ACHIEVEMENT AND STRATEGIES

CPP Investment Board

The CPP Investment Board:

Achievement and Strategies

Presentation

by

John A. MacNaughton

President and Chief Executive Officer

Canada Pension Plan Investment Board

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It is a privilege to be your luncheon speaker at this important conference on strategies to build sustainability into pension plans.

In business, one must always listen to the customer. Trite, but true. Yet somehow the point is seldom front and center when it comes to pension plans.

And when it comes to pension plans these days, as it increasingly does, to judge by the headlines, customers have only one question: Will the money be there when I need it?

What Canadians want to know … as shareholders, taxpayers and beneficiaries … is this: Can the public and private sectors keep the pension promises they have made – and at what cost?

I will leave the substantive answer to the many experts lined up by the Conference Board and its co-sponsors to address the broader financial, technical and demographic issues.

Instead, I will enter the debate on the strategies we are employing to build the sustainability of the Canada Pension Plan.

But first I'd like to break the suspense. In our case, the answer is…Yes – the plan is sound and the money will be there.

[One could argue that I should now say thank you and sit down, but I'll continue nonetheless!]

I will review the strategies we use at the CPP Investment Board to invest the CPP reserve fund.

I will conclude with a discussion of the CPP Investment Board's governance model, because it is fundamental to our ability to achieve our legislated mandate to maximize investment returns without undue risk.

Let's start with a very short history lesson.

The Canada Pension Plan was born in 1966 as a pay-as-you-go scheme.

The basic idea was that current workers would pay the pensions of retired workers. In other words, each generation would look after the previous one.

That made sense in the 1960s … when there were seven workers for every pensioner. It made less sense in the mid-1990s, when there were only five workers for every retiree and more money was flowing out in benefit payments than was flowing in from contributions. And it will make no sense whatsoever in the future. By 2030, there will be only three workers for every retiree.

In response, the federal and provincial finance ministers of the day did something remarkable. We often accuse politicians of failing to see beyond the next election. Those finance ministers looked deeply into the 21st century and took bold actions.

Among many changes, two stand out. They increased the contribution rates of employers and employees by 65 percent … from six percent on most wages in 1997 to 9.9 percent effective in 2003. And they created the CPP Investment Board to invest the plan's reserves.

Before I get to the CPP Investment Board, let me draw out a few features of the Canada Pension Plan that do not appear to be well known.

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

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

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

This segregation is a sharp contrast to other jurisdictions. In the United States, for instance, social security contributions are treated as cash flow to the government, and have been since the 1960s. In Canada, we have a lock box that Americans can only dream of.

By 2021, it is expected that a reserve fund of invested assets will meet about 25 percent of the Canada Pension Plan's obligations. Contributions from workers and their employers will pay the rest.

The Chief Actuary has stated that the plan is sound … on the basis of a 9.9 percent contribution rate and a reserve fund equivalent to 25 percent of liabilities … for at least 75 years. His opinion is endorsed by a panel of independent actuaries.

As you can see, this is a distinctly different plan design from those in the private sector and others in the public sector.

So where does the CPP Investment Board fit in? The Chief Actuary has projected that CPP contributions will exceed pension payments until at least 2021. Our job is to invest those excess contributions until they are required to pay benefits.

So…let's talk about our investment strategy.

By design, the CPP will only be partially funded from 2021 on. This means that investment income will assist -- but will not drive -- the plan's sustainability.

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

Over the long term, however, the performance of the reserve fund will influence contribution rates … though to a significantly lesser extent than in a fully funded pension plan.

Like some other pension funds, we use a risk-reward budgeting framework to shape our investment strategy. We examine risk/return tradeoffs between different asset classes measured against a minimum risk performance base.

We are highly conscious of the need to manage CPP assets prudently and in the best interests of the 16 million Canadians who contribute to or benefit from the Canada Pension Plan.

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

The CPP Investment Board has a significant advantage when it comes to our ability to pursue higher long-term risk-adjusted returns. With between $6 billion and $8 billion a year in cash flowing into the plan and no need to help pay benefits until 2021, time is on our side.

This means we can invest for higher returns over longer time periods without taking on undue risk.

We have expected returns for different asset classes.

Government bonds, of course, are at the low end of the risk/return ratio. The capital is more secure, but the returns are well below what most pension plans, including the Canada Pension Plan, require to meet the pension promise.

Equities, especially private equities, have higher risks with the prospects of higher returns … while in between are corporate bonds and alternative assets such as real estate and infrastructure.

Do we believe that there will be an equity premium going forward? Over the long term, very definitely -- and by long term I mean well beyond the next five to 10 years.

We are comfortable that equities will on average, and over the long term, earn two percentage points more than government bonds. Consequently, we can afford to invest a high proportion of assets in equities and be patient about earning that premium.

Five years ago, the CPP's assets were exclusively federal and provincial government bonds and short-term government securities. We have already diversified the portfolio to include a $31 billion portfolio of Canadian and foreign publicly traded stocks, private equity, venture capital, real estate and infrastructure assets.

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

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

Let me share with you our active management approach. It will be applied to as much as 10 percent of our public equity portfolio.

We recently selected two firms to implement global mandates equivalent to $500 million each. Two more will be selected shortly.

Unlike traditional mandates, where a fund manager is given cash to invest, each manager in what we call our active overlay program has the freedom to identify over-valued securities among the 1,200 stocks in our public equity portfolio, sell them and buy other securities that the manager believes have greater value potential.

An innovative aspect of our approach is that the managers will receive a small base fee plus a portion of the value they create. This aligns the manager's financial interests with those of the CPP Investment Board and the plan's beneficiaries. Managers who excel will receive expanded mandates.

Let me give you a bit more background about the thinking that led to this active overlay approach.

As you know, federal law restricts pension fund investing outside Canada to 30 percent of assets at cost. This is a long-term portfolio management risk for all Canadian pension funds.

One concern with these constraints is that the Canadian universe of high quality and highly liquid stocks is small at perhaps 320 companies. That's less than three percent of global market capitalization. Putting so many eggs in a tiny basket increases risk.

Another concern is that these companies populate relatively few economic sectors compared with the sectors available in the U.S. and Europe. Globally there are 12 major economic sectors. In Canada there is a heavy weighting of publicly traded companies in financial services, natural resources and utilities.

Conversely, Canada is not represented fully or adequately in others such as pharmaceuticals and technology.

So, how can we better manage portfolio risk and earn better investment returns within these constraints? One way is by bringing improved economic sector balance to the passively-managed part of our public equities portfolio. Another is by hiring experts who are nimble at finding ways to add value through active management within the portfolio.

Over time, we also plan to invest as much as 20 percent of total CPP assets in real estate, infrastructure, and private equity … with a maximum 10 percent allocation in any of these asset classes.

Large-scale commercial real estate is attractive because it generates large cash flows and its underlying value moves with inflation … as do pension benefits.

For similar reasons we plan to invest in infrastructure assets. Canada faces an infrastructure deficit measured in many billions of dollars. This should create opportunity for attractive infrastructure investments that we believe we can meet our investment return requirements without undue risk.

Already, we have made entry-level investments in infrastructure and real estate, representing about one percent, or less than $700 million, of CPP assets.

In the case of private equity … we have already committed $6 billion to more than 40 limited partnerships managed by 36 general partners … as well as to funds created with the CPP Investment Board as the sole investor.

Among our private equity funds is one devoted to investing in early-stage companies across Canada in the information technology, biotechnology, communications and energy technology sectors. Currently, our venture capital commitments in Canada exceed $500 million.

We like private equity because it can deliver higher long-term risk-adjusted returns than public equities. Consultants, even in the US, have long referred to the returns on private equity as being shaped like a hockey-stick – with a long investment horizon and sharp increases in value towards the end of the investment period.

Finally, at the base of the portfolio, we expect to maintain a large bond portfolio going forward.

As I've said before, we don't measure our results in quarters, we measure them in quarter-centuries.

Nonetheless, to provide what we would regard as a "near-term" yardstick, in ten years we expect that CPP assets will exceed $190 billion.

Let me now turn to the subject of corporate governance.

Governance is a critically important subject for any organization, but especially for us. First, because as fiduciaries we must ensure we are acting at all times in the best interests of our contributors and beneficiaries. Second, because technically we are a Crown Corporation, but we are substantially different in important ways.

In fact…the CPP Investment Board is not a department or agency of the Crown, none of its directors, officers or employees are part of the public service of Canada and it operates independently from, but subject to the oversight, of government.

Rather, the CPP Investment Board is very much an independent investment organization that operates like a private sector investment management company competing in the capital markets.

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

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

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

To give two quick examples, we file our quarterly financial statements with federal and provincial finance ministers … and release them publicly. And we hold a public meeting every two years in each of the nine provinces that participate in the Canada Pension Plan. For the CEOs and CFOs among you, this is the equivalent of holding nine "annual" meetings every two years.

By the way, if you want to learn about our mandate, policies, directors, managers, assets and much more – you'll find it all on our web site. No pension fund discloses as much as we do – or as frequently.

At its core, the corporate governance framework sets out the duties of fiduciaries … and the relationship of those who manage to the people they ultimately serve – in our case, the beneficiaries of the CPP.

Our governance model balances responsibilities and accountabilities. It protects confidential and private information in the normal course of business … while letting in sufficient light that others can see what is going on. It keeps us at arm's length from governments in our investment, procurement and recruitment decisions while ensuring that governments who are the CPP sponsors, and therefore its ultimate stewards, have appropriate oversight.

The provincial and federal ministers who conceived of this structure went to great lengths to ensure that government would not – and could not – insert itself into the management of these assets or even of the CPP Investment Board itself.

Instead, that would be left to an independent board of qualified professionals with strict and broad accountability.

This structure was not only ingenious, it was necessary to gaining acceptance for higher contributions on the basis that those contributions would be invested wisely by qualified professionals.

Let me take you inside that governance model to show how independence from political influence is balanced by a level of accountability to parliament, the provinces and the public unparalleled in Canada.

From the beginning, the federal and provincial governments resolved that ours should be an experienced board with (and I quote) “a sufficient number of directors with proven financial ability or relevant work experience”.

The criteria approved by governments identified individuals with experience in a senior capacity in the financial industry … broad investment knowledge … experience as a CFO or treasurer of a large corporation or government entity … pension consulting experience … or accreditation as an investment professional.

How the directors are appointed is also a departure from the traditional practice for crown corporations. Let me explain.

The finance ministers created a nominating committee chaired by a former private sector chief executive officer. The provinces and federal government each appoint a member to the committee, which identifies and recommends a list of qualified board candidates. The federal finance minister appoints directors from that list after consulting provincial finance ministers.

This consultation is a check on partisanship because at any particular time federal and provincial governments are led by different political parties. To be appointed to our board of directors an individual needs to be both qualified, and broadly supported in Ottawa and in provincial capitals.

The process has produced a board of independent and independently minded directors with the mix of business, professional and investment experience appropriate to informed oversight of an investment management company.

The Federal and Provincial finance ministers who created the CPPIB Act should be proud of what they created. We certainly are.

Yet we have also consciously gone beyond the legislative requirements for such now-routine governance standards as conflict of interest policies, codes of conduct, restricted trading procedures and so forth.

We strive for best governance practices, including a rigorous process for the directors to evaluate themselves collectively and individually… and for the board to evaluate my performance as CEO.

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

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

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

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

This mechanism may not be perfect, but it works!

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

I hope my remarks have been helpful to you.

In a time of rising doubts about the sustainability of pension plans, the experts agree that the Canada Pension Plan is financially sound for at least 75 years.

We are working diligently to fulfill our mandate of maximizing returns without undue risk of loss to help fulfill Canada's pension promise.

Finally, as important as what we do will be how we do it – with integrity and respect for the task we have been asked to perform on behalf of the Canada Pension Plan's 16 million beneficiaries.

Thank you.