



**CPP
INVESTMENT
BOARD**

Notes for remarks by:

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Chair**

The Canada Pension Plan Investment Board

at the

C.D. Howe Institute Policy Conference

**The Canada Pension Plan Reforms Ten Years After:
Lessons and Prospects**

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Thank you _____ for your kind introduction.

And thank you to Bill Robson and the C.D. Howe Institute for organizing this conference. As you know, the Institute has played an important role in the CPP Reform debate over the past few years.

Today's discussions have provided an opportunity for all of us to reflect on the past and to consider the challenges ahead. I am here to speak on behalf of the Board of Directors, past and present, about the challenges and opportunities created by the CPP reforms of the mid-1990s – and how we have worked since we were appointed nine years ago to turn their potential into a reality for the benefit of 17 million Canadians.

Today, I'm going to talk about governance, trust, transparency and reputation. But what I'm really talking about is what it took to achieve our mission. That mission was not just to implement a world-class governance model, but to build a world-class investment organization...an investment organization able to compete with the very best of the best in the private sector, while maintaining an extraordinary degree of public accountability.

I will begin with some of the early and important decisions in the evolution of the CPP Investment Board. I'll conclude by sharing some thoughts on some of the key challenges we expect to face in the future.

In establishing the CPP Investment Board, the reformers devised a unique governance model that made its long-term success possible, but not certain.

They recognized the greatest threat to the CPP Investment Board's ability to achieve its mission was, in fact, themselves, through the potential for political interference.

This was no simple problem. When President Clinton considered a model similar to ours to help save Social Security, Federal Reserve Board Chairman Alan Greenspan opposed him. 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.

Our political leaders had the *same* concern, but they believed the temptation *could* be cured...and they designed a governance model to do just that.

I'll talk more about that model in a minute, but its overall genius is not only in its many integrated and varied protections against political interference, but also in its willingness to empower an independent board with considerable responsibility.

This was not the Maginot Line of independence, but rather a strong framework that has permitted a qualified Board and management team the flexibility to chart its own course and adapt to external events.

The reformers created the framework. It was up to the CPP Investment Board to build a world-class investment organization that could fulfill our mandate and achieve our mission of helping to sustain the CPP.

And that is the story I'd like to share with you today.

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For the 12 of us who were the original members of the Board, it all began with an Act of Parliament, a pot of coffee and a meeting room in a legal firm, or, on a Sunday, in the Royal York Hotel. No offices, no staff...and no small mandate.

As Board Chair, my initial responsibilities included scouting out office space for an organization that didn't yet exist and whose size we couldn't predict.

In a sense, we were like any start-up company, albeit one with the pension security of millions of working Canadians at stake and a business plan that in less than ten years *actually would* produce assets exceeding \$100 billion.

I'm making light of this but the fact is we knew the size of the task at hand and were well aware that we were operating in a goldfish bowl.

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The first meeting of the Board of Directors took place in November 1998.

Only three years later The Conference Board of Canada gave the CPP Investment Board its National Governance Award. Later that year, the World Bank would praise the CPP Investment Board as “a model of a public pension investment body that is independent of government and operates in the best interests of contributors and beneficiaries.”

Now, let me be clear. That was not praise for our Board of Directors. It was praise – and high praise, at that – for the political leaders and public servants who were the true heroes of the CPP reforms.

Led by our luncheon speaker, the Rt. Hon. Paul Martin, finance ministers from all participating provinces and different political parties faced head on the reality that the failure of Canada’s pension system was not only possible – but unless action was taken, was a certainty.

Having recognized the problem, the Ministers put policy before politics and took up the challenge of saving the CPP. This was no easy task. The stakes were high and the pressure was intense. But whereas many good policy intentions crack under pressure and are distorted by compromise, the CPP reforms seemed to be galvanized by the process. The reforms bear the marks of courage, foresight and vision.

We, the Board of Directors, would be compelled early in our existence to show the same pragmatism and resolve in approaching our mission.

We knew at that meeting in November 1998 that we could receive cash flow from CPP contributions as early as February of the following year. What was our investment strategy to be? How were the funds to be managed? And what would happen if the portfolio declined in value during the first few years of our management?

With scepticism in some quarters surrounding our creation and the pain of a 50% increase in contributions, a misstep by us or a market correction now could be fatal. Surely there would be a public (or political) outcry to change our mandate and undo this experiment before more money was lost. In this respect – and in our view at the time – there was every bit as much riding on the first 100 dollars we invested as there would be on the 100 billionth dollar.

These questions certainly captured an important share of our collective minds but didn't affect our investment strategy. Rather, they confirmed for us that our governance model and mandate were only concepts, but powerful concepts indeed.

The CPP Investment Board Act, and the governance model it prescribed, recognized three key ingredients for success:

1. An independent, arm's-length relationship with governments;
2. A determination that the CPP Investment Board should be a professionally managed pension fund with a clear and singular mandate to maximize investment returns without undue risk of loss; and
3. Transparency in our operations and governance structure to ensure accountability.

Our independence is manifested in other ways, as well:

- No single government may change the Act or regulations governing our operations without a consensus among the federal government and two-thirds of the provinces representing two-thirds of the population – a formula similar to what is required to amend Canada's constitution.
- The funds that we manage are solely the property of the employees and employers that contribute to the Canada Pension Plan.
- Directors are appointed by a nominating process that itself is a model of independent governance.
- No level of government is involved in any way in the investment decisions taken by the Board, and
- All major decisions, including the hiring of the CEO and executive compensation belong to the Board of Directors.

To bring these concepts alive and to earn the trust and confidence of stewards and stakeholders, we focused on integrity and transparency. Our governing legislation recognized that the potential for conflict of interest existed because it mandated that our Board be made up of people involved in the world of business and finance who, almost by definition, were likely to find themselves in a potential conflict of interest at some point. This made it necessary to develop a strong Code of Conduct for Directors, and later for management and employees.

This Code – published on our web site for all to see – has provided an invaluable framework for the identification, minimization and resolution of conflicts, often before they occur.

To support the Code, we created the position of Conduct Review Advisor. This is a person selected from outside the Board, who has broad experience, whose integrity is beyond reproach; who has knowledge of both the public and private sectors; and, whose reputation for good judgement is widely acknowledged.

The Conduct Review Advisor offers confidential consultations to any Board member, employee or supplier of the CPP Investment Board who may find themselves with questions about a potential conflict of interest.

We have been extremely fortunate that first Mr. Purdy Crawford, then subsequently The Honourable Ted Hughes and currently, The Honourable Frank Iacobucci, have agreed to serve in this capacity. I believe that the willingness of these esteemed Canadians to take on this responsibility is in itself a validation of both our process and our Code.

The Code of Conduct was an important early statement of our values and the standards we have set for ourselves and the organization.

Transparency was another founding principle. Putting all of the protections of our legislation aside, we knew our practical ability to preserve our independence – as well as to diversify the portfolio beyond government bonds – depended on earning public trust and confidence. Operating behind a veil of secrecy was just not acceptable.

To this end, the Board adopted a formal disclosure policy that states:

“Canadians have the right to know why, how and where we invest their Canada Pension Plan money, who makes the investment decisions, what assets are owned on their behalf, and how the investments are performing.”

The power and effectiveness of this disclosure policy has served us well.

Consistent with this policy, our web site is both informative and user friendly. If you have visited the site at www.cppib.ca you will see:

- All of our operating policies, guidelines and governance directives;
- Our results posted quarterly and our portfolio holdings annually;
- A comprehensive list of our external investment partners and the amounts we have committed to each;
- Our investment principles and guidelines for proxy voting, as well as our actual proxy voting record;
- Our Policy on Responsible Investing, and much more.

This kind of disclosure policy imposes an extraordinary amount of accountability. It has also been one of our most successful investments.

The returns on this investment can be measured by the success we have had in working with our stewards to remove constraints on our ability to effectively manage the assets of the fund.

The stewards deserve full credit for never so much as trying to interfere in the affairs of the CPP Investment Board, but it would be unfair to say that and no more.

In fact, they have carried on the spirit of trust and far-sightedness that defined the 1997 reforms, as exemplified by the ongoing dialogue we have with them and their willingness

to hear our views – and share their own – in the best interests of the CPP, its contributors and beneficiaries

For that, I would like to acknowledge each and every person who has served his or her country or province as Minister of Finance over the last 10 years.

Most of the constraints I'm referring to were imposed to ensure we walked before we ran. But as we evolved as an organization they began to work contrary to their intended purposes by in fact reducing our ability to maximize returns while increasing investment risk.

The first and simplest example was "Reg. 10" – an early requirement that all of our domestic equity exposure had to be passively indexed in Canada. This was probably considered to be a conservative way to begin, until, of course, you remember that around that time Nortel grew to be about one third of the value of the TSE – a very dangerous risk concentration by any measure.

It became apparent that we could not accept such risk, so we petitioned our stewards to remove this restriction. They did – and we were able to reduce portfolio risk by selling half our Nortel position at more than one hundred dollars per share.

And so we began the transition of the portfolio from a traditional, and conservative, passive investor, to building a diversified portfolio and becoming a more active investor on a global scale.

As the organization built its expertise and proved our capabilities, the stewards agreed to remove other restrictions that stood in the way of optimal risk/return decisions. These included restrictions on our ability to invest in fixed income securities, and, the ability to use derivatives. All restrictions particular to the CPP Investment Board have now been removed.

More recent decisions have propelled us further along the path to becoming a world-class investment organization and set us on a quest for excellence.

In 2005, after significant and lengthy discussions, the Board embraced management's recommendation to pursue a value-added investment strategy and move further along the spectrum from passive to active investing.

This resulted in a revised investment strategy focused on creating investment returns above a benchmark we call the Reference Portfolio. This is a customized benchmark designed to produce the minimum 4.2% rate of return – over and above inflation – that Canada's Chief Actuary has estimated is necessary to sustain the CPP at current contribution rates.

As those of you with investment expertise will recognize, this is a high hurdle, but an achievable one – and it grew directly out of our mandate to maximize investment returns without undue risk of loss. Note that our mandate does not say: "...do the minimum necessary to help sustain the plan at current contribution rates..."

It is still early days, to be sure, but in fiscal 2007, for example, our actual performance exceeded the Reference Portfolio by 245 basis points, or approximately \$2.4 billion of additional value over what we would have achieved with a passive strategy.

While not every year will be as good as 2007, this kind of added value, compounded over time, will significantly enhance the long-term security of the CPP.

The decision to pursue a value-added strategy was one the Board made only after careful consideration and a rigorous examination of our ability to deliver superior risk-adjusted returns over time.

This decision also had far-reaching implications for the kind of organization we needed to build: one with strong leadership, deep expertise, a performance-driven culture and compensation practices that would enable us to compete with the world's best investment firms for talent and opportunities.

We have also made a strong commitment to partnering with world-class investment organizations to benefit – and learn – from their expertise.

We are managing risks through a sophisticated approach to Total Portfolio Management – a strategy that puts risk management at the very core of our investment strategy.

We have developed a compensation model that creates competitive incentives and rewards for superior results over rolling four-year periods – a model that properly reflects the long-term nature of our investment strategy.

And under David Denison’s leadership the CPP Investment Board has attracted a very strong management team and instilled a high-performance culture that is enabling us to execute on our strategy and build on our reputation.

Let me now turn to some of the challenges that lie ahead, because they are real and they are significant.

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Two challenges stand out above all others.

First is the challenge of overseeing a more active investment strategy. The second, which is related to the first, as Bill Robson and others have noted, is maintaining our arm’s-length distance from governments.

The CPP portfolio is expected to double in the next 8-9 years to approximately \$250 billion. By size alone we will attract a high degree of attention. Add to that our increasing involvement as an active investor in high profile transactions and we will inevitably attract more scrutiny and potentially more criticism from a number of quarters.

A number of commentators have warned that being directly involved in controversial business issues in Canada may well tempt politicians and policy makers to attempt to influence the decisions of the CPP Investment Board in ways that run counter to our investment mandate.

We know that these issues will arise and that some of the concerns will be valid. Our challenge – and our duty – is to understand the risks and opportunities and manage them appropriately.

At the same time, we must not become so concerned with potential reputation matters that we self-select out and reject attractive investment opportunities simply because they may be controversial.

Our Board is well aware of this tension and will manage these issues with vigilance and balance.

Which brings me back to the topic of independence.

Just last week, I spoke at an OECD conference of policymakers in Paris about our governance model – delineating the substantial differences between our national pension plan and the sovereign wealth funds that are emerging around the world.

For all the reasons I discussed earlier – our transparency, independence, investment-only mandate, the fact that we don't manage government funds and our overall governance framework – the CPP Investment Board is not a Sovereign Wealth Fund.

But we do have the word “Canada” in our name and we do manage the assets of the Canada Pension Plan, so there is bound to be confusion. We will have to work harder than ever to differentiate ourselves from those sovereign funds and to preserve both our actual and perceived independence.

These differences will become important in the months and years ahead as governments around the world contemplate the imposition of more stringent foreign investment measures – especially against government-sponsored funds.

What *is* at stake in our being mislabelled as a Sovereign Wealth Fund is our ability to compete for the most attractive assets outside of Canada, especially in the key asset classes of private equity, infrastructure and real estate.

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Before I close, let me take you back to the beginning of our journey. In 1996, the CPP took in \$11 billion and paid out \$17 billion. Its prospects were bleak, to say the least. Today, it is strong, with more than \$120 billion in assets, and Canada's Chief Actuary

estimates that it will be sustainable throughout the 75 years of his latest report. Moreover, since 1999, the CPP Investment Board has delivered investment income of more than \$48 billion.

The remarkable health of the Canada Pension Plan is a tribute to the reforms – and the reformers – of the mid-nineties, and is a great advantage for Canada.

We owe it to all Canadians to continue building on what has been accomplished by respecting the intent of the reforms, the importance of our independence, and the acceptance of a measured degree of active risk in the short-term in exchange for value-added returns in the long-term.

The stewards “got it right” 10 years ago – and they continue to get it right today.

They created a governance structure that has allowed us, as Board members, to work free from influence or pressure, to provide guidance and oversight for an organization focused on effective investment management.

We must continue to ensure and maintain our independence from government in the decision making process.

Above all, we must deliver results, not from one quarter to the next – that won’t happen, I can assure you – but over time.

And, we must continue to maintain our high standards and adherence to our Code of Conduct to preserve and strengthen the public trust and earn a reputation for our commitment to integrity, openness and excellence.

In the future we must work hard to protect that reputation that gives all of us, Board and Management alike, the ability to fulfill the mandate set out for us by our founding stewards.

In closing, the governance model created by the finance ministers 10 years ago has attracted considerable global attention as a best-practice model and is the envy of many of our international visitors. After nine years of operations, our investment professionals

are working with – and competing against – some of the most sophisticated investors in the world. Our goal is to continue building a world-class investment organization with a deep-rooted culture of integrity and trust – grounded in its innovative governance framework.

Thank you.