CPP INVESTMENT BOARD

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The Challenge of Investing for the

Pension Future of 16 million Canadians

Remarks

by

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to the

Association of Canadian Pension Management

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It is an honor to be a guest speaker at a conference searching so diligently for practical solutions to the pension fund challenge.

The ACPM has devoted today to the issue of risk.

Risk and its management have never been so critical considering the road ahead for many pension plans. It will be a bumpy road.

And we will not travel it alone. A crowd is gathering along the route to watch our progress. I am referring to the millions of Canadians who look to us for security of their retirement income.

Most of them do not have a pension plan at work. Nor are they able to save in their own RSP accounts, Consequently, they will have to rely on the Canada Pension Plan and Old Age Security when they retire.

Our own studies show that more than half of Canadians expect to be in that position … or nearly 10 million of today's working population.

And even among those covered by a registered plan, less than half have high confidence that it will be able to pay reasonable benefits when they retire. We saw this confirmed in the recent survey conducted by the Canadian Labour Congress, where Canadians ranked pension security as their number two concern, just behind health care.

This is the gloomy and changing environment in which we are talking about risk and risk management.

I want to talk about two sets of risks that we deal with all the time at the CPP Investment Board. One is investment risk. The other is reputation risk.

Before I do that, permit me to put the Canada Pension Plan itself in a risk perspective.

Fortunately, according to the actuarial experts, the Canada Pension Plan is financially sound.

The chief actuary for the CPP has stated that it is sound for at least 75 years … based on a 9.9 percent contribution rate and a reserve fund equivalent to 25 percent of liabilities. His opinion is endorsed by a panel of independent actuaries.

The CPP is designed to be only partially funded. That means investment income, while important, 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.

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

Typically, over the long term a mature pension plan will pay 80 percent of benefits from investment income and 20 percent from contributions.

In the case of the CPP, benefits are currently 100 percent funded by contributions. Even in the long term, 80 percent of benefits will be paid by contributions and 20 percent will come from investment income. This influences how we look at risk.

Other features of the Canada Pension Plan frame our view of risk. Here are three that are not widely understood.

Number one, 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.

Number two, the CPP is not financed or underwritten by government. 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.

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

With that background, let's deal first with our approach to investment risk.

We manage the CPP reserve fund in the context of the plan's liabilities. This is our investment framework. It includes our investment beliefs as well as concepts that define risk/return trade offs. Our investment policies, strategies, guidelines and procedures are all developed within this framework.

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

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

What is our risk tolerance in weathering short-term market volatility in pursuit of long-term returns? It is potentially higher than other pension funds.

One of the reasons for this is that, over the next several years, we expect to receive $6 billion to $8 billion of annual cash flow from excess CPP contributions and investment income. Another reason is that investment income will not be needed to help pay pension benefits until at least 2021. These factors also shape how we think about risk.

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

Our expectation is that equities will on average earn two percentage points more than government bonds. We can afford to invest a higher proportion of assets in equities and be patient about earning that premium.

Five years ago, CPP assets were exclusively federal and provincial bonds and short-term government securities. Continuing to invest only in government bonds will not sustain the Canada Pension Plan over the long term. We have to invest in a range of higher risk/return assets to reach and preferably exceed the four percent real rate of return considered necessary to sustain the CPP. And that is what we are doing.

We have already built a $33 billion portfolio of Canadian and foreign publicly traded stocks. Today these equities make up about 45 percent of all CPP assets.

They are invested largely on a passive basis in a portfolio of our own design. It is based on global industry sectors rather than country indices. It is designed to correlate as effectively as possible with movements in our liabilities.

We are also introducing active management to a portion of our public equity portfolio. In the past 6 months, we have retained four external managers to actively manage up to $500 million each in public equities.

Unlike traditional mandates, where a fund manager is given cash to invest, we don't give our managers any cash or securities to manage. We let them sell securities in our passive portfolio that they think are overvalued and invest the proceeds in securities they think are undervalued, ones that they believe will perform better. The risk of the portfolio purchased cannot be greater than the risk of the portfolio sold. We monitor the profitability and risk of each manager daily.

An innovative aspect of our approach is that managers receive a small base fee plus a portion of the value they create. The benchmark is the portfolio of securities sold. This aligns their financial interests with those of CPP beneficiaries. Managers who excel will be fully rewarded for their efforts and receive expanded mandates.
The $73 billion in assets currently available to the CPP are expected to exceed $190 billion within a decade.

Given our emerging size, we face a long-term portfolio risk– the foreign property rule. As you know, it restricts pension fund investing outside Canada to 30 percent of assets at cost.

The Canadian universe of high quality and highly liquid stocks is small. As we all know, it's less than three percent of global market capitalization. Putting so many eggs in a tiny basket is a long-term risk.

These companies populate relatively few economic sectors compared with the U.S. and Europe. Canada has a heavy weighting of companies in financial services, natural resources and utilities. Globally there are 12 major economic sectors. Canada is not represented fully or adequately in some of them, such as pharmaceuticals and technology.

How can we better manage portfolio risk and earn higher returns? By bringing improved economic sector balance to our public equity portfolio in line with the global reality.

That is the basic strategy for public equities … largely passive management implemented by our staff … with a portion of the portfolio actively managed externally. This format will evolve over time but it is where we are today.

We would also like 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.

Right now, these assets make up about three percent of total CPP assets … so we have a long way to go.

Large-scale commercial real estate is attractive because its underlying value moves with inflation … as do pension benefits.

For similar reasons we hope to invest in infrastructure assets. Canada faces an infrastructure deficit of many billions of dollars. There is a growing realization that federal, provincial and municipal governments cannot afford to do all the building themselves.

Yet transportation, energy, environmental safety, urban development, health care and other assets must be built if Canada is to remain competitive and deliver its citizens the quality of life they deserve.

Already, we have made entry-level investments of about $840 million in infrastructure and real estate, or roughly one percent of CPP assets.

In the case of private equity … we have committed more than $6 billion to 38 private equity partners managing 46 funds. More than $2 billion has been drawn down and invested in hundred's of underlying companies.

We like private equity because it can deliver higher risk-adjusted returns than public equities … although it can take several years for positive cash flows to materialize … and longer to realize full value.

In all this diversification, we will maintain a large fixed income portfolio, currently valued at $37 billion. The bonds in this portfolio are non-marketable and will take many years to mature.

We spend a lot of time communicating and reporting on our investment performance. Every quarter, at the minimum.

During my investment career, I have learned that investment returns alone are not sufficient to sustain public confidence. In a study conducted while I was President of Burns Fry, retail clients did not rate investment returns as number one on their priority list. Trust that their investment advisor was committed to their long term best interests was their priority.

The workers who contribute to pension plans have an implicit pact of trust with plan fiduciaries. They expect us to act with integrity, with high ethical standards… and they also expect us to manage their retirement income prudently… to be reliable… and to tell them what is going on.

They do not expect surprises – such as deep funding shortfalls or sudden contribution rate increases, let alone rollbacks in benefits.

What I am talking about is reputation risk.

Unlike most funds, we are obliged to talk to our stakeholders on a regular basis. This morning, for example, we held a public meeting in Vancouver as part of our legislated requirement to hold public meetings every two years in each province that participates in the Canada Pension Plan. Today's meeting completes our tour of western provinces. Next month we will visit eastern Canada.

Our approach to managing reputation risk is based on the simple premise that Canadians have the right to know what we are doing with their money … why and how we are diversifying assets … what assets are owned on their behalf … and how those assets are performing.

For example, we make our financial statements public every three months. Furthermore, we explain them through a quarterly media conference call.

One of the strengths of our reputation … judging by what Canadians tell us through opinion research … is our governance.

The CPP Investment Board operates like a private sector investment management company competing in capital markets.
It is governed by qualified board with directors experienced in investing, accounting, financial management, business leadership and pension funds.

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

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

However, two-thirds of Canadians are worried that there may be political interference in the way CPP assets are managed.
General public concern about the governance and performance of pension plans and pension funds will no doubt escalate in the years head. Under such a scenario, we believe managing reputation risk is as important as managing investment risk.

A cornerstone of effective reputation risk management is disclosure. Full disclosure. Plain language disclosure. And timely disclosure.

We expect full disclosure by companies in which we invest. Consequently, we support shareholder resolutions calling for greater disclosure on the funding status of corporate pension plans. We also support full disclosure, including valuations of all pension benefits awarded to senior executives. As a major investor, we want to know how those costs might influence our future returns.

As greater disclosure occurs … and shareholders begin to better understand the true impact of unfunded pension liabilities on a company's financial health … more employers may choose to abandon the defined benefits model.

Some stakeholders have a fundamental concern about investing CPP money in the stock market.

We talk about market volatility at every opportunity. We tell Canadians that in the next decade or so we could have multi-billion dollar gains or losses in a single three-month reporting period.

One of the pleasant surprises is that Canadians appear to accept short-term volatility. Between 2000 and 2003, we came through one of the worst stock market crashes in history. Yet public confidence in our mission fluctuated hardly at all.

In setting up the CPP Investment Board, the federal and provincial governments understood what it means to ask a crown corporation to compete in the commercial sector.

We must protect confidential information that is the property of those we do business with. We must keep confidential information that could signal our intentions to capital markets and affect our ability to maximize returns without undue risk.

As it is, we disclose a considerable amount of information that Canadians appear to find useful. This, as you have gathered, is a cornerstone of our reputation risk management.

Reputation management also means showing respect for stakeholders by responding thoughtfully, candidly and comprehensively to their concerns. Let me share an example.

Last December, two parliamentarians suggested the CPP Investment Board was investing in companies that produce anti-personnel landmines for the U.S. military. They named the suspect companies.

They alleged we were violating Canadian legislation and our own social investment policy. Under that policy, we consider as eligible investments the securities of any company that is in a legal business under Canadian law and operates in any country where Canada maintains normal financial, trade and investment relations.

In response, we conducted due diligence directly and through third parties and found no evidence that the companies cited were involved in the production of anti-personnel mines. We stated that if such evidence existed, we would sell our shares, in accordance with our social investing policy.

To use another example … the Canadian Medical Association recently passed a resolution calling on government to ban the CPP Investment Board from investing in tobacco stocks.

Personally, I understand and sympathize with the CMA's fight against tobacco, having been a cancer patient twice, a long time supporter of the Non- Smokers Rights Association and chair of the foundation for Toronto's Princess Margaret Hospital - one of the world's leading comprehensive cancer centres.

But professionally, given that I am responsible for managing the assets intended to help ensure the future pensions of 16 million Canadians, I am strongly opposed to the recommended prohibition.

The issue is not about tobacco, or what the CMA campaign might do to tobacco companies; the issue is what it would do to the CPP.

Defined benefit pension plans, like the CPP, have a single purpose. Their reason for being is to pay the pensions promised to their retirees. Pension funds are not vehicles for advocacy groups to advance their objectives, however worthy.

If the CMA's campaign is successful, it is only a matter of time before other equally well-intentioned organizations demand that other enterprises and industries be added to the CPP Investment Board's proscribed list. And then that certain companies or sectors or regions become required investments.

This is not a formula for success.

The management of the CPP reserve fund by investment professionals – with a focused investment mandate, accountable to a capable and dedicated board of directors and operating free of political influence – is critical to the long-term sustainability of the CPP.

As you can see, we do not take sides on issues of personal or political choice. In fact, we can't. Our legislation restricts us to investing in the best interests of CPP contributors and beneficiaries and to maximize returns without undue risk of loss, having regard for the funding and financial obligations of the Canada Pension Plan.

Screening for non-investment reasons would be inconsistent with these two objectives.

Many Canadians are disappointed when we tell them the facts and our views on screening, but our approach is that it is better to be clear and truthful.

In closing, let me leave you with three messages that I hope are as useful to you as they have been to me.

First, make sure you understand the risk exposures of your pension plan. Do the analysis. Bring in the experts. Challenge them. Learn from them. Risk -- not returns -- should be the starting point for pension management.

Second, do what you can to ensure you have a board of directors with experience and knowledge relevant to your mandate. Dealing with an intelligent board has kept my management team and me on our toes and enabled us to do a better job for those we serve.

Third, do not be afraid to disclose information to plan members … to shareholders in the private sector … and to taxpayers in the public sector. Set aside your reluctance to tell more. A commitment to disclosure and candor on tough issues helps to reinforce best business and best governance practices.

Sunlight is the ultimate disinfectant … and encourages all of us to find practical solutions to the pension challenge before it becomes a crisis.

Thank you.