Helping to Keep the Pension Promise

Canada Pension Plan Investment Board:

Helping to Keep the Pension Plan Promise

Remarks by

John A. MacNaughton

President and Chief Executive Officer

Canada Pension Plan Investment Board

to the

1999 Annual Conference

Association of Canadian Pension Management

Delta St. John’s Hotel, St. John’s, Newfoundland

8.30 a.m. Thursday, September 16, 1999

Thank you for your warm welcome and introduction.

I stand here this morning with a mixture of emotions pulling me in different directions.

Certainly I am proud to be introduced for the first time before a public audience as the President and Chief Executive Officer of the CPP Investment Board. But I have a tinge of nervousness about addressing a gathering of pension experts after only one week on the job.

I had a similar sinking feeling 20 years ago as President of a luncheon speakers' club in Toronto … the Empire Club of Canada. On that occasion the guest of honour … on my right … was the renowned violinist Isaac Stern. On my left was Canada's most lauded contralto Maureen Forrester.

At the club … we always began our program by marching in the head table … saying a blessing … and then singing O Canada. On this particular day, a prankster must have taken a wrench to our piano.

When the opening chord was struck … the pianist froze in horror. Stern and Forrester looked at me with confusion … the audience with sympathy.

I had the microphone. I was flanked by these two greater performers … before an audience full of music lovers … and it was clear to everyone that it had fallen to me to sing the opening notes of our national anthem.

I feel much the same today … trying to find my voice …surrounded by star performers and professionals from the world … not of music … but of pensions.

I don't choose the phrase "find my voice" casually because … as I will explain … an important part of my mandate is to communicate with Canadians from coast to coast …telling them about the Canada Pension Plan and how its assets … their assets … will be managed in the future.

In an ideal world, I would prefer more than six days on the job to prepare for this sophisticated audience. But perhaps there are benefits to being here early in my incumbency as well.

There is much I can share with you. And there are numerous topics on which I hope we can start a dialogue so that … as I move forward with my responsibilities … I can benefit from the expertise that exists in this room.

What I would like to do in my time slot this morning is discuss three topics.

First, I would like to tell you a little of the history of the Canada Pension Plan that led to the creation of the Investment Board.

Second, I will discuss the mandate of the Investment Board and its activities during the few months it has existed.

Third, I want to share with you what I see as the principal issues that the Investment Board must address in the next year.

These issues are very relevant to most of you. They are the ones that I must research, reflect upon, and recommend to my board of directors in the next few months. Your comments and suggestions will be most welcome.

So let's start with a review of the Canada Pension Plan … and the changes that gave birth to the Investment Board.

The plan was established on January 1, 1966 … at a time when the Beatles were the rage … and hippies hitched their way along our nation's highways.

Canada was in a festive mood leading up to the Centennial and Expo 67. And no wonder. The economy was booming …the labour force was expanding … jobs were plentiful … productivity and wages were rising … and governments were building schools, hospitals, universities and highways to keep pace with the growth.

Good days indeed. And a time to be generous to our grandparents who were entering retirement.

They were the Canadians who had endured the hardship of the Great Depression in the 1930s … and the sacrifices of the Second World War in the 1940s.

But they had been unable to save much for their retirement years. It was mathematically easy to be generous to them because they were relatively few.

It was in this socio-economic context that the Canada Pension Plan was born ... to provide all working Canadians with retirement income … as well as financial help to their families in the event the breadwinner died or became disabled.

From the beginning … the idea was to replace a portion of the worker's pre-retirement earnings with a guaranteed pension. The CPP is not … nor was it conceived as … an income redistribution program.

It is important to remember that … back in 1966 … many Canadians did not have a pension. Even those who did sometimes lost it if their employer went bankrupt.

And few had pension portability among different employers. Workers who hated their jobs had to grin and bear it … or lose their pension entitlements if they quit.

By introducing pension portability and a guaranteed retirement income … the Canada Pension Plan accomplished important social change.

The plan started with a bang. Contributions poured in faster than benefits were being paid out. By 1970 … the plan was taking in $733 million a year … but paying out only $97 million.

In the first five years … the age of eligibility was lowered gradually from 70 to 65 … and the first age-65 pension was paid in 1970.

All in all, the CPP was a great idea … providing full coverage for Canadian workers, portable benefits, inflation protection and the major source of income for many seniors.

Throughout its history … the Canada Pension Plan has been a pay-as-you-go scheme … with each generation paying the pensions of the previous generation. It was never intended to be a fully funded plan.

The contribution rate started out at 3.6 percent of pensionable earnings … split between employers and employees. No one imagined we would ever have to pay more than 5.5 percent to keep the plan viable.

Let’s fast forward 30 years … from the mid-60s to the mid-90s.

By 1996 … when the governments decided to review and overhaul many aspects of the plan … more than 10 million Canadians were contributing to the CPP … with about 3.5 million drawing benefits.

In other words, one third of Canadians supported the CPP … by contributing more than $11 billion a year … while roughly 10 percent benefited from it … by receiving close to $17 billion a year.

The contribution rate had risen to 5.6 percent … or a maximum of just under $900 a year … and the maximum annual pension was a little over $8,700.

These numbers tell part of the story. More money was going out annually than was coming in. Four factors were driving the imbalance.

First, plan costs had escalated following the periodic enrichment of benefits.

Second, the economy had not performed as well as expected back in the 60s … thus reducing contributions.

Third, the cost of disability benefits had grown more rapidly than expected following improved benefits in 1987.

Fourth, Canada's demographics had changed.

At one end of the spectrum … birth rates were much lower than had been anticipated in the 1960s … as women entered the workforce … and opted for smaller families or no children at all.

At the other end … death rates were lower … thanks to medical advances and healthier lifestyles … which meant people were living longer in retirement.

To give you a clearer idea of what this means … our life expectancy today is three years longer than in the mid-1960s … and will add another 1.4 years by 2030.

Other major demographic shifts are also on the way. As you know, the baby boom generation will start to retire in large numbers around 2011. By 2030 … about 23 percent of Canadians will be 65 or over.

That will be double today's proportion of seniors to workers. Only three workers will support every person receiving CPP benefits … versus five today.

As a result of these factors … the federal chief actuary estimated in 1995 that future generations would have to pay 14.2 percent of their contributory earnings to keep up with the needs of retired Canadians.

Think about that. If the 14.2 percent rate had been in effect in 1995 … Canadians making more than $35,000 a year would have paid $2,200 annually in CPP contributions … instead of $850.

Self-employed Canadians would have paid twice that … or about $4,500 a year.

The situation was even bleaker than I have described.

Historically … the CPP kept surplus funds in a reserve as a cushion against adverse economic and demographic fluctuations. The goal was a reserve fund equivalent to two years of benefits.

This money was lent to the provinces and federal government in the form of 20-year bonds … and earned interest based on the average federal long bond rate at the time the loans were made.

The chief actuary reported that if contribution rates were not increased sharply … the reserve fund would be exhausted by 2015.

All in all … the Canada Pension Plan was headed for serious trouble.

The federal and provincial governments are joint stewards of the plan … and are required to review the benefits, contribution rates and financial viability of the CPP. These reviews occurred every five years.

Changes had to be approved by the federal parliament and the governments of at least two-thirds of the provinces … with two-thirds of the population.

The most recent review was very thorough … and involved extensive public consultation in early 1996.

Public hearings were held across Canada … and some 270 groups representing labour, business, women, youth, seniors and other interest groups had their say … as did 6,000 individuals on a special hot line.

On top of that … federal and provincial finance ministers held a series of meetings.

It is heartening that Canadians were overwhelmingly concerned about the cost burden that would be placed on future generations if changes were not made. They were also concerned about the security of their own pensions.

And important changes were made in 1997 to put the CPP on a firmer financial footing … and make it affordable and fairer to future generations. Let's review the key changes.

First, the contribution rate is being increased to 9.9 percent of maximum pensionable earnings by 2003 … and will then, according to the finance ministers, be held steady for the foreseeable future.

This means that today's workers will cover the costs of their own pensions … instead of passing them on to their children and grandchildren.

Second, plan costs are being improved … particularly in tightening the administration of disability pensions.

Third, the size of the CPP's reserve fund is being increased from two years of benefits to five years … principally as a result of the increased contribution rate.

Fourth, federal/provincial reviews will now occur every three years instead of every five.

And fifth, the new organization I am privileged to lead was created to invest surplus funds in a diversified portfolio of securities.

These are highlights of the CPP's history and recent changes. From the financial perspective … the plan is moving from exclusively pay-as-you-go to fuller funding … a process that will take 20 years.

According to the last federal actuarial report … at the end of 1997 … the plan's assets of $36 billion represented about 8 percent of liabilities. Under the new funding formula … assets will eventually reach between 17 and 20 percent of liabilities.

This is known as steady state funding … because it is assumed that by raising the contribution rate to 9.9 percent and holding it there … contributions and investment income will cover all pension payments.

As you can tell … a great deal has changed … and had to change. And not just with the CPP.

Today, Canadians are generally better off and better able to provide for their retirement than those who were entering retirement 30 years ago.

In 1997, for example, Statistics Canada estimated that 7.5 million taxpayers put money aside for their retirement in either a registered pension plan or their own personal retirement savings plan.

Still, the CPP is very much the cornerstone of retirement income for Canadians … if not the major source of retirement income for many individuals not covered by private plans … and also for those unable or unwilling to save through their own RSP.

According to StatsCan data … Canada Pension Plan payments represent about one third of the average income of men aged 65 and over – and 50 percent or more for women in the same age group.

Consequently, striving to gain greater value from CPP contributions through a diversified investment program makes eminent sense.

So let me turn now to my second topic – the role of the CPP Investment Board.

The Investment Board, which was created by an Act of Parliament, commenced operations in October, 1998. It is dedicated to increasing the long-term value of CPP assets through prudent investments. These assets will eventually help the CPP to meet its obligations.

The Investment Board operates independently of the Canada Pension Plan … which continues to be designed by the federal and provincial governments … with various federal departments responsible for its administration.

We are a single-purpose corporation. Our job is to invest the funds we receive from the Canada Pension Plan in the best interests of CPP contributors and beneficiaries.

In stating the principle that gave rise to the Investment Board … the federal and provincial finance ministers insisted “governance structures must be created to ensure sound fund management”.

So before I talk about our investment mandate … let me address our governance practices, starting with the board of directors.

The finance ministers created a special nominating committee to select individuals with the expertise, experience and impartiality to oversee the Investment Board's management.

The committee consisted of public officials and private sector representatives. They came from across Canada … with a private sector executive in the chair.

The federal Finance Minister selected candidates from the nominating committee's list and … in consultation with provincial finance ministers … appointed 12 directors in October 1998.

The board has extensive investment, financial and business expertise …and represents all regions of Canada. It is a dedicated board … that actively supported the Chair, Gail Cook-Bennett … while she discharged the responsibilities of CEO prior to my arrival.

From a standing start … and with few staff … the directors have laid a strong foundation. As a result, the Investment Board is in the vanguard of good governance practices and public accountability.

The corporate governance committee has developed policies and practices consistent with our legislation and the guidelines of the Toronto and Montreal stock exchanges for public companies. In some cases, it has gone even further.

The directors are, of course, required to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

In our case, directors with specialist knowledge … in accounting, law and investment, for example … are subject to higher standards of care in areas that relate to their expertise.

As well our legislation sets conflict-of-interest provisions that are stronger than those found in the Canada Business Corporations Act and the Bank Act.

Another distinguishing feature of the Investment Board is the intensity of our public accountability.

We have a clearly articulated investment policy. We publish a detailed annual report and quarterly reports. Our first annual report … for the fiscal year ending March 1999 … was distributed in June … and we have released three quarterly reports. Our results for the quarter ending this month will be available by mid-November.

Furthermore, we will hold public meetings once every two years in each province. The first meetings will be held across Canada next year.

Public communication is a priority for us … and a large part of my personal responsibility. Our goal is to keep Canadians informed about our efforts to increase the long-term value of Canada Pension Plan assets.

We have also established a Web site and will keep it current. My remarks to you this morning, for example, will be published on our Web site.

Let me turn now to our investment mandate and activities.

Our legislation states that we must invest in the best interests of CPP contributors and beneficiaries by maximizing investment returns without incurring undue risk.

To keep the CPP in a steady-state funding status after 2003 … the federal actuary assumed cash flows not needed to pay pensions will earn a 4 percent real rate of return.

With inflation projected to grow to 3 percent annually over the next few years … our nominal investment objective is therefore approximately 7 percent.

We receive cash flows from three sources.

One is CPP contributions not required to pay current pensions.

A second is the government bond portfolio … currently administered by the federal Department of Finance. These are the funds lent to governments in the form of non-negotiable and non-marketable 20-year bonds.

Each province has the option to roll over its existing bonds at maturity for one further 20-year term. The bond rate for governments electing to roll over will be the market rate for that province. Funds not rolled over are transferred to the Investment Board, unless needed by the CPP.

The third source of cash flow will be the income generated by our investing in capital markets.

Over the next 10 years, the federal government's best estimate is that the Investment Board could receive $88 billion from these three sources.

In regard to our investing … we are required to develop, and review at least annually, a formal investment policy. We have one. It is a public document and copies are available on request.

Our investment policy deals with the usual issues that an institutional investor is expected to address – such as asset mix, asset diversification, expected returns, risk management and liquidity, the use of derivative products, asset valuation and the exercise of proxy voting rights attached to share ownership.

As you know … the key decision affecting long-term investment returns is the allocation of funds between equities and fixed-income securities.

In developing our asset mix, we took into consideration the CPP bond portfolio … although we do not currently manage it.

The bond portfolio at book value is earning over eleven percent -- substantially higher than our long-term investment objective of 4 percent plus inflation.

This yield was locked in when interest rates were exceptionally high in the early and mid-1980s … and, of course, cannot be replicated today.

The bond portfolio … at approximately $31 billion … represents the bulk of CPP assets. To offset its dominance and to diversify the asset base … our board of directors adopted the interim policy of investing 100 percent of cash flows in equities.

If all cash flows are invested in equities for three years … the combined mix of invested assets held by the Canada Pension Plan and the Investment Board would range between 20 percent and 35 percent equities by the end of 2001 …depending on bond rollovers by the provinces.

So shifting the asset mix from exclusively bonds to a blend of bonds and equities will take a little time.

The Investment Board currently operates under certain investment restrictions.

One is the foreign property limit that applies to all pension plans. We are in strict compliance with the letter and spirit of this rule. This means that the Investment Board does not currently use derivative contracts to increase effective exposure to foreign equity markets above the 20 percent foreign limit.

As a result … at least 80 percent of cash flows at cost are being invested in Canada.

A second restriction is that all cash flows allocated to Canadian equities must replicate substantially the composition of one or more broad indices.

This is a reasonable restriction during our start up period. It will be reconsidered and I expect we will make recommendations to governments at the time of the next review of the Canada Pension Plan.

Given these restrictions … and in view of the decision to invest all cash flows in equities … we retained TD Quantitative Capital to invest in the Toronto Stock Exchange 300 Composite Index …and Barclays Global Investors to invest in the Standard & Poor's 500 Index of large companies in the United States … and the EAFE Index of about 1,000 companies in Europe, Australia and the Far East.

What have we accomplished so far?

During the four months, starting last March, we received $525 million from the CPP … and earned net income of $8 million. These earnings are equivalent to nearly 1,000 current CPP pensions. It's a start.

At June 30 … the date of our most recent quarterly statement … the Investment Board had $533 million in net assets to help deliver the CPP pension promise.

In terms of asset mix … the CPP's bond portfolio plus cash reserves now represent 98.5% of assets … and the Investment Board's equities 1.5%. Yes, we have a long way to go before asset class diversification is achieved.

Let me now turn to my third and final topic – where do we go from here? This is where I would welcome your comments … and the input of other Canadians.

As I noted, our interim policy is to invest 100 percent of cash flows in equities. While the fund is relatively small today at half-a-billion dollars … it will likely be $88 billion or more within ten years.

As the fund grows … setting a longer-term asset mix policy will emerge as a priority. At the same time… we must make a series of other decisions that will shape our investment and operating philosophy and strategy.

Basically, we must resolve three key questions – passive versus active investing … asset classes beyond traditional stocks and bonds … and external versus internal fund management.

Let me start with indexing versus active management. I am not going to re-iterate the arguments in favor of each. I am sure all of you know them well … and know which side of the debate you are on.

What I will share with you … and this may sound like heresy from a former investment dealer … is that I believe indexing makes sense in the early years for a fund that will be investing several billions of dollars annually during the next decade.

Indexing is a cost-efficient and effective way to invest large sums of money quickly and smoothly in equity markets. The performance history of indexing is compelling.

Right now, the Canadian index pickings are slim – basically the TSE 300 index and the new S&P/TSE indices.

The realignment of stock exchanges may give impetus to new stock indices – small cap and mid-cap on the proposed western exchange … and a selection of derivative indices on the Montreal exchange.

We are not irrevocably or exclusively committed to indexing. Going forward … we will certainly contemplate adding active components to our portfolio. To do so, we would need legislative amendments.

As I said earlier … I expect that our board of directors will consider recommendations in this regard to submit for the next review of the Canada Pension Plan by governments.

Let's now move to the second question -- should we consider investment classes other than traditional stocks and bonds? The choices include merchant banking, private placements and venture capital … income-producing real estate properties … equity-based futures, forwards and options … and even infrastructure projects … other products yet to be invented.

Are there enough opportunities … with the requisite liquidity …to make these efforts worthwhile?

And what will they add, net of costs, to returns for a fund such as ours?

We are going to study these questions and others. I expect we will conclude … as other funds have …that there is merit in asset classes beyond publicly traded equities and bonds.

The third question is -- should we employ external managers or staff specialists to manage our assets?

Given that we are still a very new organization … we have the luxury of considering each alternative … or some hybrid of both … without the baggage of history or entrenched infrastructure and opinions.

Certainly the idea of a virtual corporation … where our core competency would be to select outstanding external fund managers and then work effectively with them … is one possibility.

Under this scenario … our role would be to develop a fair and comprehensive selection process … negotiate fees … establish performance and review criteria … and have supervisory expertise.

Such an approach need not be limited to asset management. It could be applied to many aspects of our operations.

At the other end of the spectrum of alternatives is building our own internal expertise in an array of functions that relate to our mandate.

If we choose this course we would be an attractive employer. Let me explain why.

For those potential recruits who like to be builders … we are in the early stages of our development. For those who like to be busy in capital markets … we will be net cash positive for at least the next decade. And for those who like bragging rights … before too long we should emerge as one of the largest funds in Canada – and as a respectively-sized fund on a global basis.

I have no doubt that we would be a magnet for a rich array of talent.

Between the two extremes of a virtual corporation and a full-service fund manager … is, of course, the great Canadian compromise. A bit of both … a combination of internal and external management.

For many reasons … coming to grips with this issue of external and internal management is a logical first item on the decision tree for me and our board of directors.

In summary, these three questions – active versus passive investing … asset classes beyond stocks and bonds … and internal versus external fund management – are the ones that will be occupying a large part of my time in the months ahead.

As well … just so that I don't leave you will the impression that these are the only items on our agenda … let me identify some others that we will be addressing.

One is our policy on voting our shares. Another is how … as a true long-term investor … we will respond to takeover bids. A third is our general position on shareholder activism. A fourth will be if, where and how we might express opinions on public policy issues that we believe could impact our performance.

I would welcome your input on all these issues today and in the coming months as I formulate recommendations for my board of directors … which will ultimately approve our policy on each item.

This is an exciting time for us to continue a Canadian legacy that reaches back to the heydays of the 1960s.

Ours is a noble quest – to help deliver the pension promise to Canadians. I hope our efforts at the Investment Board will help to make retirement more comfortable and secure for the millions of Canadians who are counting on us.

Thank you for inviting me to give my maiden address at this conference.

I now look forward to your comments and questions.