The Challenge of Managing CPP Assets

CPP Investment Board

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by

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Thank you, Gilles. And I'm delighted to participate in this conference whose theme is "A Time for Action."

With Canada's private defined benefit plans nearing a state of crisis, it's certainly a good theme. This is indeed a time for action on Canada's pension systems…but it's not the first such time.

In 1996, the Canada Pension Plan, originally designed as a pay as you go plan, paid out $17 billion in benefits, but took in only $11 billion in contributions. It doesn't take someone schooled in actuarial science to tell you…though I'm sure we have sufficient numbers of Candidates in the room if needed…that those kinds of net outflows are unsustainable.

That too was a time for action. The questions then, as now, were:

- Would the policy makers act? And,
- Would they act well?

If past is prologue, the answer to both questions should be a resounding "yes".
This may seem incredible to those of you urging the key players in today's pension puzzle to step up and help solve the current crisis in defined benefit plans.

But that's what happened ten years ago, when some of these same key players did act – and they acted well.

Tough action was needed in 1996, and tough action was taken. Canadian political leaders looked into the future, saw the demographic wave coming, and did something about it. And not just anything. They – and here I'm referring to the Federal government and the nine participating provinces – consulted with Canadians, collaborated with each other and embarked on what can fairly be called a bold and uniquely Canadian experiment.

At stake: the pension security of 16 million Canadians and the solvency of one of Canada's most important social programs.

The experiment was designed around three guiding principles: (1) inter-generational fairness, (2) affordability, and (3) sustainability. It's difficult to argue with any of those, but achieving them

required a sharing of pain among contributors, beneficiaries and the policy makers themselves, who took a political risk in tackling a problem that while absolutely real and serious, still lay off in the future.

The first big piece of the solution was to achieve a balance and symmetry of "cost sharing" across all stakeholders involved in the plan. Contributors saw an increase in contribution rates from 6 to 9.9 percent over six years and beneficiaries saw a reduction in some current and future benefits.

Second was a decision to help pre-fund the Plan by building a substantial reserve fund to be managed by professional investment managers.

And third, having heard Canadians' concerns about the potential for government interference in the investment of CPP funds, they created a new kind of entity: the CPP Investment Board. A private sector investment organization with public accountability. This was something new and untested in Canada – or elsewhere, for that matter -- and it is now recognized globally as a best practice model for other national pension funds. That took care and creativity.

It's important to also recognize that this was not just a solution for a critical time, but arguably, for all time. The reforms not only put the Canada Pension Plan back on the path to long-term sustainability, but having gotten it back on the rails the reformers took several steps to make sure it stayed there.

One is the requirement that benefits cannot be enhanced unless it is proven that they will be funded on a sustainable basis. A second is a self-sustaining fail-safe mechanism built into the CPP governing legislation that is triggered if the current 9.9% rate is determined to no longer be sufficient to sustain the CPP, and the federal and provincial governments cannot agree upon a remedy. In this event, indexing of benefits and the contribution rate will each be adjusted in roughly equal proportions to restore sustainability. And a third is the creation of the CPP Investment Board with an unambiguous investment mandate, and the independence that makes it possible for us to generate the investment returns required to help sustain the plan.

And with regard to this experiment, the early indications are certainly positive. It's been nearly ten years since the reform process was undertaken, and roughly six years since the Investment

Board began its investment program to manage the assets of the Plan. Canada's Chief Actuary has determined that the Canada Pension Plan is sustainable at current contribution rates for the 75 year time frame covered by his report and the CPP reserve fund has been growing as anticipated.

In 2000, the reserve fund had assets of $44.5 billion. It had more than doubled, to $92.5 billion, as of last December. And as we prepare to report our year end results in two weeks, you will see that we are now well beyond that mark. By 2016, Canada's Chief Actuary projects the reserve fund will have approximately $250 billion in assets under management, which makes it not only one of the fastest-growing, but also one of the **largest** single-purpose pools of investment capital anywhere in the world.

So for those of you still concerned about your Canada Pension Plan benefit…YES, the money will be there for you when you retire.

Now, for some audiences, especially those with a hefty complement of seniors who are CPP beneficiaries, that's pretty much all they want to know, and I generally sit down right about now to resounding applause and great relief, but something tells me I'm not going to get off that easily with this group.

This background is relevant to the theme of this conference because in a time when many defined benefit plans are faltering, the CPP -- in effect, a national defined benefit plan for 16 million Canadians -- is on a sound and sustainable footing.

So things are looking much better today than they did in 1996, but we within the Canada Pension Plan Investment Board still face many challenges and risks in managing the assets of the Canada Pension Plan, and this is the topic of the remainder of my talk this afternoon. I'd like to focus my remarks primarily on two areas today:

First, political risk, which is the risk that our arms-length relationship with government is eroded, resulting in political interference with investment decision-making.

And second, the Investment challenge of designing and investing a large and relentlessly growing portfolio to do our part to assist the sustainability of the CPP.

Let's begin with political risk.

The CPP reforms were designed and implemented chiefly by the Federal and provincial finance ministers at the time. In other words, by elected officials, also known as politicians. Having heard Canadians' concerns about political interference with investment decisions, the reformers designed the distinctive governance model of the CPP Investment Board to shield our investment decisions from **their own** political influence through a careful balance of independence and accountability.
This is a remarkable thing. Let me share a quick story to illustrate the point.

About four months ago, our Chairperson, Gail Cook-Bennett, and I attended a reception for former U.S. President Bill Clinton when he was here in Toronto. In discussing the CPP Investment Board, he told us how much he had wanted to create something like it to help secure the promises of Social Security in the US and actually introduced the concept in his 1999 State of the Union address. But the idea never got off the ground, he told us, because of staunch resistance from no less than Federal Reserve Board chairman Alan Greenspan. Although he acknowledged the merits of the approach, Mr. Greenspan believed the temptation for politicians to interfere in investment decisions was simply too great and could not be cured.

Greenspan wasn't alone in this. The CPP reformers had the same concern. But to their credit, they also had the ingenuity and determination to engineer a solution.

That solution could be the subject of an entire talk, so I will have to be very brief on this point and focus on a few key elements.

- First, they crafted a simple but bold mandate with a singular **investmen**t focus – maximize investment returns without undue risk of loss.
- Second, they incorporated it in legislation that can only be changed by the consent of the Federal government plus two-thirds of the provinces representing two-thirds of the population. This is essentially the same standard as the constitutional amending formula.
- Next, because the money in the reserve fund is invested on behalf of Canadians and is not part of general revenues, they enshrined in law that it cannot be used for any purpose other than to pay benefits, invest the reserve fund and administer the Canada

Pension Plan.

- Finally, they designed the CPP Investment Board to be a professional investment organization that would operate at arms-length from government but be accountable to the federal and provincial finance ministers who act as stewards of the plan.

Our arms-length status from governments manifests itself in a number of different ways. The CPP Investment Board is governed by an independent Board of Directors comprised of qualified professionals with investment or financial expertise.

Board members are appointed through a nominating process that itself balances government's legitimate role in selecting directors with private sector input, expertise and independence. In investing and managing the portfolio and operating the Investment Board, management is accountable only to the Board of Directors – not to government.

On the other hand, we have a variety of accountability measures to the 10 finance ministers who act as stewards of the plan. For instance, the CPP is subject to a formal review every three years by the federal and provincial finance ministers. We undergo a special exam by an external audit firm every six years, and the Federal Finance Minister can call a special audit of the CPP Investment Board at any time. As part of our accountability framework, we also disclose more information more often than any other pension fund in Canada.

Finally, each year our Chairperson formally asks board members and the CEO if any of us have been subject to any attempted interference with regard to investment, procurement or hiring decisions. None of us has ever had to answer "yes" to that question. If in the future, any such interference were to occur, I know our directors would take this matter very seriously and would act to challenge it.

In an excellent paper published last month on Canada's retirement system, the Center for Retirement Research at Boston College wrote: "Most Canadian observers view the CPPIB as well protected from political influence…Because of the explicit "institutional investor" mandates included in the 1997 legislation, and the elaborate governance and reporting structures, the CPPIB is widely viewed as professional, independent and accountable."

Professional…independent…and accountable. That is a big part of what we are – and what we must be. But there is one other criterion, as well. And that is, we have to achieve the investment mandate set for us. In other words, we have to perform.

So now I would like to turn to a discussion of our investment challenge.

One of the primary catalysts for the CPP reforms was the simple recognition that a portfolio comprised solely of fixed income assets was virtually guaranteed to fail to achieve the returns necessary to fund the Plan's future liabilities – the benefits it has committed to pay out to future generations.

In setting 9.9% as the targeted long-term sustainable contribution rate for the CPP, the policy reforms anticipated a corresponding long-term return on investments and, as already noted, gave the CPP Investment Board the mandate to "maximize returns, without undue risk of loss".

So our challenge at the CPP Investment Board is to first determine what an appropriate return and risk balance is to achieve that goal, and then to manage the portfolio to do so.

In quantitative terms, according to the most recent best estimates of Canada's Chief Actuary, we need to earn a 4.2% real return over the long term – just to sustain the plan at the current 9.9% contribution rate.

I think it's probably fair to say our stewards – and we, ourselves – would like to do better than just help sustain the current rate, but let's use that as a starting point.

Now, sadly as everyone here appreciates, there is no way to guarantee achieving a real return of 4.2%, but in order to have a reasonable prospect of doing so we have to consciously build in a healthy level of systematic risk into the portfolio.

The CPP's partially funded status makes it quite different in a number of respects from the plans that many of you have responsibility for. One consequence of this is that investment earnings play a smaller role in funding benefits over both the near-term and long-term for the CPP than for fully funded plans. For example, a 1% reduction in the long-term real investment earnings would increase the CPP sustainable rate by about half a percent. However that same reduction

in investment earnings could increase the contribution rate for a fully-funded plan by as much as 9% of pay – an 18-fold higher proportional increase. Consequently, one could conclude that the CPP has a higher ability to bear the risk of more volatile investment policies than most corporate plans. However, a countervailing consideration about the CPP is that any increase in contribution rates seen to be caused by investment performance is extremely visible and controversial, because almost every wage earner and company in Canada would be affected. Both of these perspectives help us interpret what the phrase "undue risk of loss" in our mandate means in practice.

To crystallize these various return and risk considerations, we have created the concept of the CPP Reference Portfolio. Its composition is 25% Canadian equity, 40% foreign equity, 25% nominal Canadian bonds and 10% real return Canadian bonds.

In our view, this portfolio embeds the level of systematic risk that makes a 4.2% real rate of return feasible with reasonable capital markets return assumptions, and yet avoids taking on undue risk that might lead to excessive volatility in the contribution rate. It has other features as well - it's relatively high foreign equity component helps hedge the risk of lower than expected contribution inflows if the Canadian economy performs poorly. And the real return bond exposure provides a contractual inflation return that matches the CPP's indexed benefits.

The CPP Reference Portfolio also represents a low cost, low complexity passively managed strategic option to achieve the returns required to help sustain the CPP. Lest anyone think that this reference portfolio is, in dog-racing terms, a "slow rabbit", its returns over the last one and four year periods have actually exceeded the benchmark returns of the largest public pension plans in the country.

Having created this CPP Reference Portfolio, the investment challenge for us now becomes quite clear and simple – net of all the costs that we incur, achieve a better risk adjusted return with our actual portfolio than the reference portfolio. Our accountability also becomes quite clear and simple – did we achieve this result or didn't we?

So how do we plan to meet this investment challenge and outperform this reference portfolio? Well, the basic tools available to us are the same as those available to any investment management organization – seek out additional low-correlation asset classes that create a more

efficient portfolio, and also seek to capture some excess returns over the passive market alternatives, the much pursued and highly elusive alpha. Given that our tools are the same as those used by other organizations, our challenge is to deploy them in ways that create advantage for us.

One way that we believe we will have advantage in designing and constructing a more efficient portfolio is to adopt what we have called a Total Portfolio Approach. The essence of this concept is that the portfolio is primarily designed as a mix of risk/return attributes rather than a series of allocations to traditional asset classes.

For example, under conventional asset class labels, government bonds, utility stocks, established infrastructure (such as a toll road) and a core class A office building are four entirely different kinds of investments. Using our Total Portfolio Approach, we consider them to have similar risk return attributes and hence would treat them as potential substitutes. Similarly we would view distressed debt, venture capital, construction phase infrastructure and leveraged real estate development projects as potential substitutes.

One practical consequence of this approach is that we will not establish and be bound by fixed allocations to asset classes such as Real Estate, Infrastructure, or Private Equity, and nor would we apply one single return expectation or benchmark return across all investments in these categories.

This total portfolio approach definitely entails greater operational complexity than other alternatives to portfolio design and construction, but we believe it allows us to make better investment decisions and more effectively manage risk and diversification at the overall portfolio level.

In terms of the pursuit of what I earlier called the elusive Alpha, I will speak briefly about one amongst a number of areas where we will seek to create advantage, and that is in private market investing.

The size of global private market investment opportunities in real estate, private equity, private debt and infrastructure vastly exceeds those available in public markets. However, accessing

those opportunities requires both specialized skill and, importantly, local knowledge and presence.

Given this, we believe that the best way for us to access these private markets, in the scale required for our portfolio, is to forge aligned strategic relationships with organizations that have demonstrated that specialized skill and knowledge in all major markets around the world.

We also think that our asset size and hence our willingness to commit large amounts to individual transactions, our ability to be a patient investor and hold assets for a very long investment horizon, and our resolve to have the internal resources and processes that allow us to quickly but thoroughly analyze opportunities and make commitments in what is often a compressed timeframe, together make us a very attractive investment partner to other organizations around the world. And our goal in pursuing these private market investments is simple – on a risk adjusted basis produce returns that outperform the public market alternatives available to us.

In the active management of equities, we see the vast majority of research and investment focus placed on short horizon factors that have equally fleeting impact on valuations of stocks. We are beginning to incorporate longer horizon factors into our investment process that we think are under analyzed and have not been fully reflected in company valuations. One example of this is the potential impact that environmental, social and governance, or ESG factors can have on financial performance of companies over quite long-term horizons

We were involved in the formulation of and are one of the first signatories to the United Nations' recently launched "Principles of Responsible Investing." We are the first Canadian member of the Enhanced Analytics Initiative, a partnership of global institutional investors with more than $1 trillion in combined assets aimed at spurring the development of investment research that considers the impact of extra-financial issues on long-term company performance. And we have joined the Carbon Disclosure Project. All of these are designed to spur the development of research, tools and methodologies that will help us incorporate ESG factors into our investment process.

One aspect of our investment challenge is the sheer size of our portfolio - $100 billion growing to an anticipated $250 billion over the next 8 – 10 years. Sometimes that size can be a disadvantage – for instance, we won't pursue investment opportunities even though they have attractive returns if they aren't sufficiently scalable to make an appreciable contribution to our portfolio given the resources we would have to devote to them.

As well, we sometimes identify valuation anomalies in companies that we hold that, unfortunately, would be offset by the market impact of trading in the volumes entailed by our portfolio size if we tried to capture them.

That being said, in many other respects, size does indeed matter, and matter in a very positive way, in that it enables us to forge partnerships, access large less competitively bid private markets transactions, develop leading edge trading, investment and risk management technology and other capabilities, and allows us to have internal specialization across a broad range of investment categories.

So to wrap up now, it's been almost ten years since policy makers took bold action to solve a national pension crisis. The CPP reformers at the time got it right. They identified a problem and created a thoughtful, sophisticated and far-sighted solution. The Canada Pension Plan Investment Board was part of that solution.

We know what we need to do in order to fulfill the mandate that was created for our organization. We are confident that we are building the organizational capabilities to meet the investment challenge of managing the CPP assets and to deliver our part in keeping the Canada Pension Plan on the rails not just in the near-term, but for generations to come.

Can history repeat itself? Will we through conferences like this and other measures be able to muster the political will and insight to address the current pension funding crisis in time to prevent the continued decline in private sector defined benefit pension plans?

From the perspective of the CPP Investment Board, we certainly hope so. While in a sense the decline of private DB plans makes the CPP benefit that much more important and significant, that fact provides satisfaction to no one. As valuable as it is, the CPP benefit is only one piece of the retirement security solution. But if the CPP experience proves anything, it's that

seemingly intractable pension issues can be solved, and that Canada has something of a knack for doing it.

Thank you once again for inviting me to speak today.