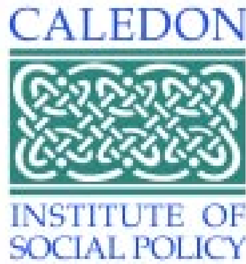

Investing Social Security Funds: Principles and Considerations

by

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Introduction

The world-wide debate on the financing of pension plans has focussed primarily on the advantages and disadvantages of unfunded, publicly managed pay-as-you-go plans and fully funded, privately managed schemes based on individual accounts. Little attention has been paid to hybrid plans which are publicly managed and fully or partially funded.

Yet, there are many such plans around the world. In a report published by the World Bank [Iglesias and Palacios 2000], 26 countries are identified which have partially funded, publicly managed, defined-benefit pension programs. These include major publicly managed plans in Africa, the Americas, Asia and Europe. In addition, there are a substantial number of countries in Africa and the Asia/Pacific region that have publicly managed provident funds with significant reserves.

The number and size of existing publicly managed pension plans which are partially or fully funded, and the possibility that other countries may consider this option in the future, make it especially important to consider what is required to ensure the security of the assets that such plans hold in trust for their insured persons. At the same time, these plans must provide a reasonable rate of return at reasonable cost.

This paper will consider six interrelated principles and considerations that should underlie the investment of social security funds. These are:

- clarity of objectives
- independence from political interference
- accountability to insured persons
- sound governance
- low operating costs
- prudence in investments.

To illustrate the application of these principles and considerations in the actual investment of the assets of a publicly managed pension program, the paper will draw on the experience of the Canada Pension Plan, a mandatory social insurance program which provides benefits in the event of the retirement, disability or death of a contributor.

The Canada Pension Plan, which began operation in 1966, was designed as a pay-as-you-go program, with a relatively small reserve equal to about two years of expenditures (benefits and administration). Until 1999, the assets of the reserve fund were invested entirely in non-marketable bonds of the federal and provincial governments. The bonds paid (and continue to pay) interest equal to the average yield to maturity of all outstanding Government of Canada obligations with terms of 20 years or more.

Important changes to the financing of the Canada Pension Plan were enacted in 1997 in order to ensure the financial sustainability of the Plan in the face of an aging population. The changes were made after extensive public consultations which demonstrated the importance the great majority of Canadians place on their public pension programs. They effectively turned the Canada Pension Plan from a pay-as-you-go program to a partially funded one.

Over a period of seven years from 1997 to 2003, the contribution rate (paid half by employees and half by employers) is being increased from 5.85 percent of insured earnings to 9.9 percent. The latter is the 'steady-state'

rate which, according to actuarial valuations [Office of the Chief Actuary 1998], will ensure sufficient revenues (when combined with the investment earnings from the reserve fund) to remain unchanged for the foreseeable future (100-year projection).

The increase in the contribution rate will result in significant growth in the size of the reserve fund. From its 1997 level of two times annual expenditures or 7.8 percent of the Plan's actuarial liabilities, the fund is projected to reach five times annual expenditures or almost 20 percent of the Plan's actuarial liabilities by 2017. In dollars terms, the reserve fund, which stood at $36.5 billion (at current exchange rates, USD 24.8 billion) in 1997, is projected to grow to $298.8 billion (USD 203.2 billion) by 2017 and to $1,006.2 billion (USD 684.2 billion) by 2040.

In order to increase the rate of return, the new assets of the fund are being invested in capital markets. A public agency, the Canada Pension Plan Investment Board, has been established by an Act of Parliament to manage these investments. The design of the Investment Board, and its implementation, has required careful thought as to the principles that should underlie the investment of social security funds. This paper draws on the lessons learned from that process.

Clarity of objectives

The first factor which must be taken into account in the investment of social security funds is the purpose for which such investments are being made. On initial consideration, the objective would seem to be obvious: The funds are being invested in order to increase the amount of money available to pay promised benefits. In reality, however, other considerations, often related only tangentially to social security or not related at all, frequently come into play.

The promotion of domestic savings and investment, for example, is often a consideration. For this reason, most countries limit the extent to which social security funds can be invested abroad. In many developing countries, there are additional macroeconomic consequences of offshore investments which also must be taken into account. For one, large-scale out-of-country investments from any source could reduce the value of national currencies. In addition, there are usually competing purposes to which limited export of national currencies can be put. As a result, many countries either prohibit outright the offshore investment of social security funds, or place so many restrictions on such investments as to make them effectively impossible.

Objectives related to national economic and social development are frequently placed on the uses to which social security funds must be put. The rationale is that social security funds, when invested in national development, contribute to economic growth, improve the standard of living and ultimately strengthen the conditions necessary for the long-term sustainability of social security programs [McGillivray 2000]. Properly done, this can certainly be the case. However, it also can limit investment opportunities and entail greater risk. Moreover, it may result in investments whose rate of return is more variable, and often lower, than would be achieved through other forms of investment.

Considerations related to 'ethical' or 'socially responsible' investments are sometimes raised. These may be linked, for example, to environmental or political issues. In some instances, such as the widespread bans on

investment in South Africa during its apartheid period, there is strong consensus on the appropriateness of taking such considerations into account. In other instances, however, they may be more problematic.

Yet another objective which is sometimes imposed on the use of social security funds is to finance part of public sector debt. Some countries *require* that funds be invested, either in whole or in part, in government-issued bonds. When such bonds pay interest at market rates, the return may be reasonable. However, if the interest paid is set at an amount below market rates, the return will be lower than otherwise could be achieved, or there may be no real return at all. In a worst-case scenario, there actually may be a loss in real terms.

There is no simple right-or-wrong approach to setting the objectives for the investment of social security funds. Obviously, national circumstances have to be taken into account. However, it is essential that clear and consistent objectives be set from the beginning, that the application of those objectives be monitored by supervisory authorities to ensure compliance and that the continued relevance of the objectives be regularly evaluated. Unclear or contradictory objectives seriously jeopardize the security of the funds and can put fund managers in a difficult, if not untenable, position.

As a general rule, any objective, whether stated explicitly or implicitly, which differs from the fundamental purpose of pre-funding – increasing the value of the assets from which future, promised benefits will be paid – must be scrutinized very carefully before being adopted.

The *Canada Pension Plan Investment Board Act* sets clear objectives for the Investment Board.

The objectives of the Board are:

> (a) to manage any amounts that are transferred to it … in the best interests of the contributors and beneficiaries …; and
>
> (b) to invest its assets with a view to achieving a maximum rate of return, without undue risk of loss, having regard to the factors that may affect the funding of the Canada Pension Plan and the ability of the Canada Pension Plan to meet its financial obligations.

The establishment of clear objectives provides a benchmark against which the performance of the Canada Pension Plan Investment Board can be measured by Parliament, the federal and provincial governments, and insured persons.

Limitations on the Board's investments are imposed by statutory provisions which, in effect, require the Board to follow substantially the same investment rules as apply to private[1] (occupational) pension plans in Canada. In particular, the portion of the Board's assets that may be invested outside Canada is limited by the provisions of the *Income Tax Act* that apply to private pension plans. Until 1999, not more than 20 percent of a pension plan's assets (at cost) could be invested abroad. Under provisions of the February 2000 federal Budget, the allowable maximum was increased to 25 percent for 2000 and rose again to 30 percent for 2001 and subsequent years.

The Canada Pension Plan Investment Board has complete discretion in determining the asset mix of its portfolio (subject, as just noted, to substantially the same rules as apply to private pension plans; these are discussed in more

detail later in this paper). However, *if* the Board decides to invest in bonds during a month, statutory provisions require it to allot a portion of those investments to provincial government bonds (the latter include any debt obligations issued or guaranteed by a provincial government.) The portion which must be invested in provincial bonds is calculated according to the ratio of the aggregate amount of provincial and municipal bonds held by all the private pension plans in Canada and the aggregate amount of all bonds (both from the private and public sectors) held by private pension plans. This provision is linked to the investment policy applicable before the establishment of the Investment Board. Under that policy, all of the reserve fund was invested in government bonds (primarily those of the provinces[2]).

To ensure that funds are not used to subsidize public debt, there is a specific statutory requirement that the provincial bonds "contain terms and conditions that are equivalent to market terms and conditions." Moreover, the provincial bonds must "bear interest at a rate that is substantially the same as the interest that the province would be required to pay if it were to borrow the same amount of money for the same term through the issuance of a security on the open capital market."

Independence from political interference

In order to invest effectively, the managers of a social security fund must be confident that they can make investment decisions which conform with the established objectives of the fund and which are backed by sound investment analysis, without the risk of political second-guessing and interference. Given the size of many social security funds, there is sometimes a temptation for governments to try to influence the uses to which those funds are put for short-term political purposes or, in some instances, even for personal gain. Safeguards must be put in place to prevent this from happening.

Ensuring independence from political interference does not, in any way, mean that managers of social security funds are not accountable to governments and insured persons for the decisions they make. Quite to the contrary. Accountability is essential. Equally, ensuring independence from political interference does not eliminate the role of governments in establishing frameworks within which social security funds are managed and in monitoring and regulating the operation of those funds. Mechanisms must be put in place that, at the same time, allow governments to carry out the legitimate functions of monitoring and regulating, while minimizing the risk of inappropriate interference.

In many countries, the mechanism chosen to achieve this goal is through the involvement of social partners – representatives of employers, labour unions and insured persons – in the management of social security funds, along with officials designated by government. Other countries employ different mechanisms.

In Canada, an important means of ensuring independence from political interference is through the process by which the directors of the Canada Pension Plan Investment Board are selected. The process is based on the fact that the Canada Pension Plan itself is a partnership of the federal and provincial governments. Although the Plan is administered by the federal government, all major policy decisions regarding the Plan (and, now, the Canada Pension Plan Investment Board) require the concurrence of the federal government and the governments of at least seven provinces with at least two-thirds of the population of Canada. Given the different

political parties which form the governments at the federal level and in the provinces, this requirement virtually ensures decision-making through consensus and minimizes the risk of partisan interference.

The selection process for the directors of the Investment Board reflects the federal-provincial partnership by which the Canada Pension Plan is managed. The federal government and each of the nine provinces participating in the Canada Pension Plan (the province of Quebec has its own parallel scheme, the Quebec Pension Plan) designate a member of a nominating committee which is responsible for recommending new directors and the reappointment[3] of existing directors. The nominating committee is a mix of public officials and leaders of the private sector; the chair is from the private sector. The recommendations of the nominating committee are given to the federal Minister of Finance who, in consultation with the provincial ministers of finance, decides on the directors of the Board. The formal designation of the directors of the Board is done by the federal cabinet (council of ministers).

The *Canada Pension Plan Investment Board Act* specifically requires that the federal Minister of Finance *must* consult with his or her provincial counterparts in deciding on the directors of the Board. The Act further stipulates that "the Minister shall have regard to the desirability of …having on the board of directors a sufficient number of directors with proven financial ability or relevant work experience such that the Board will be able to effectively achieve its objectives." Finally, the Act disqualifies employees and agents of the federal and provincial governments, as well as sitting members of either house of the federal Parliament or of provincial legislatures, from appointment to the Investment Board.

In addition to the method by which the directors of the Investment Board are selected, there are other mechanisms which ensure independence from political interference. These include the accountability measures which are discussed in the next section of this paper. By making the Investment Board clearly and visibly accountable – and answerable – to the Canada Pension Plan's contributors and beneficiaries, much greater public and media scrutiny is directed at all aspects of the Board's operation. Any government that might try to interfere inappropriately with the Board's investment decisions would stand a very high chance of being found out.

Accountability to insured persons

In order for a social security program to work effectively, it must have the confidence of the persons it insures, both contributors and beneficiaries. A program that has the confidence of its insured persons is much more likely also to have the support of decision-makers. In addition, as the experience of many countries has shown, confidence in a social security program can be an important factor in encouraging employers and insured persons to comply with the rules of the program, in particular the obligation to pay contributions.

An important element in establishing and maintaining the confidence of insured persons is accountability to them, as well as to government and to the other social partners, on the operation of the program. A program should provide accurate, comprehensive and timely information on all the major aspects of its operations, including the investment of its funds. This information has to be made available in ways that are accessible to insured persons and understandable by them.

Accountability, of course, is not just about maintaining confidence. It lies at the heart of public administration, and is integrally linked to the fundamental right of citizens to know about the actions of public agencies that affect their lives.

The legislation establishing the Canada Pension Plan Investment Board contains specific provisions regarding the Board's accountability to Canadians.

The Board is required to produce an annual report which must be tabled in Parliament and made publicly available. The *Canada Pension Plan Investment Board Act* stipulates a prescribed period following the end of the fiscal year within which the report has to be completed. The Act also stipulates information that must be contained in the annual report. This includes:

- the Board's objectives for the year and a statement on the extent to which the Board met those objectives
- the Board's objectives for the next year and for the foreseeable future
- a summary of the Board's investment policies, standards and procedures
- financial statements for the fiscal year
- the report of the Board's auditors for the year
- a certificate, signed by a director on behalf of the board of directors, stating that the investments of the Board held during the year were in accordance with the Act and the Board's investment policies, standards and procedures
- the compensation paid to the directors and officers of the Board.

The annual report and the Investment Board's policies are available both in the traditional paper format and in electronic format on the Board's website (*www.cppib.ca*).

In addition to issuing an annual report, the *Canada Pension Plan Investment Board Act* further requires that the Board hold a public meeting once every two years in each participating province to discuss the Board's most recent annual report and its plans and strategies for the future. These meetings, the first of which was held in November 2000, give Canadians a first-hand opportunity to provide their feedback directly to the Board on its activities and plans.

Sound governance

In recent years, governance has become a subject of increasing interest in both the private and public sectors. It has become clear that an organization must have sound and transparent governance structures if it is to function effectively.

Governance encompasses a wide range of subjects. In its broadest terms, it has to do with the way in which an organization is managed at its most senior level and how critical decisions are taken and implemented. Governance includes:

- the mandate and role of the board of directors of an organization and its senior officers
- the process by which the members of the board and the officers are selected and their performance evaluated

- the development and enforcement of codes of conduct and conflict-of-interest guidelines

- the structures and processes for planning and decision-making

- the allocation of responsibilities and accountabilities within the organization as well as between the organization and its key external stakeholders

- reporting relationships

- control mechanisms

- the measurement of the organization's performance against its established goals and objectives.

For an agency or institution managing a social security program, many aspects of its governance will be prescribed in the legislation establishing the program. However, the legislation is likely only to give a framework. Effective governance requires a greater level of detail which the board of directors and senior management of the program must develop.

In its first two years of operation, the Canada Pension Plan Investment Board has devoted a great deal of attention to governance issues. The Board has developed and adopted a statement of mandate based on its enabling legislation. The Board also has set annual objectives.

Four committees of the Board have been created – Audit, Human Resources and Compensation, Governance and Investment. (The legislation establishing the Board requires that there be, at least, an Audit Committee and an Investment Committee.) The roles of the committees, as described in the Board's most recent *Annual Report* [CPPIB 2000], are as follows:

- The Audit Committee oversees financial reporting, the external audit, information systems and internal controls and practices. Responsibility for overseeing the management of broad business risks is shared with the Board and other committees.

- The Human Resources and Compensation Committee reviews and recommends the compensation philosophy, recommends the performance evaluation for the Chief Executive Officer, ensures a succession plan is in place and reviews organizational structure.

- The Governance Committee recommends governance policy, guidelines and procedures; makes recommendations on the Board's effectiveness; monitors application of the code-of-conduct and conflict-of-interest guidelines; and assumes other duties at the Board's request.

- The Investment Committee, which consists of the full Board, approves investment policies, standards and procedures; and reviews, approves and monitors management's annual investment plan. It reviews investment risk management and approves the engagement of external fund managers and asset custodians.

The *Canada Pension Plan Investment Board Act* requires the Board to establish procedures for dealing with conflicts of interest. The Act also requires the Board to adopt a code of conduct for its members and employees, and to

monitor the conflict-of-interest procedures and the code of conduct.

In compliance with these legislative requirements, the Board has developed written policies and procedures regarding code of conduct and conflicts of interest. These are publicly available both in written form and on the Board's website – another aspect of the Board's accountability to insured persons.

The code of conduct establishes an unambiguous test which members of the Investment Board, its officers and employees must apply in the face of a questionable situation:

- Is it legal?

- Is it in conflict with the best interests of the Investment Board and the Canada Pension Plan's contributors and beneficiaries?

- Will it meet or exceed the standard of behaviour expected by the Canadian public?

The conflict-of-interest policy and procedures require each director to submit an annual statement describing changes in relationships that could give rise to a conflict. Directors also must inform the Board's chairperson before accepting any directorship or position of authority in a company or organization that might benefit from, or be in conflict with, the Canada Pension Plan Investment Board. Directors and employees must make timely disclosure of *any* investment transactions, and not just material transactions, between the Investment Board and entities in which they have a material interest. Directors cannot participate in discussions about, or vote on, resolutions involving transactions in which they have a material interest. The conflict-of-interest policy and procedures also impose strict rules regarding the disclosure of inside information and personal trading.

Low operating costs

The operating costs involved in the investment of social security funds are an important consideration. Clearly, it is to the benefit of the program and its insured persons if those costs can be kept low. However, sufficient resources need to be available to ensure that sound investment decisions are taken, that investment portfolios are carefully monitored and that adjustments to portfolios are made as circumstances require.

In the fiscal year ending March 31 2000, the Canada Pension Plan Investment Board incurred total operating costs of $3.7 million (at current exchange rates, about USD 2.5 million). The fair market value of its investments at the end of the fiscal year was $2.4 billion. Expressed as a percentage of average assets administered during the year, the Board's total operating costs were 0.31 percent of assets.

The Investment Board's operating costs as a percentage of assets under administration compare favourably with pension plans in the private sector. In Canada, the operating costs of private pension plans are about 0.7 percent of assets under management [Statistics Canada 1998]. The report from the Stockholm Initiative of the International Social Security Association [Thompson 1998] notes that the operating costs of large United States defined-benefit plans average 0.5 percent of assets under management.

It must be noted that the Investment Board's operating costs will change, in future,

as the funds which it administers grow and the Board moves to more aggressive investment strategies. In its most recent annual report, the Board projects that the cost of administration and governance will decline as a percentage of assets administered, but that direct investment costs will increase. It also must be noted that the Investment Board is responsible *solely* for the investment of the reserve funds of the Canada Pension Plan. The administration of the Plan itself (e.g., collection of contributions, payment of benefits) is the responsibility of various departments and agencies of the federal government, in particular the Department of Human Resources Development. The Plan's administrative costs for the fiscal year ending March 31 2000 were $336 million on total benefit payments of $18.8 billion.

As a key part of its efforts to ensure that operating costs will remain low in future years, the Investment Board has taken a strategic decision to adopt the model of a 'virtual corporation.' In the Board's most recent annual report [CPPIB 2000], its President and Chief Executive Officer, John A. MacNaughton, describes this model as follows:

> In the traditional corporate model, most implementation and support functions are performed internally and are an integral part of the core organizational structure. If we had chosen this model, we would have had to build an elaborate organization with extensive research and analytical resources, numerous portfolio managers, trading rooms for stocks, bonds and other financial products, specialized departments for such investment classes as merchant banking, real estate, and infrastructure projects, a large investment accounting department, and corporate departments for human resources, legal affairs and other services.
>
> Instead, we chose the vision of a virtual corporation with a small team of senior executives responsible for working to develop investment and operating strategies, and then accessing and leveraging external expertise to help us manage our assets and increase their long-term value. This approach will ensure broad exposure to ideas, deal flow and service providers through partner-like relationships at home and abroad, while leaving open the option of developing staff expertise to implement components of our strategy wherever and whenever equal or better results can be achieved internally at lower cost.
>
> Whether executed internally or externally, the senior team will be responsible and accountable for all aspects of our investment and business performance as well as compliance and control ...
>
> We believe that the virtual corporation model will focus our energies on high value-added activities, provide access to more specialized skills and resources, offer flexibility in choosing required skills and capabilities, generate potentially better results at less cost, and provide risk management and diversification benefits. In other words, we will emerge as a strategic think-tank organization that takes full tactical advantage of the implementation talents already flourishing in the competitive marketplace.

Prudence in investments

The administrators of social security funds have a fiduciary responsibility to the insured persons who have contributed to the fund. This responsibility requires them to act in the best interests both of the social security program as a whole and of insured persons. In carrying out their investment duties, they must act prudently and must avoid both undue risk and possible conflict of interest. To ensure that this is the case, governments usually establish supervisory or regulatory bodies, or delegate such oversight responsibility to an existing ministry or agency.

The *Canada Pension Plan Investment Board Act* specifically describes the duty of care required of the directors and officers of the Board. The Act states that they must "(a) act honestly and in good faith with a view to the best interests of the Board, and (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." The 'prudent person' test is one which is used in many countries with a common law tradition.

As noted earlier, there are statutory provisions which impose limitations on the Board's investments. In effect, the Investment Board is required to follow substantially the same investment rules as apply to private pension plans. Canada, at both the federal and provincial levels, has had a good record in the regulation of private pension plans. In light of this, it was felt that it would be appropriate to extend the rules for private plans to the Investment Board.

The limitations on the Board's investments include the following:

- The Board cannot invest, either directly or indirectly, more than 10 percent of the total book value of its assets in the securities of one person, or two or more associated persons, or two or more associated corporations. (For purposes of this rule, 'person' includes both natural persons as well as trusts, partnerships, funds and unincorporated associations or organizations.)

- The Board cannot invest, either directly or indirectly, in real estate or Canadian resource properties if the book value of the investment in any one parcel of real estate or Canadian resource property exceeds 5 percent of the total book value of the Board's assets, or if the aggregate value of all its investments in Canadian resource properties exceeds 15 percent of the total book value of the Board's assets, or if the aggregate value of all its investments in real estate and Canadian resource properties exceeds 25 percent of the total book value of the Board's assets.

- The Board cannot invest, either directly or indirectly, in the securities of a corporation to which are attached more than 30 percent of the votes that may be cast to elect the directors of the corporation.

The Investment Board was the first of its kind at the federal level in Canada.[4] (However, a comparable agency, the *Caisse de dépôt et de placement du Québec*, has operated successfully in the province of Quebec since the 1960s. The *Caisse* is responsible for the investment of the reserve funds of a number of provincial pension and insurance plans, including that of the Quebec Pension Plan.) Because of the novel nature

of the Investment Board, special statutory limitations have been placed on its investments during its startup period. These special limitations give the Board time to develop the hands-on experience and the operating rules and procedures which it requires. They also respond to concerns expressed in some quarters regarding the effect that a large, publicly managed investment agency might have on Canadian capital markets.

The most significant of the special limitations is the requirement that, during its start-up period, the Board can invest only *passively* in domestic equity markets. ('Passive investment' means replicating a predetermined market index of securities. 'Active investing,' on the other hand, means selecting and trading individual securities, with the goal of outperforming market indexes.) There is no statutory requirement for passive investment in non-Canadian equity markets.

As noted earlier, until 1999 all of the reserve fund of the Canada Pension Plan was invested in non-marketable government bonds. In order to diversify the *overall* investments of the Plan, the Investment Board decided in late 1998 that it would put all its cash flows during its initial period of operation into equities.

In regard to the approximately 80 percent of its overall portfolio held in Canadian equities, the Board has carried out the requirement for passive domestic investments by replicating the largest stock index in Canada, the Toronto Stock Exchange (TSE) 300 Index. In keeping with its prudent approach to investment, the Board has decided that the remaining 20 percent of its portfolio, which is invested in non-Canadian equities, should also be invested passively during its startup period. For this purpose it is closely replicating the Morgan Stanley Capital International (MSCI) World Index, excluding Canada.

The results of the Board's investments during its first two years of operation are shown in the table below, which also gives various measures against which the Board's actual results can be compared as well as the total year-end value of the assets managed by the Board. The measures for assessing performance include:

- the Board's 'benchmark,' which aggregates the TSE 300 Index and the MSCI World Index (excluding Canada) according to their weight in the asset mix (80 percent Canadian investments and 20 percent non-Canadian investments)

Rates of return

Fiscal year	Investment Board %	Benchmark %	Inflation + 4% %	Bonds held by the plan %	Assets at year-end ($ millions)
1998-1999	5.0	4.7	4.9	11.4	12.1
1999-2000	40.1	39.3	5.7	11.3	2,392.8

- the sum of the average annual inflation rate plus 4 percent (the actuarial valuation of the Canada Pension Plan assumes a long-term real rate of return of 4 percent)

- the rate of return on the government bonds (provincial and federal) held by the Canada Pension Plan.

As the table shows, the Investment Board's performance for the 1999-2000 fiscal year was outstanding, reflecting the fact that the TSE 300 Index (which is the basis for the passive investment of 80 percent of the Board's assets) had one of the highest increases among major exchanges in industrialized countries, going up 45.5 percent. The MSCI World Index (excluding Canada) that year increased 16.1 percent.

In both fiscal years, the Investment Board did better than the benchmark. This achievement was due to the fact that the actual asset mix of the Board's portfolio was slightly higher in terms of Canadian equities than the 80 percent assumed in the benchmark. As well, in both fiscal years, the Board achieved a real rate of return in excess of 4 percent, the real rate of return assumed in the Canada Pension Plan's actuarial valuations. In the 1999-2000 fiscal year, the return on the Board's equity investments significantly exceeded the return on the provincial and federal bonds held in the Canada Pension Plan reserve fund, although in 1998-99 it was the other way around.

In reporting on its 1999-2000 performance, the Board cautioned that such returns could not be expected year after year. In the words of the Board's President and Chief Executive Officer [CPPIB 2000]: "as we broaden our asset allocation base, the volatility of our portfolio will decline, as will the likelihood of achieving such outstanding annual results again." The Board's President also noted that "since the Canada Pension Plan was founded (in 1966), the TSE 300 nominal return has exceeded 40 percent on only three occasions. Also the index was highly volatile from year to year, losing 11.3 percent as recently as fiscal 1999."

The Board's positive experience in its first two years of operation already has resulted in a relaxing of the restriction on its domestic investments. In late 1999, the federal and provincial governments agreed to authorize the Board to invest up to 50 percent of its domestic portfolio actively. The statutory changes implementing this agreement came into force in August 2000. The federal and provincial government also have agreed to review, by the end of 2000, whether the remaining requirement for passive investment of 50 percent of the Board's Canadian equities should be lifted.

While the Board will, almost certainly, move to active investing, it has not done so yet. In keeping with its prudent and studied approach, the Board will first develop a new investment strategy designed to allow it to diversify its asset mix. In the development of this new strategy, which is now under way, consideration is being given to the benefits of passive and active investing in equity and debt, merchant banking, private equity, infrastructure projects, venture capital opportunities, real estate investments and the use of derivative contracts. Strict risk-management policies and procedures will accompany the new investment strategy.

Conclusion

As countries around the world continue to address the issue of making publicly mandated social security programs financially sustainable in the face of aging populations, it is likely that

increasing attention will be given to moving to pre-funding (whether on a partial or full basis) and the investment of the reserve funds of pre-funded schemes. There are those who argue that such investments should be done only through private sector mechanisms in order to ensure that the discipline of markets will prevail. However, as the experience of some countries has shown, exclusive reliance on private sector mechanisms can entail real costs, both direct (in terms of administrative expenditures and investment fees) and indirect (in terms of regulation and supervision).

The Canadian example used in this paper shows that a mixed model, involving a publicly managed agency operating according to substantially the same rules as private pension plans, can combine the best elements of each. The model that underlies the Canada Pension Plan Investment Board allows for the possibility of an aggressive and diversified investment strategy which can take a long-term perspective, and which avoids the costs associated with competing plan managers and extensive regulatory mechanisms.

It is, of course, too early to declare the Canada Pension Plan Investment Board an unqualified success. The Board has only been in operation two years, and more time will be required before making such a pronouncement. However, its record in its first two years has been very encouraging and augers well for the coming years.

Endnotes

1. When the term "private pension plan" is used in this paper, it means a trusteed pension plan, the type of pension arrangement generally found in the private sector in Canada. The term "trusteed pension plan" is defined as follows [Statistics Canada 2000]: A fund established according to the terms of a trust agreement between the employer (or plan sponsor) and an individual or corporate trustee. The trustee is responsible for the administration of the fund and/or the investment of the moneys. The employer is responsible for the adequacy of the fund to pay the promised benefits.

2. Under the previous investment policy, as noted earlier in this paper, revenues of the Canada Pension Plan which were in excess of current needs were invested entirely in non-marketable government bonds paying interest equal to the average yield to maturity of all outstanding Government of Canada obligations with terms of 20 years or more. Each province was allocated a portion of the bonds in accordance with the proportion of total contributions to the Canada Pension Plan paid by the residents of that province. If a province did not take up its full allocation, the Government of Canada was required to take up any remaining balance.

3. The founding directors of the Investment Board were appointed for terms of up to three years. As positions become vacant, new directors are appointed for three-year terms. Directors may be reappointed for two additional three-year terms.

4. Since the creation of the Canada Pension Plan Investment Board, a similar agency, the Public Sector Pension Investment Board, has been established to manage the investments of the federal government's occupational pension plans for civil servants (including members of the Canadian armed forces and the Royal Canadian Mounted Police).

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