



CPP INVESTMENT BOARD

1999 Annual Report
Canada Pension Plan Investment Board

For the six-month period ended March 31, 1999

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Corporate Profile

The role of the Canada Pension Plan Investment Board is to increase the long-term value of Canada Pension Plan (CPP) assets through prudent participation in capital markets. In this way, the Investment Board will help the plan to keep its long-term pension promise to Canadians.

The Investment Board receives funds not required by the CPP to pay current pensions. The first transfer of funds occurred in March 1999 and the Board had \$12 million in investment assets at March 31, 1999. The federal government has projected that assets should grow to \$88 billion by 2008, based on the Board receiving approximately \$66 billion of CPP funds over the next 10 years.

The Investment Board is governed by a 12-member board of directors with extensive business, investment, financial and professional expertise, and is managed independently of the Canada Pension Plan.

The Canada Pension Plan itself is administered by the federal government, which collects contributions and pays pensions. The federal government sets contribution rates and benefit levels in conjunction with the provincial governments.

Report from the Chair



The directors of the CPP Investment Board are privileged to have the opportunity to create an investment organization that will be of vital importance to Canadians in the decades ahead by helping to sustain the financial viability of the Canada Pension Plan. We hope this first annual report reflects the care taken in laying the foundation for this new venture.

The 12 founding directors of the CPP Investment Board met for the first time on November 18, 1998 to implement the legal framework for the new organization. Subsequently, the board of directors formulated governance procedures, outlined investment policies, examined approaches to communications, developed procurement guidelines and selected external fund managers to handle the first cash flow projected to arrive by March 1, 1999.

Integrity and Independence

The corporate governance practices, code of conduct, and conflict of interest guidelines formulated by the directors are all designed to set high standards of performance, disclosure and ethical behaviour.

The Investment Board operates independently from the Canada Pension Plan under legislation that gives the responsibility for investment decisions to the Investment Board. Our focus is on CPP contributors and beneficiaries whose interests will be served by maximizing the investment returns on funds transferred to the Investment Board by the pension plan without putting the money at undue risk.

Initial Investments

An early decision was the determination of the asset mix between equities (such as the shares of publicly traded companies) and fixed-income securities (such as bonds).

In setting the asset mix, the Investment Board is required to take into consideration federal and provincial government bonds that constitute most of the pension plan's assets. The bond portfolio is administered by the federal Department of Finance. Starting with these fixed-income assets, the goal, under the current investment policy, is to diversify the asset mix by investing all new cash flows in equities.

Initiating exposure to public capital markets and shifting the assets from all bonds to a mix of bonds and equities are important changes for the Canada Pension Plan. We are proceeding carefully in implementing this policy. Currently, federal regulation restricts the Investment Board in the short term to substantially replicating broad market indices for Canadian equity investments. This is an efficient and low-cost way to build broad equity exposure quickly. This policy will be reassessed, with a recommendation from the Investment Board, as part of the current triennial review of the Canada Pension Plan by the federal and provincial governments.

The shift to equities includes investments outside Canada, where the Investment Board has chosen to invest in stock index funds.

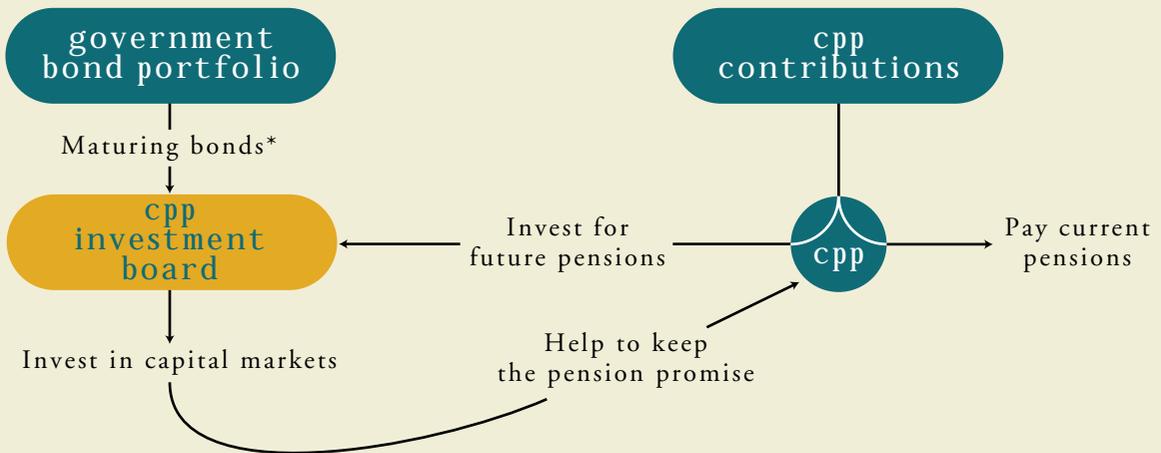
To implement the strategy, a fund manager was retained to replicate The Toronto Stock Exchange 300 Index and a second fund manager was retained to replicate the Standard & Poor's 500 Index in the

United States and the EAFE (Europe, Australia and New Zealand, and Far East) Index overseas. The TSE 300 Index contains the shares of large Canadian companies in sectors such as financial services, consumer goods, resources, and telecommunications. The S&P 500 Index is a broad cross-section of large U.S. companies, while the EAFE Index consists of about 1,000 leading enterprises in Europe, Australia, New Zealand, and the Far East. At least 80% of new cash is being invested in the TSE 300 fund and up to 20% in foreign indices.

The portfolios will approximate the returns of Canadian and foreign stock markets. In the short term, these markets could fluctuate widely and even turn negative. Over the long term, based on market history, they should exceed fixed-income returns, including federal and provincial bonds.

The asset mix and interim policy of investing 100% of cash flows in stock index funds mean that our investment performance may not be comparable to other large Canadian pension funds.

sources of cash flow



*Bonds not required to pay current pensions and not renewed.

Board Staffing and Expenses

The board of directors made the deliberate decision to maintain organizational flexibility until the Chief Executive Officer is recruited. Accordingly, we retained outside advisors, and employed contract staff to lead the transition team, act as Director of Finance and Operations, and develop monitoring and accounting procedures for investments. These activities involved the directors more than would have been the case if a permanent management team had been in place from the beginning.

At the request of the federal and provincial governments, and with the consent of the board, I discharged the responsibilities of the Chief Executive Officer during the start-up period. A special board committee is conducting the search for a permanent CEO and expects to announce its decision later this year.

Operating expenses were approximately \$1 million for professional and consulting fees, directors' fees and expenses, staff salaries and benefits, and office facilities.

Communicating with Canadians

A large part of the Investment Board's responsibility is communication with stakeholders, and we have begun by issuing two quarterly reports and this annual report. The annual report is being distributed to major libraries, as well as federal, provincial and territorial governments. Future distribution will be reviewed based on the first year's experience.

The annual report will be published on the CPP Investment Board's Web site at www.cppib.ca in June. Investment policies, code of conduct, quarterly financial statements and other basic information, along with answers to frequently asked questions, will also appear on the Web site.

The board will hold public meetings in each participating province once every two years to discuss the most recent annual report and give Canadians an opportunity to comment. The first public meeting will be initiated after the CEO has been appointed and has become established.

Outlook

The Investment Board's goal is to increase the value of CPP assets to help to cover the cost of future pensions, recognizing that the CPP pension is the basic retirement income for many people. The focus is long term to ensure the best returns possible are obtained for Canadians, consistent with prudent capital management.

Acknowledgements

The officials in the Department of Finance were instrumental in ensuring an orderly transfer of responsibilities to the board; the Director, Transition Team, provided expertise and assistance which proved invaluable to our start-up; and the directors were productive and enthusiastic participants in the wide range of decisions required of a new organization. To all of them – a sincere thank you.



Gail Cook-Bennett
Chairperson

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Board Mandate and Governance



In 1996 the federal, provincial and territorial governments agreed on the need for a new Canada Pension Plan investment policy. This agreement, based on public consultation, ultimately gave birth to the CPP Investment Board. Its mandate is spelled out in the *Canada Pension Plan Investment Board Act* and regulations.

Appointment of Directors

The federal and provincial governments created a special nominating committee to identify and recommend individuals with the expertise, experience and impartiality appropriate to overseeing the Investment Board's formation, management and performance. The committee consisted of business executives and government officials representing each province, with a private sector executive in the chair.

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

The board has extensive investment, financial, business and professional expertise, and represents all regions of Canada. Brief director biographies appear on pages 10, 11 and 12.

In future, the board of directors plans to recommend criteria to the Minister of Finance for consideration in filling board vacancies.

The founding directors are appointed for up to a three-year term and are eligible for reappointment by the Minister of Finance for an unspecified number of terms.

Separation of Board Chair and CEO

The positions of Board Chair and Chief Executive Officer are separate, with the Chair responsible for leading the board of directors and the CEO for leading management. Under legislation, the Chair cannot serve as an officer of the Investment Board, and the CEO cannot serve on the board of directors.

When the CEO is hired, the board will finalize terms of reference for the Chair in relation to the role and responsibilities of the CEO.

The Value of Corporate Governance

The directors have formulated corporate governance policies and practices consistent with legislated requirements and the guidelines of the Toronto and Montreal stock exchanges for public companies.

Corporate governance focuses on:

- the *board of directors*, which represents the stakeholders, sets policies and oversees the management;
- *management*, which implements the policies set by the directors, develops the operating strategy, annual business plan and budgets, and manages the day-to-day business; and
- *stakeholders*, who are primarily CPP contributors and beneficiaries.

The governance process defines and clarifies these relationships – including roles, responsibilities, control mechanisms, reporting and accountability. The result is an emphasis on delivering value to stakeholders by increasing the long-term value of pension assets.

Role and Duties of Directors

The board of directors accepts responsibility for the stewardship of the Investment Board and supervising management.

As fiduciaries, directors are required to act honestly and in good faith with a view to the best interests of the Investment Board. They must exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. Directors must use their specialist knowledge in carrying out their duties. Directors with accounting, actuarial, investment, business or legal expertise, for example, are subject to higher standards of care in areas that relate to their expertise.

Among other duties, the directors are responsible for:

- investment policies, standards and procedures;
- appointing an independent auditor;
- procedures to identify and resolve conflicts of interest;
- a code of conduct for directors, officers and employees;
- monitoring management, including decisions requiring prior board approval, and assessing management's performance;
- assessing the performance of the board itself; and
- stakeholder communications, including financial statements.

The board of directors has adopted corporate governance guidelines, a code of conduct, and conflict of interest guidelines developed with the assistance of an external advisor. It will complete a summary of the corporate governance process in a working document and develop annual performance evaluations for the Chief Executive Officer and the board of directors, as well as processes for strategic planning and succession planning.

Board Committees

The board created four committees, two of which (the investment and audit committees) are required under the CPP Investment Board Act and two of which advance corporate governance and operating objectives.

The *investment committee* establishes investment policies, standards and procedures; and will review and approve management's annual investment plan and monitor its effectiveness. It will also review the investment risk management approach and approve the engagement of external fund managers and asset custodians. The committee consists of the full board.

The *audit committee* is responsible for overseeing financial reporting, the external and internal audit, information systems, internal control policies and practices. Responsibility for risk management is shared with the board of directors. The committee has four members.

The *human resources and compensation committee* will be responsible for reviewing and recommending the compensation philosophy for the Investment Board, recommending the performance evaluation process for the Chief Executive Officer, ensuring a succession planning program is in place, and reviewing organizational structure. The committee has three members.

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 committee has five members.

The board formed ad hoc committees at the request of the Chair to address issues requiring immediate decisions, such as the hiring of an investment advisor to identify, screen and short-list qualified fund managers. During this process, directors previously associated with companies on the short list were excluded from board discussions.

Code of Conduct

The code of conduct is designed to create a corporate culture of trust, honesty and integrity. When there is doubt that is not addressed by written policies, situations are to be tested against questions such as – is it in the best interests of the Investment Board, and therefore CPP beneficiaries and contributors, and will it meet or exceed the standard of behaviour expected by the Canadian public?

Among the requirements of propriety, the code states that directors and members of their immediate families should not accept entertainment, gifts or favours that create or appear to create a favoured position for contractors or suppliers doing business with the Investment Board. Directors must notify the Chair before accepting a directorship or any position of authority in an entity that might benefit from, or be in conflict with, the Investment Board.

Conflicts of Interest

Because the board requires directors with financial and investment expertise, conflicts of interest must be expected from time to time and managed appropriately. Conflicts are most likely to arise because directors serve on the boards of companies in which the Investment Board owns shares.

The Investment Board's legislation sets conflict-of-interest provisions that are even stronger than those found in the *Canada Business Corporations Act* and the *Bank Act*. Specifically directors are required to:

- 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;
- abstain from voting on resolutions concerning transactions in which they have a material interest; and
- abstain from participating in discussions about transactions in which they have a material interest.

Conflicts of interest must be disclosed in writing and entered into the minutes of board or committee meetings.

Director and Management Compensation

A consulting firm was retained to advise on board compensation and recommended fees based on the median compensation for directors of TSE 300 companies. Directors are paid an annual retainer of \$12,000 plus \$900 for each board or committee meeting attended. However, separate fees are not paid for investment committee meetings when they are held on the same day as board meetings, which is the expected schedule. Committee chairs are paid an additional \$3,000 annual retainer.

The board met six times between November 1998 and March 1999. The investment committee met five times, the audit and governance committees twice each, and the human resources and compensation committee once. Directors also attended numerous CEO search and ad hoc committee meetings to address key start-up issues. Director compensation for meetings, including retainers, totalled \$168,550.

As an interim arrangement during the start-up period, Board Chair Gail Cook-Bennett discharged the responsibilities of the chief executive at the request of the federal and provincial governments, and with the consent of the board. She earned total compensation of \$135,000 in that capacity from October 1, 1998 to March 31, 1999. Dr. Cook-Bennett received no additional compensation as Chair or as a director.

When senior staff are hired, the board of directors will develop appropriate compensation-for-performance targets, and the compensation of the top five officers will be disclosed in the annual report.

Role and Duties of Management

Under the leadership of the CEO, management will be responsible for developing a strategic plan for review and approval by the board of directors. Management will be accountable for its performance through the CEO to the board of directors.

The Investment Board had no permanent staff in fiscal 1999. When the CEO is hired, management's responsibilities will be defined further, including spending and investment limits that do not require prior board approval.

Public Accountability

The Investment Board's governing legislation imposes rigorous accountability, including a transparent investment policy, a detailed annual report that must be publicly available, quarterly reports, and public meetings at least once every two years in each participating province.

In addition, the federal Minister of Finance can order a special audit at any time, and must initiate a special examination of the Investment Board's systems and practices at least once every six years.

As part of its accountability, the Investment Board is required to publish in the annual report its success in reaching the prior year's investment objectives and the objectives for the next year and the foreseeable future. The objectives for the year 2000 are to recruit the Chief Executive Officer; to invest more than \$1 billion of new cash flow in Canadian and foreign equities; to develop comprehensive longer-term investment and operating strategies; to keep stakeholders informed through quarterly reports, the annual report and a Web site, and to plan public meetings for each participating province; to further advance corporate governance policies by adding performance evaluation processes for the CEO and board of directors, as well as processes for strategic planning and succession planning.

The Board of Directors



Gail Cook-Bennett



Mary C. Arnold



Susan C.E. Carnell



Gerard V. La Forest

Gail Cook-Bennett, *Ontario*

Economist; Chairperson of the CPP Investment Board. Held academic positions at University of Toronto and senior executive positions at Bennecon Ltd. and the C.D. Howe Institute, Montreal. Director of Cadillac Fairview, Enbridge Consumers Gas Company, Groupe Transcontinental G.T.C. Ltée, Mackenzie Financial Corporation, The Manufacturers' Life Insurance Company, and Petro-Canada. (Former director of the Ontario Teachers' Pension Plan Board.)

Mary C. Arnold, *Alberta*

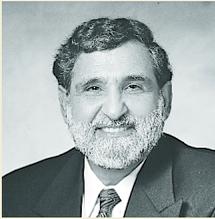
Chartered accountant; senior member of Arnold Consulting Group Ltd., management consultants, Edmonton. Director of Atomic Energy of Canada, EPCOR, Alberta Credit Union Deposit Guarantee Corporation, Edmonton Community Foundation, and Alberta Performing Arts Stabilization Fund.

Susan C.E. Carnell, *Ontario*

Economist, retired. Held senior positions in the investment and financial services sector, including chief economist with Richardson Greenshields of Canada and economist at Royal Trust Corporation and Conference Board of Canada.

Gerard V. La Forest, *New Brunswick*

Counsel at Stewart, McKelvey, Sterling, Scales. Following career in legal practice and academe, served on New Brunswick Court of Appeal and Supreme Court of Canada. Consultant to and member of federal and provincial government task forces and royal commissions.



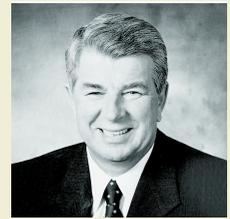
Jacob Levi



Richard W. McAloney



Helen M. Meyer



Pierre Michaud

Jacob Levi, *British Columbia*

Actuary; partner in Eckler Partners, actuarial consultants. Serves as external actuary to public sector pension plans and Workers' Compensation Board of British Columbia. Former chairman of the workers' compensation committee of Canadian Institute of Actuaries and member of B.C. executive of Canadian Pension and Benefits Institute.

Richard W. McAloney, *Nova Scotia*

Chartered Financial Analyst and chartered accountant; CEO of Nova Scotia Association of Health Organizations Pension Plan. Served in senior investment, pension and treasury positions with Nova Scotia Department of Finance. Past director of several boards, including Pension Investment Association of Canada.

Helen M. Meyer, *Ontario*

Financial executive; president of Meyer Corporate Valuations Limited. Served in senior corporate finance positions with Merrill Lynch Canada, Morgan Bank of Canada and Dominion Securities Limited. Commissioner with Ontario Securities Commission, governor of the Cundill Funds.

Pierre Michaud, *Quebec*

Chairman of Réno-Dépôt Inc. and Provigo Inc. Director of Castorama S.A. of France, Capital d'Amérique (subsidiary of Caisse du Dépôt et Placement du Québec), Laurentian Bank of Canada, Loblaw Companies, Old Port of Montréal Corporation, and Montreal Expos. Active in non-profit and charitable organizations.



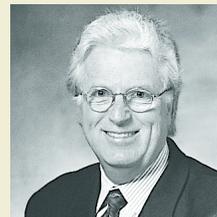
Dale G. Parker



M. Joseph Regan



Richard M. Thomson



David Walker

Dale G. Parker, *British Columbia*

Corporate director. Former CEO of British Columbia Financial Institutions Commission, Bank of British Columbia, and Workers' Compensation Board of British Columbia. Director of Talisman Energy, North West Life Insurance Company of Canada, North West Life Insurance Company of America, and Agro Pacific Industries. Active in charitable and non-profit organizations.

M. Joseph Regan, *Ontario*

Bank executive, retired. Spent 40 years with Royal Bank of Canada, ultimately as senior executive vice president for strategic initiatives. Former Chair of Pension Commission of Ontario. Served as director of Canada Pension Plan Advisory Board and Ontario Pension Board. Currently director of Bank of Tokyo – Mitsubishi (Canada) and High Liner Foods.

Richard M. Thomson, *Ontario*

Bank executive, retired. Former chairman and CEO of Toronto Dominion Bank. Director of Canadian Occidental Petroleum, CGC Inc., INCO, S.C. Johnson & Son, Prudential Insurance Company of America, The Thomson Corporation, Toronto Dominion Bank, TrizecHahn, and Hospital for Sick Children Foundation.

David Walker, *Manitoba*

President of West-Can Consultants Ltd. Former professor of political science, Member of Parliament for Winnipeg South, and Parliamentary Secretary to Minister of Finance. Chief federal representative for federal, provincial and territorial consultations on the Canada Pension Plan. Director of Fulbright Foundation, St. Boniface Hospital and Manitoba Theatre Centre.

Management Discussion and Analysis of Financial Condition and Results of Operations

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Management Discussion and Analysis of Financial Condition and Results of Operations



The CPP Investment Board is a single-purpose corporation dedicated to increasing the long-term value of Canada Pension Plan assets through prudent investments. These assets will be used in the future by the Canada Pension Plan to pay pensions to Canadians.

The Investment Board is in the early stages of development. It had one month of investment experience in March 1999 and had assets of \$12 million on March 31.

CPP Funding

The present value of accrued pension benefits under the Canada Pension Plan totalled \$465 billion on December 31, 1997, according to the plan's 17th actuarial report. The plan had \$36.5 billion in assets, mostly government bonds. As a result, assets represented almost 8% of liabilities.

The CPP will be funded on a "steady-state" basis – that is, contributions will level off after 2003 at 9.9% of pensionable earnings for employed Canadians and are then expected to remain steady to sustain the pension promise. (Contribution rates and benefit levels are decided by the federal and provincial governments.) Under the steady-state formula it is expected that the total of CPP and Investment Board assets will eventually reach about 17% – 20% of liabilities.

The Investment Board was created to help the CPP achieve its steady-state funding by earning investment returns on cash flows transferred from the CPP. The Investment Board is essentially an investment manager building a diversified investment portfolio.

Investment Objective

The actuarial report assumes that cash flows not needed to pay current pensions will earn a 4% real rate of return (that is, over and above inflation) to keep the Canada Pension Plan in a steady-state funding status after 2003. With inflation assumed by the actuarial report to grow to 3% annually over the next few years, the nominal investment objective is approximately 7%.

Sources of Cash Flow

The Investment Board will receive cash flows, not required to pay current pensions, from three sources, as illustrated in the diagram on page 3:

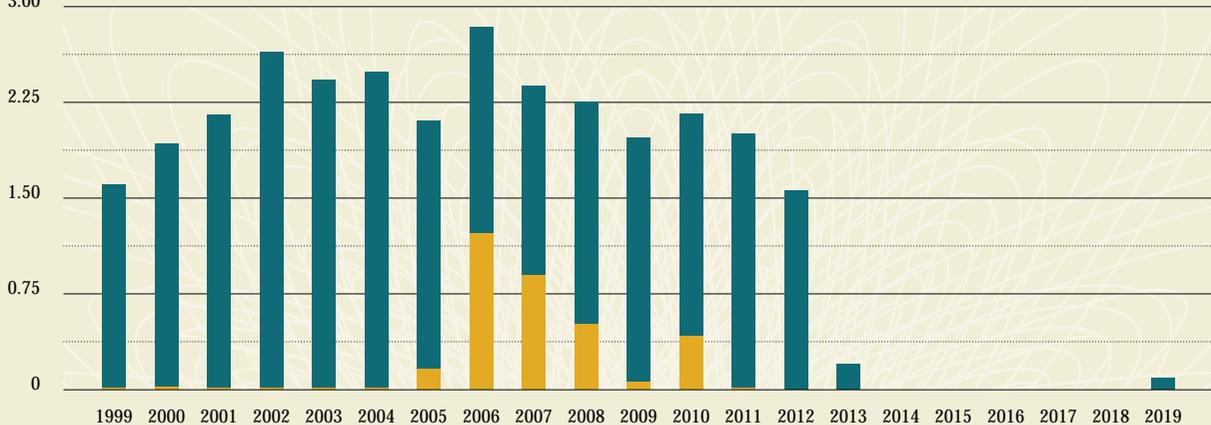
- CPP contributions by employees and employers;
- the government bond portfolio, currently administered by the federal Department of Finance, when these bonds mature; and
- income generated by its own investment activities.

The flow-through of CPP contributions will grow rapidly. A January 1999 projection by the federal government estimated that the Investment Board will receive approximately \$66 billion in CPP contributions by 2008.

government bond portfolio:
annual maturities

● provincial bonds*
● federal bonds

(in billions of dollars)



*Includes approximately \$4 million of territorial bonds.

Between 1994 and 1998 no bond rollovers were permitted as the funds were required by the CPP. This accounts for the absence of maturing 20-year bonds from 2014 to 2018. The bonds maturing in 2019 reflect rollovers in the first three months of calendar 1999. There could be new maturities subsequent to 2019 if the provinces roll over bonds due between now and 2013.

It is difficult to project the cash flow from the government bond portfolio. Historically CPP funds have been lent to the federal, provincial and territorial governments in the form of non-negotiable 20-year bonds. Under a 1996 agreement among these governments, each province has the option to roll over its existing bonds for one further 20-year term. Funds not rolled over are transferred to the Investment Board, unless needed by the CPP.

Over the next 10 years, the federal government estimates that the Investment Board could receive as much as \$80 billion in total cash flow (i.e., from contributions and bonds) from the CPP if the provinces decide not to roll over maturing bonds.

The government bond portfolio includes \$3.4 billion in federal bonds (at cost) that cannot be renewed and will be transferred to the Investment Board when they mature.

The third source of cash flow will be income, such as dividends, capital gains and interest, generated by the Investment Board from investing in capital markets.

Investment Policy

The board of directors is required to develop, and review at least annually, a formal investment policy, known as the Statement of Investment Policies, Standards and Procedures. This is a public document and copies are available on request. The policy will be reproduced on the Web site www.cppib.ca, scheduled to be online in mid 1999.

The Investment Board is required to “adhere to investment policies, standards and procedures that a person of ordinary prudence would exercise in dealing with the property of others.” (*Canada Pension Plan Investment Board Act*, section 35.) It must invest in the best interests of CPP contributors and beneficiaries by maximizing investment returns without incurring undue risk. However, as discussed in this section, investment activities are restricted by federal legislation and regulation.

The investment policy considers factors that may affect the funding of the CPP and its ability to meet the long-term pension promise to Canadians. It addresses such matters as investment asset mix, asset diversification and expected investment returns; risk management and liquidity; the use of derivative products; asset valuation; and the exercise of proxy voting rights attached to share ownership.

The directors adopted an interim investment policy on December 18, 1998 that will continue at least until a Chief Executive Officer is appointed. At that time, the directors will evaluate the strategic options with the CEO and develop a longer-term investment policy.

Asset Mix

The key decision affecting long-term investment returns is the allocation of funds between equities and fixed-income securities. In developing the asset mix, the Board is required to take into consideration the CPP’s bond portfolio.

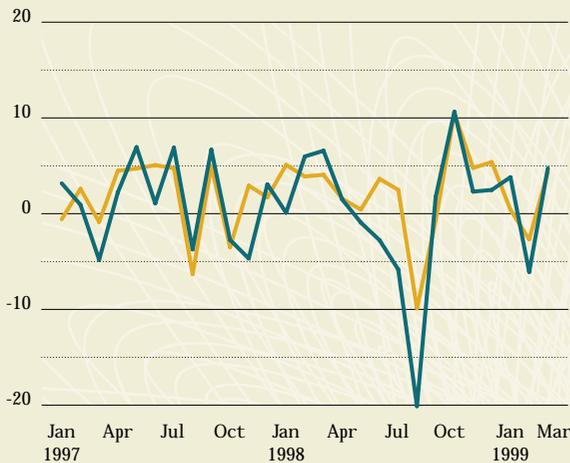
To diversify the asset base and offset the dominance of the CPP’s fixed-income securities, the Investment Board has adopted the interim policy of investing 100% of cash flows in equities.

In the short term stocks are volatile...

...but show steady growth over the long term.

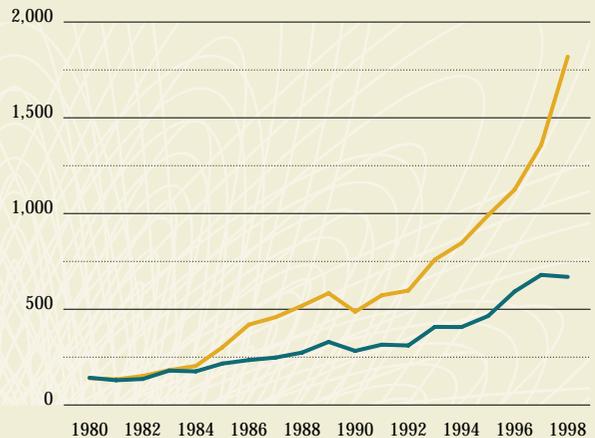
monthly equity returns

(% total return)



value of \$100 invested in 1980

(\$)



- msci world index ex-canada
- tse 300 composite index

Stocks can be highly volatile in the short term and even produce negative returns, as occurred with Canadian markets in 1998. Based on historical experience, equity values increase over the long term despite short-term market downturns. Regardless of market cycles, the Investment Board's cash flows are invested as soon as they are received.

Even if all new cash flows continue to be invested in equities over the next three years, the combined mix of investment assets held by the Canada Pension Plan and the Investment Board would only range between 20% and 35% equities by the end of 2001, depending on bond rollovers by the provinces. As the asset mix moves to higher levels of equities, the Investment Board will review its investment policy.

Current Investments

Under its interim policy, the Investment Board is investing in equity securities through stock index funds that substantially replicate stock exchange indices; short-term securities, such as treasury bills and bankers' acceptances; and derivatives that replicate direct investments in relevant stock indices. Cash flows are not invested in debt securities, such as bonds.

Foreign Investment Restriction

The Investment Board cannot invest more than 20% of assets (at cost) outside Canada. As a result, at least 80% of cash flows at cost are being invested in Canadian equities and up to 20% in non-Canadian equities.

In recent years, stock markets in the United States, Europe and other major economies have generally performed better than Canadian markets, although this could change in the future. Foreign investing diversifies risk, reduces volatility and can improve the long-term value of assets by earning returns from world economies that grow at different rates and on different cycles than the Canadian economy.

Use of Derivatives

Derivatives are financial contracts that derive their value from an underlying asset, such as a stock, stock index, bond, interest rate or exchange rate.

Certain non-North American stock index funds are only open to new investments at certain times of the month. To ensure continuous exposure to equity markets, cash flows destined for these stock index funds are invested temporarily in a synthetic equity-based fund utilizing derivatives until equity index fund units can be purchased.

Under the interim policy, the Board does not currently use derivative contracts to increase effective exposure to foreign equity markets above the 20% foreign limit.

Interim Equity Strategy

The federal and provincial governments are conducting a triennial review of the Canada Pension Plan. Until the review is completed, federal regulation requires that cash flows allocated by the Investment Board to Canadian equities must substantially replicate the composition of one or more broad market indices.

(This is known as passive investing. Active investing involves the selection of individual stocks and bonds, and the regular buying and selling of these securities to realize gains, with the objective of outperforming market indices.)

The Investment Board has retained an external fund manager to invest in a Canadian stock index fund and another manager to invest in foreign stock index funds.

The Canadian stock index fund mirrors the Toronto Stock Exchange 300 Composite Index, which represents over 90% of the market capitalization of Canadian-based companies listed on the TSE and includes Canada's largest public corporations. The stock exchange selects companies for inclusion in the index.

The foreign stock index funds are the Standard & Poor's 500 Index of large companies in the United States and the MSCI EAFE Index of about 1,000 companies in Europe, Australia, New Zealand and the Far East. Together, these indices represent more than 70% of the combined market capitalization of 22 countries.

Government Bond Portfolio

The government bond portfolio has an average yield to maturity of 11.36%, with interest paid semi-annually to the CPP. This coupon rate of interest reflects past high levels of interest rates, especially in the early 1980s, and is substantially higher than the Investment Board's long-term investment objective of 4% plus the inflation rate. Interest rates are currently low and bonds being renewed at market rates today yield close to half the current portfolio rate.

In March 1999, \$251 million of the government bond portfolio matured. Of this amount, \$88 million was renewed for a further 20 years at an average yield to maturity of 5.8%. Approximately \$151 million was needed by the Canada Pension Plan to replenish its operating reserve to pay current pensions, and the Investment Board received the remaining \$11.9 million.

Investment Return Expectations

It is inevitable that the CPP Investment Board's performance will be compared with other Canadian pension funds. However, it is important to note that many large pension funds have diversified portfolios that include passively and actively managed stocks, private placements, income-producing real estate, and foreign derivative portfolios, as well as corporate and foreign bonds, mortgages, and real-rate bonds that are indexed to inflation. The Investment Board is not acquiring these types of assets under its interim policy and is investing only in stock index funds that generally match the returns of their respective markets.

Stock markets, most notably in the United States and Europe, have generally produced the strongest investment returns in the 20th century during the past few years. While there is some risk that the Investment Board may be initiating its passive equity program toward "the top of the market," history suggests that better returns can still be expected from equities over the long term compared with most other investment opportunities. Furthermore, recognizing that the CPP's existing government bond portfolio is a large part of the asset mix, investing in equities is a prudent risk diversification strategy.

Financial Performance

The Investment Board received \$11.9 million in cash flow from the CPP during March 1999 and, therefore, had only one month of investment experience. Investment activities earned approximately \$202,000 (net of investment expenses) with almost \$10 million invested in Canadian equities and about \$2 million in foreign equities.

The Board incurred slightly more than \$1 million in expenses, which are discussed in Note 7 to the financial statements. These expenses were deducted from a \$6 million allocation by the federal government to cover start-up costs. The remaining allocation, approximately \$5 million, will be repaid in the first quarter of fiscal 2000.

Investment Performance

To measure performance objectively, the Canadian equity portfolio is compared with the TSE 300 Index; and the two foreign equity portfolios combined are compared with the Morgan Stanley Capital International (MSCI) World Index, excluding Canada. The MSCI World Index, excluding Canada, measures the performance of approximately 1,400 companies listed on stock exchanges in the U.S., Europe, Australia, New Zealand and the Far East. This index is converted to Canadian dollars for measurement purposes.

The total fund return is measured against a composite benchmark weighted 80% for the TSE 300 Composite Index and 20% for the MSCI World Index. The asset mix policy specifies the target percentage of assets to be invested in each approved asset class.

The investment returns are calculated on a time-weighted basis, consistent with methods established by the Association for Investment Management and Research and the Pension Investment Association of Canada. The returns are before investment management fees.

Investment Returns vs. Benchmark Returns

For the month of March 1999	Actual	Benchmark
Canadian index equity	4.9%	4.8%
Foreign index equity	5.4%	4.4%
Total Fund	5.0%	4.7%

Stock index funds are expected to closely match their respective benchmarks. The Investment Board's returns were above the benchmarks, notably the foreign index equity fund. It earned 100 basis points (one full percentage point) more than its benchmark because (as explained in the subsection Use of Derivatives) cash flows allocated to the EAFE fund were temporarily invested in a synthetic equity-based fund that utilizes derivatives. The timing of the purchase and sale of these synthetic fund units produced higher returns in March, 1999 than the benchmark.

Risk Management Policies

The Investment Board has investment risk management policies and procedures in place and will develop new policies consistent with the expanding scope of its activities.

Proxy Voting Rights

Owning shares gives the Investment Board the right to vote on management proposals that could affect equity values. The directors have reviewed the proxy voting guidelines of the external fund managers and assigned voting powers to them as their policies are acceptable to the Investment Board at this stage. The fund managers are required to provide a voting report to the board of directors.

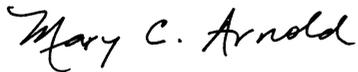
Year 2000 Readiness

The Investment Board has taken steps to ensure its computer systems are able to handle the transition to January 1, 2000 without interruption in service. As a start-up organization, the Investment Board's systems are new and Year 2000 compliant. The Investment Board has completed an analysis of the information provided by external fund managers, its custodian, and key suppliers to ensure that they have processes and resources in place to prepare for the year 2000. There is, of course, no guarantee that problems will not arise with services provided by third parties.

Investment Certificate

The *Canada Pension Plan Investment Board Act* (the “Act”) requires that a certificate be signed by a director on behalf of the board of directors, stating that the investments of the Investment Board held during the period are in accordance with the Act and the Investment Board’s investment policies, standards and procedures. Accordingly, the Investment Certificate follows.

The investments of the Canada Pension Plan Investment Board (the “Investment Board”), held during the six-month period ended March 31, 1999, were in accordance with the *Canada Pension Plan Investment Board Act* and the Investment Board’s Interim Statement of Investment Policies, Standards and Procedures.



Mary C. Arnold,
Chair of the Audit Committee
On behalf of the Board of Directors
May 26, 1999

Auditors' Report

To the Board of Directors

Canada Pension Plan Investment Board

We have audited the balance sheet and the statement of investment portfolio of the Canada Pension Plan Investment Board (the "Investment Board") as at March 31, 1999 and the statements of income and of changes in net assets for the six-month period then ended. These financial statements are the responsibility of the Investment Board's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Investment Board and the investments held as at March 31, 1999 and the results of its operations and the changes in its net assets for the six-month period then ended in accordance with generally accepted accounting principles.

Further, in our opinion, the transactions of the Investment Board that have come to our notice during our audit of the financial statements have, in all significant respects, been in accordance with the *Canada Pension Plan Investment Board Act* (the "Act") and the by-laws.

Further, in our opinion, the record of investments kept by the Investment Board's management pursuant to paragraph 39 (1) (c) of the Act fairly presents, in all material respects, the information required by the Act.

The logo for Deloitte & Touche LLP, featuring the company name in a stylized, cursive script font.

Chartered Accountants

Toronto, Ontario

May 26, 1999

Balance Sheet

March 31, 1999

Assets

Investments (Note 2)	
Canadian equities	\$ 9,982,904
Non-Canadian equities	2,160,746
	<u>12,143,650</u>
Cash and short-term investments (Note 3)	5,745,442
Other assets	68,392
	<u>17,957,484</u>

Liabilities

Due to Canada Pension Plan (Note 3)	4,948,187
Accrued liabilities	864,835
	<u>\$ 12,144,462</u>
Net Assets, Represented by	
Share capital (Note 4)	\$ 100
Accumulated net income from operations	202,362
Canada Pension Plan transfers (Note 5)	11,942,000
	<u>\$ 12,144,462</u>
Net Assets	<u>\$ 12,144,462</u>

Statement of Income

For the six-month period ended March 31, 1999

Investment Activities

Investment income (Note 6)	\$ 203,209
Investment expenses	(847)
	<u>202,362</u>

Administrative Activities (Note 7)

Professional and consulting fees	455,993
Salaries and other operating expenses	356,650
Directors' expenses	263,022

1,075,665

Recovery of Start-up Expenditures (Note 3)

(1,075,665)

Net Income from Operations and Accumulated Net Income from Operations at Period End

\$ 202,362

Statement of Changes in Net Assets

For the six-month period ended March 31, 1999

Net Assets, Beginning of Period \$ —

Changes in Net Assets

Canada Pension Plan transfers (Note 5)	11,942,000
Net income from operations	202,362
Share capital paid	100

Increase in Net Assets and Net Assets at Period End

\$ 12,144,462

Statement of Investment Portfolio

March 31, 1999

	Cost	Fair Value	% of Portfolio (At Cost)
Canadian Equities			
(Managed by TD Quantitative Capital)			
Emerald Canadian Equity Fund – 509,846.87 units (invested to substantially replicate performance of the Toronto Stock Exchange 300 Composite Index)	\$ 9,799,173	\$ 9,982,904	
Total Canadian Equities	9,799,173	9,982,904	82%
Non-Canadian Equities			
(Managed by Barclays Global Investors)			
EAFE Equity Index Fund B – 21,685.47 units Barclays Global Investors Canada Limited	1,097,687	1,091,235	
US Equity Index Fund (Canada) – 97,722.09 units Barclays Global Investors Canada Limited	1,045,396	1,042,157	
Unhedged Synthetic EAFE Equity Index Fund – 2,728.02 units (collectively invested to substantially replicate the Morgan Stanley Capital International (MSCI) World Index ex-Canada)	25,984	27,354	
Total Non-Canadian Equities	2,169,067	2,160,746	18%
Total Equities	\$ 11,968,240	\$ 12,143,650	100%

Organization

The Canada Pension Plan Investment Board (the “Investment Board”) was formed pursuant to the *Canada Pension Plan Investment Board Act* (the “Act”). The Investment Board is responsible for managing amounts that are transferred to it under Section III of the *Canada Pension Plan* in the best interests of the beneficiaries and contributors under that Act. The amounts are to be invested 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 (the “CPP”) and the ability of the CPP to meet its financial obligations.

The Investment Board commenced operations October 1, 1998.

1. Summary of Significant Accounting Policies

a. Basis of Presentation

These financial statements present the financial position and operations of the Investment Board as a separate legal entity, and therefore include only a portion of the assets (as described in Note 2) and none of the pension liabilities of the CPP. The statements have been prepared in accordance with generally accepted accounting principles and the requirements of the Act and the accompanying Regulations.

b. Valuation of Investments

Investments are recorded as of the trade date and are stated at fair value. Fair value is the amount of the consideration that would be agreed upon in an arm’s length transaction between knowledgeable, willing parties who are under no compulsion to act.

Fair value for the equity investments represents unit values in pooled and mutual funds which reflect the quoted market prices of the underlying securities. Short-term investments are valued at cost plus accrued income which approximates fair value.

c. Income Recognition

Investment income is recorded on the accrual basis and represents realized gains and losses on disposal of investments, unrealized gains and losses on investments held at the end of the period, and interest income.

Realized gains and losses on investments sold during the period represent the difference between sale proceeds and cost, less related costs of disposition. Unrealized gains and losses represent the change in the difference between fair value and cost of investments at the beginning and end of each period.

d. Translation of Foreign Currencies

Transactions in foreign currencies are recorded at the rates of exchange on the transaction date. Investments denominated in foreign currencies and held at the period end are translated at exchange rates in effect at the period end date. The resulting realized and unrealized gains and losses are included in investment income.

e. Canada Pension Plan Transfers

Transfers made in accordance with the *Canada Pension Plan* are recorded on a cash basis.

f. Income Taxes

The Investment Board is exempt from Part I tax under paragraph 149(1)(d) of the *Income Tax Act (Canada)* on the basis that all of the shares of the Investment Board are owned by Her Majesty in right of Canada.

2. Investments

The statement of investment portfolio provides detailed information on the investments held as of March 31, 1999.

a. Investment Policy

The Investment Board has prepared an Interim Statement of Investment Policies, Standards and Procedures (the “Statement”) which sets out the manner in which assets shall be invested. In determining the asset mix, the Investment Board must take into consideration certain assets of the CPP which are held outside of the Investment Board. As of March 31, 1999, these assets totalled approximately \$30.8 billion (at cost) and consisted of government debt obligations. As a result, and in accordance with the Statement, 100% of the assets of the Investment Board are invested in equities with approximately 80% allocated to Canadian equities and the remainder to non-Canadian equities.

The Regulations under the Act require the Investment Board’s Canadian equities to substantially replicate the composition of one or more broad market indices. The Toronto Stock Exchange 300 Composite Index (the “TSE 300 Index”) has been selected as an appropriate market index for the Canadian equities. Under the terms of the Statement, the Investment Board’s investments in non-Canadian equities should also substantially replicate broad market indices. The Morgan Stanley Capital International (“MSCI”) World Index ex-Canada has been selected for this purpose.

To implement the investment strategy, a Canadian equity fund was purchased to substantially replicate the TSE 300 Index, and U.S. and EAFE (Europe, Australia and New Zealand, and the Far East) index funds were purchased to substantially replicate the MSCI World Index ex-Canada.

b. Derivative Financial Instruments

Derivatives are financial contracts, the value of which is derived from the value of underlying assets, interest rates or exchange rates.

As outlined in the Statement, certain derivatives may be used from time to time to achieve market exposure by replicating direct investments in relevant equity indices. Because the non-Canadian EAFE Equity Index Fund B is open to new investment at only certain times of the month, a synthetic EAFE index fund utilizing derivatives (primarily forward foreign exchange contracts and futures contracts on equity indices of countries within EAFE) is used in the interim period to maintain continuous equity exposure.

In accordance with the Statement and the Regulations, the Investment Board may not use derivatives to create leverage. The synthetic EAFE index fund in which the Investment Board holds units has a policy of no leverage and uses a combination of Canadian dollar money market instruments and forward foreign exchange contracts to cover the amount of outstanding futures contracts.

c. Foreign Currency Exposure

The Investment Board is exposed to currency risk through holdings of units in pooled funds of non-Canadian equities where investment values will fluctuate due to changes in foreign exchange rates. The underlying currency exposures as at March 31, 1999, are as follows:

Country/Region	Investment Value	% of Total
United States	\$ 1,042,157	48%
Europe	802,370	37%
Far East	282,138	13%
Australia and New Zealand	34,081	2%
	\$ 2,160,746	100%

In accordance with the Statement, the foreign exchange exposures are not hedged.

3. Due to Canada Pension Plan

As permitted under Section 57 of the Act, the Investment Board received an allocation of \$6,000,000 from the CPP for start-up expenditures. Of this amount, a total of \$1,075,665 was utilized during the period. Since the Investment Board is now regularly receiving transfers under Section III of the *Canada Pension Plan*, the excess amount of \$4,948,187 (including interest of \$23,852) is scheduled to be repaid to the CPP in the first quarter of the 2000 fiscal year. The excess funds have been invested in short-term investments.

4. Share Capital

The issued and authorized share capital of the Investment Board is \$100 divided into 10 shares having a par value of \$10 each. The shares are owned by Her Majesty in right of Canada.

5. Canada Pension Plan Transfers

There are two conditions under which transfers to the Investment Board are permitted, as outlined in Section III of the *Canada Pension Plan*. The first relates to the approximately \$30.8 billion in government securities held by the CPP outside of the Investment Board. In certain instances these securities may be rolled over at maturity, either wholly or in part, at the option of the issuer. To the extent that the existing issuer does not replace the matured securities and the funds are not required by the CPP to pay current pensions, the proceeds are transferred to the Investment Board. The second condition of transfer occurs when the Minister of Finance determines that the CPP has an excess operating balance. The excess portion is then transferred to the Investment Board.

During the period, a total of \$11,942,000 was transferred to the Investment Board.

6. Investment Income

Investment activity commenced with receipt of the first cash flow on March 1, 1999. As a result, the investment income and the performance measurement information reflect only one month's activity. The investment income for the six-month period ended March 31, 1999, is comprised of:

Unrealized gains	\$ 175,410
Realized gains	19,506
Interest income	8,293
	\$ 203,209

Investment performance and benchmark returns for the six-month period ended March 31, 1999, are as follows:

	Portfolio Return	Benchmark Return
Canadian Equities	4.9%	4.8%
Non-Canadian Equities	5.4%	4.4%
Total Return	5.0%	4.7%

The benchmark for the Canadian equities is the TSE 300 Index and for the non-Canadian equities is the MSCI World Index ex-Canada. The total return benchmark aggregates the two benchmark returns according to the weightings (80% for Canadian equities and 20% for non-Canadian equities) specified in the Statement.

Returns have been calculated in accordance with the methods set forth by the Association for Investment Management and Research and the Pension Investment Association of Canada.

7. Administrative Activities

Administrative expenses for the six-month period ended March 31, 1999, are comprised of:

a. Professional and Consulting Fees

Consulting fees	\$ 291,417
Legal fees	125,610
Professional accounting and audit fees	38,966
	\$ 455,993

Consulting fees represent amounts paid for professional advice in connection with the development of the Statement of Investment Policy, Standards and Procedures, the creation of corporate governance procedures, the selection of a custodian and external fund managers, the search for a Chief Executive Officer, and other advice required to prepare the Investment Board for the receipt of cash flows from the CPP.

b. Salaries and Other Operating Expenses

Salaries	\$ 256,930
Other operating expenses	99,720
	\$ 356,650

Until such time as the Chief Executive Officer has been recruited and commences full-time employment, the Chairperson of the Board of Directors has undertaken certain management responsibilities. Salaries include compensation for these services as well as compensation paid to other temporary employees.

c. Directors' Expenses

Directors' expenses include remuneration earned, and travel and accommodation expenses incurred in connection with their role as directors of the Investment Board. In accordance with the fee schedule established in Bylaw 2 of the Investment Board, the remuneration earned by the directors during the six-month period was \$168,550.

8. The Year 2000 Issue

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect an entity's ability to conduct normal business operations.

The Investment Board has undertaken a review of the potential impact of the Year 2000 Issue on its operations and has worked with third-party service providers such as its custodian and fund managers to assess their Year 2000 readiness. It is not possible to be certain, however, that all aspects of the Year 2000 Issue affecting the Investment Board, including those related to the efforts of the fund managers, custodian, suppliers, information providers and other third parties, will be fully resolved.

Corporate Information

Board Committee Membership

Audit Committee

Mary Arnold (Chair)
 Jacob Levi
 Helen Meyer
 Joseph Regan

Governance Committee

Dale Parker (Chair)
 Susan Carnell
 Gerard La Forest
 Richard McAloney
 Helen Meyer

Human Resources and Compensation Committee

Richard Thomson (Chair)
 Pierre Michaud
 David Walker

Investment Committee (Committee of the Whole)

Search Committee

Gail Cook-Bennett (Chair)
 Mary Arnold
 Joseph Regan
 Richard Thomson
 David Walker

Canada Pension Plan Investment Board

Chair, Board of Directors

Gail Cook-Bennett

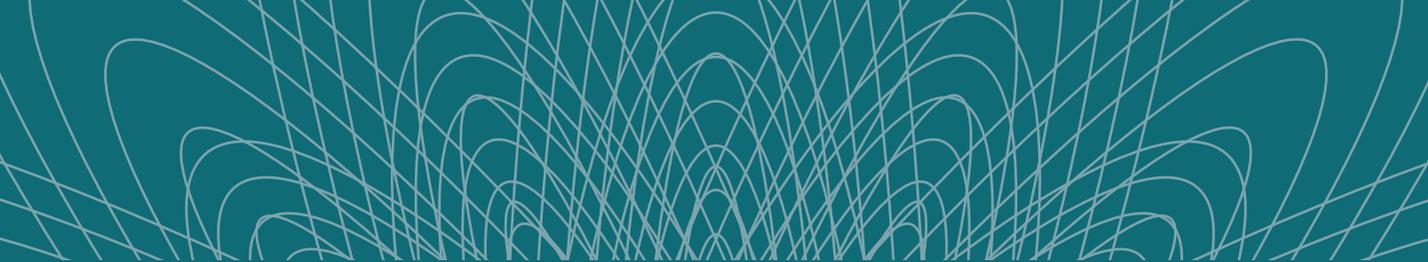
President and Chief Executive Officer Designate

John A. MacNaughton
 (appointment effective September 7, 1999)

Canada Pension Plan Investment Board

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Ce rapport annuel est aussi disponible en français.



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