CPP INVESTMENT BOARD

(Check Against Delivery)

Know Thyself: What Canada's Pension Plans Can Learn from Each Other

Notes for remarks by

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Good morning everyone. Thank you Dan for that introduction. And if I may speak on behalf of all of us here today, thank you to the staff and directors of PIAC for the excellent work you do to give our industry a forum for sharing knowledge and a common voice with lawmakers and regulators.

The Canada Pension Plan Investment Board is proud to be a member of PIAC. To be sure, we have our own professional development, governance and advocacy programs, but they are no substitute for the work PIAC does to promote prudent investment standards, represent Canadian pension plans on policy matters, and raise awareness of best practices for pension fund governance.

So thank you all for the work you do, and for inviting me here today.

According to the conference program, the topic of my remarks this morning is, "Pension Funds Large and Small: What Can We Learn from Each Other?"

It's an interesting question but perhaps, I think, the wrong one.

This isn't to suggest that big funds and small funds can't learn from each other – of course, we can – but rather, that the key to success for any organization is how well its strategy, governance and business practices align to *its own unique* beliefs, challenges and characteristics.

The better question then, might be: "What can we learn from *ourselves*?" And so I have taken the speaker's prerogative to re-name remarks this morning to: "Know Thyself: What Canada's Pension Plans can Learn from Each Other."

In trying to organize my thoughts around this point, I was reminded of the famous advice Polonius gave to his son, Laertes, in Hamlet, when he said: "To thine own self, be true."

It was good advice for a young man about to travel to Paris, and it is good advice for all of us as we seek out portfolio designs and investment strategies to advance our respective goals.

In reading further on this point, I noted Polonius also cautioned Laertes, “Neither a borrower nor a lender be!” – also prescient advice these days!

Finally, and in the same breath, no less, he reminded his son that “Brevity is the soul of wit.”

Taking this last point to heart, so to speak, let me get on with it before someone thrusts a dagger through the curtain!

I will spare you the complete and unabridged history of the Canada Pension Plan Investment Board, but this much is relevant:

- In 1996, the CPP was facing a pension funding crisis. That year, it received $11 billion in contributions and paid out $17 billion in benefits, with an asset base of $35 billion.

- The federal and provincial finance ministers who reformed the CPP in 1997 envisaged the creation of a diversified portfolio to grow beyond the $35 billion legacy portfolio of non-marketable federal, provincial and territorial government bonds at that time.

- The CPPIB was created in 1997 by Act of Parliament to help sustain the Canada Pension Plan by investing the funds not needed to pay current benefits.

- We operate at arms’ length from government and according to a clear, singular and legislated mandate “to maximize investment returns without undue risk of loss.”

- At inception, the CPPIB had only a board of directors and an Act of Parliament. There was no office, no management team and no strategy.

- Today the CPPIB manages approximately $120 billion in assets in a broadly diversified portfolio and earned 13.6 per cent annualized rate of investment return over the past four fiscal years or $43 billion.

- Finally, Canada's Chief Actuary estimated in his last report that CPP contributions will exceed annual benefits paid through 2019, providing a 12-year period before a portion of the CPP Fund’s investment income would be needed to help pay CPP benefits. He has also projected that the CPP Fund will grow to approximately 312 billion by 2019, and will be sustainable throughout the 75-year period of the report.

These basic facts tell us a few things that provide important context for this discussion of what we can learn from ourselves. Chiefly, they tell us that:

- Number one, we have had to create an organization – and an investment strategy – from scratch, in relatively short order;

- Number two, that in our mission, mandate, size and investment challenge, we are not like most other funds; and

- Number three, that strategy emanates from the investment beliefs we hold, and the unique challenges and characteristics of our organization.

Let me build on this last point to trace the evolution of the CPPIB’s strategy, because it

seems to me the key strategic questions for any pension organization, as they were for us, are:

- What are we trying to achieve?
- What investment beliefs do we hold?
- What are our comparative advantages and disadvantages? And,
- What are our strategic options?

If I am successful in answering these questions as they relate to the CPP Investment Board, I hope to then be able to draw some general insights applicable to all of us.

So, what are we trying to achieve?

As indicated earlier, by the mid 1990s, the CPP had become unsustainable. Benefits paid far exceeded contributions received, and the plan was destined for insolvency. The CPPIB was created as part of a plan to create a new funding mechanism for the CPP.

The solution had three elements:

1. Modest reductions in future benefits;

2. An accelerated increase in the contribution rate from 5.6 to 9.9 per cent in order to create a sizeable reserve fund; and

3. The creation of the Canada Pension Plan Investment Board to manage this fund for the benefit of 17 million Canadian contributors and beneficiaries.

From its inception, the clear goal established for the CPPIB was to generate sufficient investment income to help sustain the CPP at its 9.9% contribution rate.

In analyzing the assumptions used to establish the 9.9% contribution rate, it was clear that the reformers of the CPP incorporated return assumptions comparable to other large public sector funds operating at that time, along with a corresponding level of systematic risk within the anticipated CPP Fund portfolio.

To put a finer point on it, Canada's Chief Actuary has estimated that the CPP Fund needs to achieve a 4.2% rate of return, after inflation, over time, to help sustain the CPP at its current contribution rate.

So that – at least, from an investment perspective -- is the minimum threshold for what we are trying to achieve.

I think the investment professionals in the room will agree that this is not an easy hurdle to clear. But at least it is clear how high we have to jump, and that clarity is a very valuable thing when it comes to defining a long-term strategy.

What do we believe?

The investment beliefs we hold, and why that is an important governance matter for pension funds to contend with, could be the topic of a lengthy dissertation in and of itself. And indeed, it will be a chapter, in an upcoming book to be published by our Senior Vice President of Public Market Investments.

The essential point is that finance is a relatively young discipline in which data are limited, biased or both; and in which the ratio of noise to signal is very high. In other words, it is very difficult to *know* anything with a high degree of certainty when it comes to investment theory, therefore we must *believe* certain things and shape our strategies according to those beliefs.

I'll give you two examples of investment beliefs held by the CPP Investment Board.

- The first is that investment costs are more predictable than investment risks and that these risks are more predictable than returns.

- The second is that average returns of illiquid assets (including private equity and real estate) are highly correlated to the comparable, passive public market alternative over a sufficiently long horizon.

As I'll discuss a bit later, these kinds of beliefs are important because the goal of strategy development should be to decide where, how and when to build capabilities and infrastructure that aligns to these beliefs and the organization's investment goals.

Which brings us back to Polonius's advice: "Know thyself."

Knowing what you believe is one thing, knowing how to apply those beliefs and understanding what you have to work with is another.

What are our comparative advantages and disadvantages?

In its early years, the CPP Fund was passively managed and subject to certain constraints – such as the foreign property rule, which applied to all Canadian investors; and certain limits on our ability to use derivatives, for example, that were unique to us. At least with respect to the latter, this was done by design, to ensure that this young organization would 'walk before it ran'.

Over time, however, these constraints were removed and it was time for us to chart our own strategic course.

Having defined our investment challenge, we next looked at what we had to work with. In our case, the answer was rather unique. We saw two broad areas of comparative advantage.

The first area of advantage was structural. These are advantages that arise from the nature of our role and mandate, and they include: a very long-term investment horizon, the certainty of our cash inflows and the current and projected size of our portfolio.

Let me touch briefly on each of these. Given the partially funded status of the CPP Fund, we have an implied minimum 75-year amortization period for investment returns. This is dramatically different from fully-funded plans and provides additional flexibility to make investments with longer-term return characteristics.

Next, we have relative certainty about the amounts and timing of additional cash flows into the CPP. Unlike most investment management organizations, we do not face sudden client redemptions or withdrawals and need not be concerned about being forced to sell assets at potentially inopportune times. As a result, we can utilize our liquidity to capitalize on opportunities to buy assets when other market participants are constrained or may be forced to sell to meet their own liquidity demands.

Finally, the size of our portfolio provides us with sufficient scale to create sophisticated internal investment, technology and operational capabilities. These enable us to compete in asset classes where significant capital and expertise is required – infrastructure investments, would be a good example – to make comparatively large individual investments that would be beyond the reach or concentration limits of many other organizations. The size of the fund also permits us to operate as a global investor with meaningful scale in key geographic regions.

The second broad area of advantage are what we call developed advantages. Developed advantages are choices we make about how to operate as an investment organization, and they include things like our ability to partner with world-class firms, and what we call Total Portfolio Management.

Total Portfolio Management is a simple concept with profound implications for how we structure our organization and conduct our investment activities. In a nutshell, Total Portfolio Management is designed to achieve diversification at the total portfolio level, rather than within each asset category, by requiring our portfolio design and investment teams to analyze investments according to their underlying risk-return attributes and their impact on the total portfolio, rather than their asset class labels.

In this view of things, owning a toll road, for example, can have similar characteristics to owning a government bond. Balancing the total portfolio according to these characteristics, rather than by labels like “infrastructure” or “fixed income” can help clarify the decision-making process and reveal the underlying risks within a portfolio.

For all its benefits, however, TPM requires:

- An active total portfolio policy and decision-making body;
- A high degree of information sharing and collaboration across all investment departments;
- An objective assessment of risk-return characteristics of investment opportunities;
- Sophisticated risk and performance attribution systems; and
- Compensation policies that are aligned with this approach.

As you can appreciate, Total Portfolio Management entails a certain amount of scale and a relatively high degree of operational complexity. As such, it isn’t for everyone. But it does underscore the link between investment beliefs, investment strategy and organizational structure.

I’ve given you a quick summary of our advantages. But what of our disadvantages? The

most obvious is, once again, the size of our portfolio. Just as size enables us to build internal capabilities, forge strategic partnerships and capture opportunities available only to a small universe of the largest investors, that same size reduces the attractiveness of programs such as small cap equities or venture capital that are inherently difficult to scale.

What were our strategic choices?

We come now to the critical question. Knowing what we had to achieve, the investment beliefs we hold, and what we had to work with, what strategic choices were available to us?

Well, from our perspective, there were two valid and distinct ways of achieving the minimum 4.2% real return needed to sustain the Plan at current contribution rates.

The first option was an easy-to-understand, low-cost, low-complexity model built to reflect the objectives and risk preferences envisioned by stakeholders, as well as our current view of the unique nature of CPP's net liabilities.

This approach would have seen the fund adopt an entirely passive approach to access the returns from liquid, developed public markets in a low-cost manner. It would be implemented by a small organization primarily focused on portfolio design and using passive investment programs run by external managers. A priority would be placed upon cost minimization and Board oversight would be relatively straightforward.

Using reasonable capital market assumptions, this portfolio could reasonably be expected to generate the required long-term returns to help sustain the contribution rate. As such, it constituted a viable strategic alternative for CPPIB. Indeed, this essentially was the strategy we followed in the early years of the CPPIB.

The second option was a value-added approach using more active investment strategies to achieve higher risk-adjusted returns. As I alluded to a minute ago, this approach requires a larger and more complex organization comprised of people with diverse skills and backgrounds, along with corresponding systems, policies and procedures.

When confronted with a stark choice between these two vastly different approaches, we did what any rationale person would do. We chose both…in a manner of speaking.

Option 1, the low-cost, low-complexity model, serves as our benchmark. We call it the CPP Reference Portfolio, and it is the yardstick by which we evaluate strategic decisions and measure our own performance.

Option 2, an active, value-added approach, is the choice we made. We made it because it plays to our advantages, it fully reflects our legislated mandate to "maximize investment returns without undue risk," and because it takes into account the nature of the CPP liabilities.

It is also consistent with our investment beliefs, including the few I spoke of earlier.

I said that investment costs are more predictable than investment risks and that these risks are more predictable than returns. This suggests that an organization that lacks the size to compete for internal or external talent or to build world-class investment systems, partnerships and other capabilities, might be better off pursuing a passive strategy that minimizes costs while capturing market-based returns. In this regard, a penny saved is a penny of "alpha" earned, and that is a good strategy, to be sure.

I also said we believe that average returns of illiquid assets, private equity for example, are highly correlated to the comparable, passive public market alternative over a sufficiently long horizon. This suggests that we would be better to avoid these asset classes, unless we have the scale and other characteristics necessary to access top quartile

– and top decile – funds or direct investments, in which case the long-term returns are significantly greater than those that can be achieved in the public markets.

Indeed, we do believe active management can not only add value, but that it can add value without dramatically increasing portfolio risk.

In either case, the implications are clear. There is no "one-size-fits-all" rule for pension fund management. There is truly more we can learn by looking deeply into our own situations, than by looking at others. In the absence of fundamental investment beliefs, there is always the potential for organizations to find that they have followed not a strategy, but a herd, into an asset class, geography or type of security that does not serve its goals.

To chart a successful investment strategy, we must first look inward to determine our beliefs and assess our advantages and disadvantages. Only then can we move outward into the realms of strategy and the competition for investment returns that match our respective investment goals and liabilities.

Once there, we should not forget the value of sharing our insights at forums like this to advance the overarching goal of pension security and a common voice on issues of common interest.

I've covered a lot of ground today. I hope you have found it useful, and I would be more than happy to take your questions.

Thank you