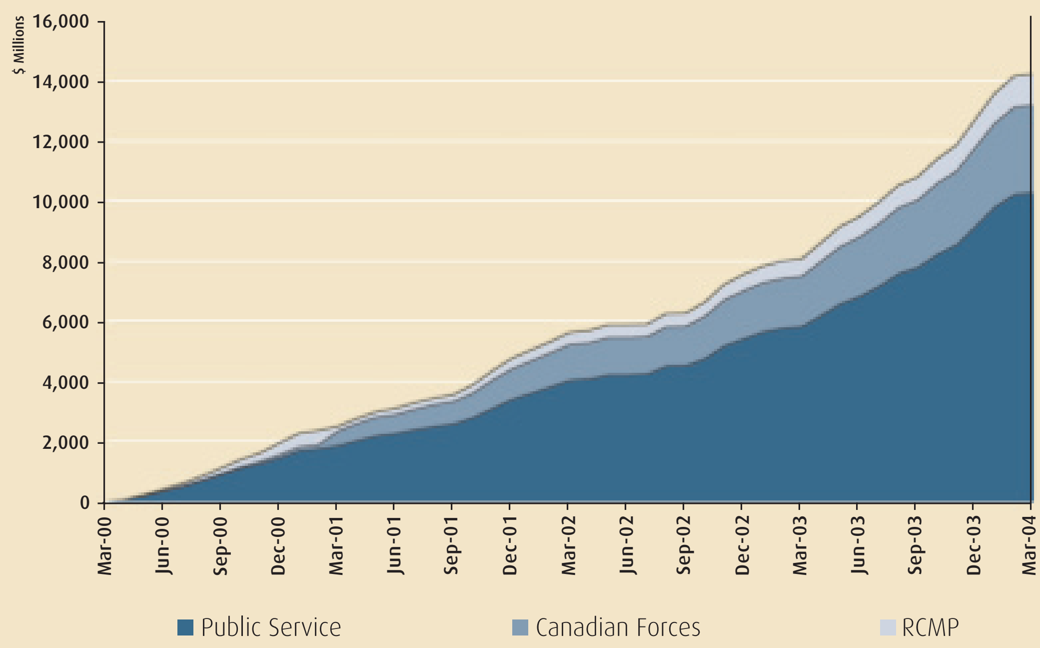
Cash Flow and Rebalancing

Over the course of fiscal year 2004, PSP Investments received $3.7 billion of new money to invest. This cash flow represented 46% of the total assets of $8.1 billion at the beginning of fiscal year 2004.

Cash flow is received several times a month in amounts ranging from relatively small sums to as much as $380 million. Consequently, clear policies and procedures for investing cash flows are an important consideration in the implementation of the overall investment policy. On receipt of cash flow, it is immediately invested in the asset classes in such a manner that the resulting asset class weights of the asset mix are not disturbed.

The total portfolio's rebalancing is triggered by a change in the overall equity weight. Discretion is used to rebalance the total assets should the weights of the asset classes move outside the acceptable ranges. However, new contributions will not be invested in such asset classes until the weights of those asset classes fall within the acceptable ranges.

Investments at Fair Value - April '00 to March '04



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 the fulfillment of its legislated mandate.

This section of the Annual Report presents pertinent information on PSP Investments' mandate, the role of the Board of Directors and key policies designed to guide the organization's activities and behavior.

The Committees of the Board dealt diligently with all regular matters related to their respective Terms of Reference. More specifically, the following initiatives were undertaken in fiscal year 2004: amendments to the Code of Conduct to incorporate a "whistle-blowing" provision; the introduction of an orientation program for new directors as well as on-going training for Board members; revisions to the Directors' Compensation Policy; formalization of existing expense controls and procedures into a formal Directors' Expense Policy; and initiation of the Special Examination required by the *Act* to take place every six years.

Legislated Mandate

The legislated mandate of 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 the 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 financial markets.

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 Minister of Public Safety and Emergency Preparedness 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 is also 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 currently comprised of 10 members, including the Chairperson, governs PSP Investments. The Governor in Council appoints all members on the recommendation of the President of the Treasury Board. Qualified candidates for the Board of Directors 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 58.)

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.

Two ad-hoc committees, a Management Committee and a Search Committee, were established in March 2003, following the departure of the President and Chief Executive Officer. The Management Committee and the Search Committee were disbanded on August 7, 2003 following completion of the search for a new President & Chief Executive Officer. Furthermore, the subcommittee of the Investment Committee was disbanded in September 2003.

The Investment Committee is comprised of all the members of the Board. The composition of the other committees is set out on page 58 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 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.

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".

To that end, the Governance Committee engaged an independent compensation consultant to assist it in identifying appropriate comparative groups and in analyzing director remuneration data from those groups. The Committee also collected and considered additional information with respect to other persons having similar responsibilities and engaged in similar activities.

Following the latest review, the Board approved adjustments to directors' compensation to take effect April 1, 2004, for fiscal year 2005. Each director will receive 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 Investment's reporting relationship to its stakeholders – will be paid a total of $98,000 per annum in recognition of those services, while foregoing all other retainers and meeting fees.

The Board met seven times during fiscal year 2004 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 2004 is summarized in Note 8(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 behavior.

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 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.

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 Board of Directors' performance 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. This year, the Board hired an outside consulting firm to assist the Board in evaluating its effectiveness.

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 behavior.

During fiscal year 2004, the Code was amended to incorporate a new "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, gifts and favours from or to third parties; membership in and public representation of non-profit 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.

Investment Objectives

Clearly defined investment objectives help ensure that the investment strategy followed by PSP Investments is properly aligned with the funding liabilities of the Plans. The objectives are as follows:

1. 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. Achieving a return exceeding the Policy Benchmark return by 0.50% (with a minimum value-added component equal to expenses).

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 behavior of corporations... may be one of a number of relevant 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.

Glossary

A

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

Active Investment Management
Selecting individual investments or groups of investments with the goal of earning higher returns than the general market. Active investment management can also reduce portfolio risk.

AIMR Performance Standards
The Association for Investment Management and Research (AIMR) is an international, nonprofit organization of more than 50,000 investment practitioners and educators in over 100 countries. On May 9, 2004 AIMR changed its name to “CFA Institute”. The investment performance standards of AIMR are ethical principles and guidelines that promote uniformity in reporting investment performance.

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. As a rule, investors with long-term needs can tolerate the higher risk of equities compared to fixed income securities in the expectation of higher returns. Consequently, their asset mix may be weighted more heavily to equities.

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

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
A fee that the manager of a fund charges for managing the portfolio and operating the fund. The fee is usually set as a fixed percentage of the fund's net asset value.

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, Australasia 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 future chance or probability of loss in relative (that is, versus a benchmark) or absolute terms.

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

440 Laurier Avenue West ,
Suite 200
Ottawa, Ontario
K1R 7X6
Tel: 613-782-3095
Fax: 613-782-2228

Principal Business Office

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

Ce rapport annuel est aussi disponible en français.

Project coordination: GGA Communications Inc. | Graphic Design: Groupimage | Photography: Yves Renaud

www.investpsp.ca

Investissements PSP Investments