

**THE RISK-LADEN APPROACH TO INVESTING CANADIANS'
PENSIONS: AN ANALYSIS OF THE CANADA PENSION PLAN
INVESTMENT BOARD AND ITS MARKET-BASED INVESTMENT
STRATEGY**

by

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Bachelor of Arts Honours, University of Regina 2005

M.A. PROJECT
SUBMITTED IN PARTIAL FULFILLMENT OF
THE REQUIREMENTS FOR THE DEGREE OF

MASTER OF ARTS

In the
Political Science Department

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SIMON FRASER UNIVERSITY

Spring 2009

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Abstract

The Canada Pension Plan Investment Board (CPPIB) has introduced substantial risk into the investment of Canadians' public pensions by moving assets from secure government bonds to market-based equities, real estate and hedge funds. This risk, because of the recent economic recession, has resulted in substantial losses to the Board's portfolio assets of over \$17.5 billion in this current fiscal year alone. Under the guise of its internally developed "Policy on Responsible Investing," the CPPIB invests the assets without concern for corporate social responsibility, promising to engage with rather than divest from irresponsible corporations. This adherence to a market-based investment philosophy has resulted in Canadians' pension assets being risked and lost. The CPPIB therefore eschews its fiduciary responsibility to protect Canadians' pensions for the foreseeable future. Failing the implementation of better risk management strategies including the reallocation of assets, new contributions may be required to fund future pension liabilities.

Keywords: pension investment - Canada; investment; public policy; Neoliberalism - Canada; Canada — Politics and government

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1. Introduction

The Canada Pension Plan Investment Board's (CPPIB) market-based investment strategy has resulted in a loss, between April 2007 and December 2008, of over \$17.9 billion of Canadians' public pension assets. This is likely to have repercussions that could affect both contribution rates¹ and future benefit rates. The CPPIB has a fiduciary duty to manage these pension contributions responsibly. Given the CPPIB's increasingly speculative strategy of investing in securities, however, the current contribution rates of the Canada Pension Plan may need to increase or benefits may need to be frozen. The CPPIB's risky operations demonstrate Canadians' pensions are not growing as promised, and as a result, the Investment Board does not follow its own mandate to act as a responsible investor.

While the CPPIB recognizes that there has been a tremendous erosion of public funds, it maintains that its long-term investment cycle will sustain the plan. It states even during the global recession its risk management strategies leave Canadians' pensions safely managed, responsibly invested and eventually profit-generating. (CPPIB February 13 2009) This belief that future returns will ultimately reverse this poor performance is not reassuring given the substantial drop in profitability of the managed funds and the depletion of its more stable investments of bonds.

Historically, the Canada Pension Plan returns were always positive when, before the creation of the new investment board, all of the funds were invested in government bonds. A problem in the perceived viability of the fund led to significant changes in 1997. Because of many decades of low contribution rates, a large unfunded liability developed. Contrary to popular belief, the strategy of investing in fixed assets

¹ Current contribution rates are 9.9% of Canadians' income paid half each by the individual and employer.

itself did not cause problems for the fund: secure provincial and federal bonds paid relatively high interest and generated returns on par with most other Canadian private and public pension plans². This apparent crisis in the underfunding of the Plan led to significant changes in the name of fiduciary responsibility. This included a strategy that increased contributions of workers by 65% over a six-year period³, decreased net benefits to retirees, and shifted the investment assets away from secure government bonds into market-based instruments like corporate equities.

Canada's Chief Actuary calculated that the new strategies would prevent the plan from becoming insolvent in the future, based on the assumption that the new portfolio could generate investment returns large enough to fund future pension liabilities. The intention was to use these new returns to prevent the necessity for larger contribution rates in the future. The result is the CPPIB's portfolio is no longer 100% in bonds; the investments constitute a mixed approach as of 2008 of only 25% in bonds and 75% in various private equities including stocks, real estate, derivatives and hedge funds. The solvency of the plan is dependent on these private equities generating substantial investment income.

The current global economic recession, however, demonstrates how risky this strategy has been. Because of substantial losses in 2001, 2005, 2008 and 2009 fiscal years, the CPPIB's gains made in 2006 and 2007 have been wiped in half and constitute an underperforming and underwhelming overall return. Future obligations may now need to be paid for with increased contributions or lower real benefits, the exact results

² The Governments of Canada even stated, "Returns on the CPP fund have been comparable to returns on other pension funds over recent decades due in large part to the high returns on CPP investments made in the early to mid 1980s." (Secretariat February 1996, 29)

³ Employee contributions rose from 3% to 4.95% of income, matched by equally increased employer contributions. (Service Canada October 28 2008)

the reforms were intended to prevent. The Chief Actuary's 2007 predictions for plan stability rested on key assumptions that have not materialized: stable unemployment rates, increasing incomes and, most importantly, high investment earnings in the CPPIB's market-based investment portfolio have all not happened.

This poor performance is precisely what the creators of the CPPIB sought to avoid. The CPPIB's preferred market-based investment portfolio has traded guaranteed returns in bonds for potential gains in private assets, but these gains have not materialized due to high market fluctuations in the last decade, and current economic conditions threaten to eliminate altogether the cumulative gains since the CPPIB's creation. The irony is the Investment Board's own Policy on Responsible Investing, crafted to restrict investment decision criteria solely to the financial bottom line, has not been used to make responsible investing choices on behalf of Canadians. Even as the CPPIB excludes investments that target social, regional economic or environmentally sustainable development because such targets might increase risks to performance, it has increased performance uncertainty by purchasing high-risk private investment instruments. Managers are willfully dismissive of calls for the pension investments to actually accomplish something of social value even as their own performance targets are not being met.

Rather than making solid performance gains, the CPPIB has not served Canadians well in its investments and the current strategy threatens the assets in its management. In three ways, this study will determine why the CPPIB is risking Canadians' assets. First, I will describe the historical circumstances that created the CPPIB and have allowed it to exist. This framing will demonstrate the CPPIB has always had a focus on market dependency for its investments. Second, I will describe

how the CPPIB's economic responsibility to sustain Canadians' pensions is failing due to its pension investment asset allocations. Third, I will demonstrate the CPPIB does not uphold its Policy on Responsible Investing, which mandates the CPPIB to act in the best interests of Canadians. I will explain that Canadians' pensions are at risk because of the risky investment strategies of the CPPIB. Although the CPPIB titled its commissioned history "Fixing the Future," there is no evidence that the Investment Board's current operations and investment strategy have fixed Canadians' pensions. If anything, there are serious doubts about the future of the Canada Pension Plan and its sustainability as a result of the risky investing of the CPPIB.

2. Research Approach: What frames the CPPIB's conception of responsibility?

This analysis of the CPPIB's shift in investment strategy requires a focus on key instruments, actors and institutions. The first focus is on the creation of the CPPIB itself, as it is a relatively new crown corporation constructed to invest the assets of the Canada Pension Plan. Exploring the CPPIB requires an understanding of the underpinning ideological considerations of the CPPIB's design, the debate about the appropriate makeup of the Investment Board, and an examination of the CPPIB's management and their policies regarding investment. Primarily, this analysis will define the history behind the CPPIB's creation and how the notion of responsible investing came to be a policy of the CPPIB. Second, this review will illustrate how pension reform in the 1990s came to take on a neo-liberal policy trajectory. Third, this review will illustrate what responsible investing has come to mean in Canada as a result of this policy and others in the pension system. These variables will illustrate what responsibilities the CPPIB holds as the public pension investor.

The second aspect of this research approach will analyze the economic impacts the CPPIB's investments have made on Canadians' pensions. I will chronicle the rise and fall of the assets the CPPIB manages, and examine the impacts of an unstable and risky portfolio to Canadians' retirement incomes. I will also look at the costs of operating the CPPIB, as it rewards its top executives generously in relation to performance of the portfolio. Because it is a public crown corporation, these bonuses come out of the contributions and generated revenues of the pension plan itself.

The third and final analytical approach will examine what implications the CPPIB's Policy on Responsible Investing (PRI) has regarding its investment strategy. There is a conflict between what is perceived as "responsible" by the CPPIB and what, in reality, the Investment Board undertakes in its investment approach. The result of this analysis will uncover that the CPPIB has avoided implementing measures of corporate social responsibility in its operations precisely to avoid any increased risk to its investments, while at the same it has introduced substantial risk to investing pensions based on other operating policies. Because the CPPIB, as a public corporation, has implemented its PRI to satisfy political pressures from various critics about the investment decisions it has made, the PRI does not effectively use responsible investing as a method of operation because this practice has not prevented low performance.

3. Origins of the Canada Pension Plan Investment Board and its market-based investment strategy

Why a pension fund investment board?

While the Canada Pension Plan has existed for over forty years, the investment board model of investing pension assets is a relatively new strategy. In 1966 the Government of Canada created the Canada Pension Plan, managed within the federal

bureaucracy, and Quebec created a parallel equivalent, the Quebec Pension Plan, managed by the Caisse de dépôt et placement du Québec (Drover 2002, 86). The CPP required small contributions of employees and their employers to sustain the fund, and was always designed to replace a portion of an individual's retirement, not all one would need to live in old age. (Secretariat 1996, 9) As a general rule of thumb, the CPP pensions were designed to replace 25% of an individual's income upon retirement. (Ibid, 11) The CPP invested these contributions in fixed assets composed of mostly provincial and some federal bonds. (Ibid, 17) In the early 1980s the bonds paid high interest rates because the CPP loaned substantial funds to the provinces when the average interest rate was 11%.⁴ As a result of the locked-in high interest rates, actual returns for the CPP's investments were substantial and contributed greatly to the assets the CPP accumulated in order to pay pension benefits.

Not only were the rates high, they were also considered to be a strong investment. In Bruce Little's historical accounting of the Investment Board (commissioned by the CPPIB), he notes that the investment community, the Federal Department of Finance and most observers viewed the investment strength of the bond portfolio as quite acceptable. The 9% real return on investments counters the argument that the CPP loaned its money to the provinces at absurdly low rates, an accusation that came from select conservative commentators. (Little 2008, 133) In general, the performance of the actual investments was deemed acceptable and solid.

A 1994 report by Canada's chief Actuary sparked the beginning of change and created more generalized doubts about the sustainability of the CPP's structure and pension liabilities. These liabilities gained attention in the era of the beginning years of

⁴ This 11% was higher than in subsequent years, but the CPP's bond purchases meant the rates were locked in for the duration of their terms.

the Chrétien government, during which the federal deficit ballooned and the debt-to-GDP ratio increased. A concerted effort to reduce government expenditures, reduce future liabilities and downsize the role of the welfare state accelerated.⁵ The Actuary's report found that contribution rates of Canadians would not be sufficient to pay for future pension liabilities, a problem that, he argued, would result in a bankrupt and insolvent pension system by 2015. (Secretariat 1996, Ibid.) This would occur, according to the Actuary, because Canada's large post-WWII baby boom population would retire by 2011 and would withdraw pension funds at a rate not to be replaced by the next generations of workers. This large withdrawal of funds would effectively bankrupt the Canada Pension Plan unless contribution rates increased. While critics of the Canada Pension Plan often cited the Chief Actuary's report as the evidence needed for reform, the main point of the report was to demonstrate current contribution rates were too low to finance benefit payments rather than to critique of the investment strategy of the CPP.⁶ The result of the Actuary's report was an acknowledgement by the Federal Finance Department that pension reform in Canada, as was currently occurring in many industrialized countries in Europe, was needed.

While governments of Canada pondered the issue, media commentators also focused on the potential for CPP insolvency and preached various privatization forms as a method for change. A 1994 *Globe and Mail* editorial stated, "the premise behind the OAS and CPP - that the government must force Canadians to save for their own retirement - is a paternalism we have surely outgrown... Maybe it's time to privatize

⁵ McBride's thorough discussion of the implications of the 1995 Federal Budget, for example, details how the shift in focus from the maintenance of the social safety net to deficit reduction allowed for the downsizing of the welfare state. (McBride 2005, 106)

⁶ Evidence of this discussion is contained in the Secretariat's preliminary consultation paper of February 1996, 17.

pensions.” (As quoted in Little 2008, 88) Andrew Coyne, writing for the *Globe and Mail* the same year, called the purchasing of pension funds by provincial governments a “slush fund... a private no-questions asked line of credit that saves them the bother of facing either their legislature or the capital markets.” (Ibid.) Other media outlets including the *Vancouver Province* and the *Halifax Daily News* caught wind of these ideas and approvingly editorialized about creating a system of “super RRSPs” where individually directed pension plans would entirely fund retirement for Canadians. (Ibid, 89) *The Economist* magazine published similar viewpoints, advocating privatization of global public pension systems. (Ibid.) Rather than discussing other potential solutions to the problems raised by the Chief Actuary, these editorials illustrate the simplistic way that privatization was presented in this era by major media institutions as the answer for any particular public policy measure, especially that of pension reforms.

The media was not alone in preaching a privatization agenda for pensions; the World Bank, in the same year, released its study advocating a similar perspective. It proposed pension reforms similar to those by Coyne and the media giants in Canada: a three-pillar approach to retirement funding, with a minimal reliance on the state for old-age security and a maximum reliance on private savings through individual retirement plans. The Bank justified this approach by calling any redistribution of income as a result of public social security programs a “myth” of progressivism and chided those who argued for public pensions. (World Bank 1994, 13) This mantra of increasing the role of private investment as a pillar of retirement income demonstrates that the dominant public discourse by large institutions of global finance and media on pension reforms focused on market-based solutions as the only tools to be used for restoring pension solubility.

Secretariat-led consultations: seeking inputs on a market-based investment board

In order to regain public confidence in light of the negative press about the sustainability of the plan, a process for reforms began in February 1996. A joint Consultations Secretariat of the federal, provincial and territorial governments launched a series of public consultations to seek input on reforming the system. The consultations began where the media and World Bank discourse had been: using some measure of private investment methods to generate enough assets to stabilize the pension system. The Secretariat published a discussion paper written during a review of the pension plan by the federal and provincial governments, and it used the paper to frame the consultations. “An Information Paper for Consultations on the Canada Pension Plan” outlined the demographic crunch that faced the CPP and potential solutions to the problem, including the shifting of pension funds from secure government debt into market-based investments. (Secretariat February 1996, 30) The CPP was comparable to many pay-as-you-go pension funds around the world because it was largely funded by current contributions and interest from government bonds. With an aging population it could be argued that it was unsustainable and that its liabilities exceeded the national debt. (Drover Ibid, 94) The shift to the marketization of the pension funds was only one of seven options presented by the information paper to the Canada Pension Plan’s overseers. (Ibid, 96) Given the shift in Canada’s policy terrain towards responding to social programming challenges with market-based approaches, the prominence of this option is not surprising. (Caroll and Shaw, 2001, 197) In light of the reform options presented in the consultation paper, the Secretariat had successfully raised awareness among interest groups about the need for changes in the way the CPP operated, and had laid the institutional groundwork for a future investment board.

Numerous Canadian interest groups, lobbyists and members of the investment industry participated in the consultation; the Secretariat received over 400 submissions in person and in writing at 33 sessions in 18 cities across Canada. (Secretariat June 1996, 3) While few participants sought an outright privatization of the pension plan, proposals for privatized pensions came from the Fraser Institute and the Canadian Taxpayers Federation (CTF), both whom cited the private pension accounts created in Pinochet's Chile in 1981 after his coup.⁷ Oddly, given its substantially different conclusions from all others presented, the CTF proposal almost mirrors the current iteration of the CPPIB. The CTF sought a "mandatory, defined-contribution, fully funded, privately managed plan." (Secretariat Ibid, 17) The proposals the Secretariat received illustrate Canadians were somewhat engaged in the reform process, but that those who had advocated other privatization policies reiterated the same method for reforming pensions.⁸ While there was some dissension from this penchant for privatization to prevent the CPP from becoming insolvent,⁹ the institutions of the Canadian investment community overwhelmingly argued for pension reform in Canada to use a market-based investment board.

In general, those who opposed the reforms were most concerned with the proposals to reduce the actual benefit to Canadians to an income replacement rate of 22.5% but this proposal was eventually dropped from the final plan and replaced with a

⁷ The appeal of the Chilean system was the mandated nature of private pension accounts. Given little public pension funds existed because of a lapsed state system, the Chilean system had a positive effect on local economic growth and individual savings rates because there was little precedent preceding it. This is why Fazio and Riesco (1997) note its successes are not likely to be seen universally and have not been ever duplicated.

⁸ The consultation paper mentions, "Some labour groups criticized the CPP Information Paper, saying, for example, that the CPP is affordable; that the paper doesn't indicate how changes to the CPP will affect other parts of the pension system; that it doesn't adequately assess the implications of economic factors such as increased productivity; and, finally, that it is designed to raise fears." (Secretariat 23)

⁹ Townsend notes the costs of the public pension, even given increased contribution rates, at 8% of GDP by 2030, would still be lower than 9.2% of GDP in 1991 as an average of OECD countries. See Townsend 2001, 5.

host of other benefit cuts. (Secretariat February 1996, 34) Funding for disability benefits changed significantly; qualifying for disability benefits became more difficult, requiring an individual to have worked within the last two of the last three years to be eligible, and the actual benefits were reduced. (Lindgren October 9 1997 A4) This effectively meant some workers who were previously eligible for disability benefits would no longer be eligible. (Hansard October 8 1997) Second, the maximum benefit of survivor benefits was decreased from \$3580 to \$2500 and frozen. (Ibid.) Third, it froze the previously rising bottom of contribution requirements, a regressive measure that effectively finances more of the Canada Pension Plan on the backs of low-income Canadians. (Ibid.) The benefit cuts, while opposed by many at the consultations and at the root of the BC and Saskatchewan provincial governments' opposition to the reforms, ended up being implemented.

Secretariat findings propose a widely-accepted investment board implementation

While presenters to the Secretariat's consultations differed on the proposals concerning increased contribution rates and the benefit cuts, there were not substantial differences on the point of the investment strategy of the new Investment Board. According to the Secretariat's findings, "there was near unanimous support among those who commented on investment policy in the general consultations for a better investment strategy for the CPP fund. Most advocated that the CPP fund be invested in a diversified portfolio of market securities to enhance returns." (Ibid, 55) The notion of enhancing returns became more palatable because growth rates of private markets in

the later 1990s in Canada exceeded the OECD average.¹⁰ (Drover 2002, 94) Business and pension fund representatives who presented at the public consultations unanimously approved of a refocused investment strategy into market-based investments. The proposal made, and agreed on, by most participants in the Secretariat's consultations was that "a larger fund earning a higher rate of return [than the then-current CPP plan of investing solely in bonds] would help to pay for future pensions." (Secretariat Ibid, 55) The Secretariat noted there was agreement "that the inevitable increases in contribution rates must be kept in check through diversified investment that will earn a higher rate of return." (Ibid, 36)

Labour representatives held a similar view as investment and business representatives about the necessity for an investment board. While the Secretariat held two specific consultation sessions regarding the investing policy of the board, only Hugh MacKenzie of the United Steelworkers of America attended as a labour representative. MacKenzie believed the investment board's policy should consider regional economic investment and job creation in addition to the financial returns of the pension. (Ibid, 58) David Walker of the Canadian Labour Congress agreed that the fund should invest in the market, and recalled that regional labour groups wanted solid growth of pensions rather than a particular economic development agenda for the Investment Board. (Little 2008, 164) The Public Service Alliance of Canada representative, Gary Paynter, "suggested establishing an advisory board of investment professionals and government employees whose role would be to maximize the profitability of the plan." (Secretariat June 1996, 36) Given the lumping together of all

¹⁰ Pesando notes, "The very high rates of return observed over the past five to ten years do imply... that rates are more likely than not to be relatively low in the next five to ten years." (2001, 146) Such a result occurred.

of the CPP reforms, the actual investment strategy received little attention in the consultations by citizens groups or labour representatives who might have traditionally raised questions about investment board and its mandate. This lack of diverse opinions and general agreement on the principle of an investment board in its formative stage is likely one of the clearest reasons for why the Canadian governments implemented the investment board model above all other considerations for reforming the CPP.

A preferred outcome to a public policy problem

The Government of Canada preferred, at least internally, these reforms to the CPP during the consultation phase. Little states, “to a considerable extent, the governments loaded the dice in favour of their preferred outcome - not in the details, to be sure, but in the broad direction of a reform with higher contribution rates, reduced benefits, and a new investment policy.” (Little 2008, 307) This preferential treatment of the market-based investment policy by the Secretariat in its public consultations illustrates that the agenda was set before the public was even consulted on what it believed would be a wise investment of their pension funds. Little states the feedback at the public consultations was clear: “get a good return on the cash generated.” (308) Given the multitude of reforms presented to Canadians during the consultation phase, it is not surprising that getting a good return became synonymous with a new investment strategy even though it was not the investments that caused the problem of future insolvency.

When it came time to implement the extent of the CPP reforms in Federal government legislation, there was minimal debate. While BC and Saskatchewan, provinces with NDP governments at the time, opposed the creation of the CPPIB for

their deep cuts to disability and survivor benefits, the proposal had received the support of the largest provinces and was thus brought forward as legislation in 1997. The debate over the ability of the Investment Board to act as a passive or active investment manager served as the only issue of major contention during the legislation process. (Condon Ibid, 93) Also, because the Federal Liberal government sought immediate implementation of the CPPIB, it pushed through the legislation guiding its creation through the Finance Committee and the House of Commons. The Reform Party opposed the reforms on the grounds that they believed the CPP should be replaced with private accounts as found in Chile. Chile's private RRSP-like pension plans came up repeatedly in debate from the Reform Party in the House of Commons as a potential solution to the issue of solubility of the pension plan. (Little 2008, 270) Diane Ablonczy, a Reform MP for Calgary, called the CPP's reformed fund "the finance minister's slush fund"¹¹ and rationalized opposition to the fund on the notion that it would be used for targeted economic development initiatives. (Pesando 2001, 144) While the issue of private RRSP-like plans had come up during the consultations by the Canadian Taxpayers Federation and the CD Howe Institute's presenters, they received little attention from the government. (Robson 2006, 1) Implementation of the CPPIB came with swift speed in Parliament. In order to establish the CPPIB immediately, the Liberal government rushed the legislation through committee and passed it within weeks of its introduction.¹²

The Liberals, Progressive Conservative Party, Reform Party and Bloc

Québécois all supported the general idea of creating a crown corporation investment

¹¹ See the Debate, October 18 1997.

¹² Hansard notes the bill was prioritized and rushed through the House of Commons, to the chagrin of opposition members who sought longer time to debate the changes. (Canada. House of Commons December 4 1997)

board for public pensions. The NDP did not support the idea; in committee hearings on the proposed legislation, MP Lorne Nystrom questioned whether the strategy would include any qualifiers such as regional economic development targets for the CPP's funds. (Standing Committee on Finance October 29 1997) The Finance Department's assistant deputy minister of financial sector policy, Bob Hamilton, replied, "the objectives of the board will clearly be to invest in the best interests of the beneficiaries and contributors of the plan. There is no secondary objective, if you like, in order to have another criterion to satisfy, whether it be economic development or other." (Ibid.) In the end, the NDP opposed the legislation based on an unsatisfactory investment strategy and the substantial changes to benefits. The legislation passed easily without their support, however.

Satisfying ideological considerations

The reforms creating the CPPIB follow an ideologically planned agenda of the Finance Minister of Canada in the 1990s to reform the social welfare state and its various institutions. Paul Martin, as finance minister, saw market-based solutions as the best measure for generating wealth in Canada. Canada's reforms of social programming, as a result of substantial expenditure reduction, paralleled reforms in other industrialized nations in Europe during this era of deregulation and liberalization. (Brooks 2002, 499) Public debt accounted for 35% of the federal GDP and 25% of the average provincial GDP; in countries that undertook similar reforms to Canada to their pension systems, public debt ratios were much lower. (Vittas 2008, 11) The Canadian investment of public pensions in this government debt gained a solid return; in other countries, private investment funds had less of an opportunity because of the lower

public debt-GDP ratios. (Ibid.) Nevertheless, Martin's preoccupation with the deficit led to multiple successive budgets, starting in 1994, that substantially cut social programming: his eye was next on reforming old age security and retirement funding by the government. (Little 2008, 126)

The implementation of an arms-length crown corporation to manage the funds accomplished a second goal in that it satisfied the ideological considerations of Martin's provincial counterparts in Alberta and Ontario, especially in an era of implementing neo-liberal policies to handle numerous aspects of the social welfare state. (Carroll & Shaw 2001, 210) Martin required the support of a majority of provinces, which included these two, in order to make these changes to the CPP; Alberta in particular wanted a "full-blown market-oriented investment policy" and an arms-length investment board to manage the fund (Little 2008, 186) Gaining BC and Alberta's support, necessary because BC and Saskatchewan did not support the plan, came at a price for Martin in the form of a change in investment philosophy. This package explicitly meant the Investment Board was prohibited from taking an investment approach that might be construed as using social investing as criteria, a demand of Alberta and Ontario, provinces both governed by the Progressive Conservative party. (Ibid., 245) This means the investment policy was designed explicitly to appease the most conservative of the two provincial governments and their influence in its creation should not be understated. The market-based investment approach was adopted and the CPPIB became an official crown corporation in 1998.

The first employee by the newly chosen board members of the CPPIB demonstrated a willingness to carry out the ideological agenda bestowed upon the new board. The CPPIB selected John A. MacNaughton, a one-time key figure in he

Progressive Conservative Party of Canada and a financial industry executive, as its first CEO. As CEO, MacNaughton had the task to set up the organization's workforce and organizational structures, including establishing its policies. The CPPIB took an active stance in lobbying for changes in its investing abilities.¹³ In the 2001 annual report, John A. MacNaughton wrote, "Federal and provincial finance ministers are considering the removal of the remaining regulatory restrictions on our Canadian equities during fiscal 2002. This would give us the same flexibility to enhance returns and mitigate risks as other investors." (CPPIB 2001, 8) This statement in the annual report serves as a reminder that the management and staff of the CPPIB ultimately had a vision for the organization outside of what was legislated and approved of by the provinces and federal government. Their lobbying included convincing Finance Minister Paul Martin to make the changes to the legislation.¹⁴ This willingness to actively lobby the Canadian Finance Minister for changes to the Investment Board's structure illustrates a profound shift in the institutional development of the Pension Plan and how it operates.

The purpose of this exploration of the CPPIB's development has been to provide insight into how a market-oriented investment strategy, aiming at higher returns for the CPP's funds, came to be at the centre of the pension plan reforms. Generating these returns for Canadian retirees is not without merit. A one percent increase in the annual return of a pension fund will, over the time of the fund, increase the benefit by 20%. (Brooks and James 1999, 7) Thus, the allure of potentially higher returns by shifting investment to be more heavily weighted in the stock market was

¹³ Weaver (2003) notes complications with the original design of the CPPIB's portfolio as a strictly index-based fund resulted in new regulations for the CPPIB by lifting certain restrictions on its investment opportunities. This was, in part, the result of MacNaughton's work as CEO to lobby for the lifting of the foreign content limit. (CPPIB 2000, 8)

¹⁴ Interview with the author, August 13 2008.

strong: market performance that had been historically stronger than government bond performance had the potential to yield a substantial means of income for Canadians. However, market failure does occur, and as a result, the substantial risk of potential investment performance of market-based instruments is made clear. The sustainability of the pension plan is entirely dependent on the success or failure of financial markets. (Townsend 2001, 59) Although the returns of common stocks were strong between 1990 and 1995, their stability and sustainability has been quite irregular over time. (Ibid, 60) Thus, investing the portfolio of the CPP must be conducted responsibly so that the assets are sustainable for future generations who contribute to the funds. Investigating precisely how the CPPIB utilizes its market-oriented strategy to invest responsibly is critical. Given that increased performance of the pension fund investments is one of the key reasons for the creation of the CPPIB, analyzing this performance will illustrate what implications the reforms have on the sustainability of the plan.

4. The CPPIB's market-based approach to economic security

Fiduciary duty to increase pension assets

While the core of its existence is to secure Canadians' pensions, the CPPIB has not succeeded in its fiduciary duty of economic responsibility because of its adherence to its market-based investment policy. The legislation creating the CPPIB specifies that any amount transferred to the CPPIB must be managed "to the best interests of the contributors and beneficiaries" of the Canada Pension Plan. (1997, c. 40, s. 5) The best interests of contributors and beneficiaries means the CPPIB must not make risky investments that threaten future pensions. The rapid decline in assets in the 2008-2009

fiscal years of the CPPIB's operations demonstrates the CPPIB has not upheld this responsibility to make sound investments. This can be demonstrated in two ways. First, the performance of the fund will be measured and analyzed to show exactly how the losses of the CPPIB have increased in this economic recession. Second, because the CPP functions as the public pillar of retirement income for Canadians, losses of the CPPIB's portfolio demonstrate a weakening of the financial security of Canadians who rely on public pensions for their income upon retirement.

Performance of the CPPIB's portfolio: high expectations, vastly missed targets

The most important test of economic responsibility for the CPPIB is the actual performance of its investments. The CPPIB's explicit role as an institution, "consistent with its mandate, is to maximize investment returns without undue risk of loss."

(CPPIB 2009, 1) All pension plans, regardless of investment strategy, share this common economic responsibility to the plan holder to provide financial security. The CPPIB's economic responsibility to Canadians, referenced in the legislation and in the mandate section of the Policy on Responsible Investing, is to manage and invest the CPP assets in the best interests of CPP contributors. It must have an investment philosophy that allows a long-term focus for its investments to generate new wealth to supplement all of its pension liabilities long into the future.

Ensuring the investment philosophy is sound is the focal point of the Chief Actuary of Canada, who reviews biannually the income, performance and costs of the CPP to detail how solvent and secure the CPP is. This reassurance is important, for it was missing when the Government of Canada restructured the CPP's investments in the first place. The solvency of the plan was limited to only a few years at the 1996 rate

of contribution and expected payouts to retiring workers, because the contribution rate was widely acknowledged to be too low to sustain the benefit levels, disability payments, decreasing economic activity and aging of the population. (Baldwin 2004, 18)

In fact, the Chief Actuary's report made it clear it was not the actual investments and their returns that caused the needed influx of contributions, which were projected to grow to 14.2% of gross earnings by 2030 to sustain the plan. (Ibid, 19) Table 1 describes what factors the Chief Actuary saw for increasing the costs of the CPP contributions.

The Actuary found 1994 contribution rates to be insufficient to ensure solvency of the CPP.

Table 1: Cost increases as percentage of earnings: 1994 Actuary Study vs. 1997 Reforms

Cost Increase	Actuary Figures: Cost as % of earnings	1997 Reform Figures: Cost as recalculated after reductions and reforms
changing demographics	2.6	(-1.4)
changing economics	2.2	?
Enrichment of benefits	2.4	-10 to 15% of total costs
Disability	1.5	? *
Projected 2030 Costs	14.2	9.9
<i>Original projections from Secretariat Report 1996, 4. Revised projections from Baldwin 2004, 21. * Benefit cuts primarily taken from disability & survivor benefits.</i>		

Justifying the reforms and implementation of the market-based investment fund was difficult because the previous investments in government bonds generated solid returns. In 1995, calculating projections of a hypothetical market-invested fund by the Federal Finance Department became difficult precisely because the predictability and good returns of the CPP's government bond investments made it easy to calculate

exactly what money and gains would be in the fund in years to come. (Little 2008, 133)

In the public consultation document released by the Secretariat, the Governments of Canada noted, “Some contend that this policy [of investing solely in government bonds] is the main reason that the plan risks becoming unsustainable. This is incorrect. ... For example, on a fund of two years of benefits (the target established in 1986), a full percentage-point increase in the rate of return would lower the long-term contribution rate by less than 0.25 of a percentage point.” (Secretariat 1996, 17) This finding means the bond portfolio performance did not threaten substantial increases in contribution rates, and also means a better performing portfolio would have minimal effect on future contribution rates. This point illustrates the justification for investing CPP funds via an investment board was misleading. The Secretariat’s findings meant contribution rates needed to increase regardless of the investment strategy. The small differential in contribution rate potentially created by a higher performing portfolio would be minimal compared to the substantial increase in the base contribution rate in the first place.

The CPPIB has subsequently failed to meet that expectation of substantially increasing pension assets, for over its ten year period the performance of the CPPIB’s investment history illustrates precisely how unfeasible that expectation was. While the recent economic turbulence has all but eroded all gains made over the last ten years, this recent period has not been the only period of substantial losses for the CPPIB. Table 2 illustrates the cumulative gains and losses over the ten years of the CPPIB’s investing history.

The data shows that the CPPIB’s market-based investment portfolio made positive gains in its first two years of operations but suffered substantial losses in the market following 2001. While equities recovered in 2004 for four years, over half of

this recovery has been wiped out in the last two fiscal years, with a substantial likelihood that more will be lost in the final quarter of the 2009 fiscal year. As the global economic recession has already eliminated nearly \$18 billion of accumulated income, the CPPIB's portfolio stands to have lost over three years of growth. Given the accumulated size of the portfolio has increased to \$94 billion of contribution transfers from the CPP, the \$14.8 billion of total investment income represents a small percentage of annualized growth over 10 years of operations. These returns are not very high, representing just 15.74% total growth since the change in investment strategy. The expectation that the CPPIB would generate 4% annual returns on average has not come true and was wildly and erroneously optimistic; the average annual net return is approximately 1.43% per year over the CPPIB's entire operations.

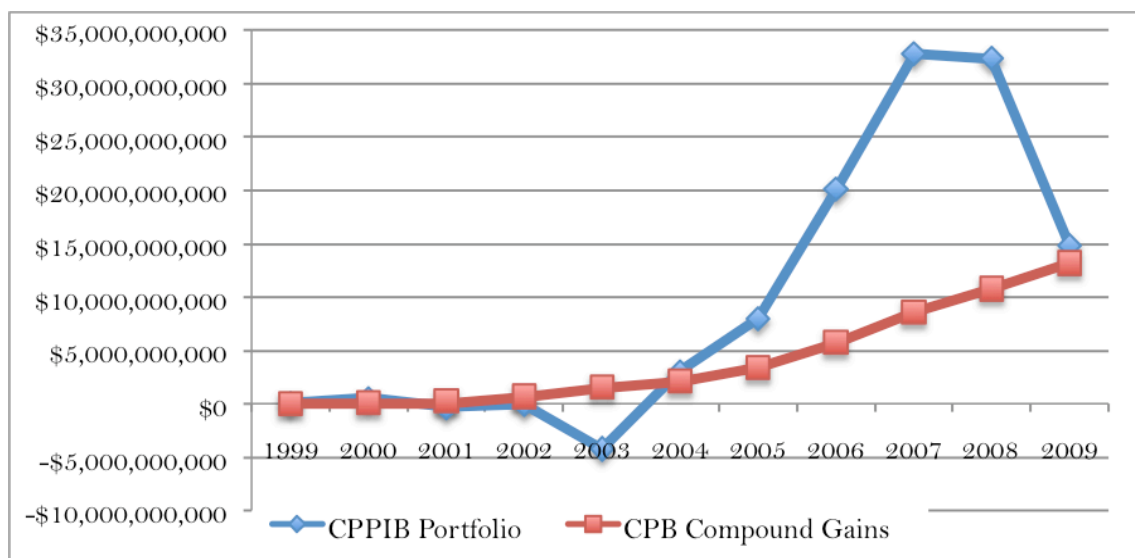
Table 2: CPPIB Gains / Losses and Total net income from investments

Year	CPPIB Gains / Losses	CPPIB Net Income from Investments
1999	\$202,362	\$202,362
2000	\$460,135,638	\$460,338,000
2001	-\$851,590,000	-\$391,252,000
2002	\$304,626,000	-\$86,626,000
2003	-\$4,152,290,000	-\$4,238,916,000
2004	\$7,209,707,000	\$2,970,791,000
2005	\$4,982,209,000	\$7,953,000,000
2006	\$12,139,000,000	\$20,092,000,000
2007	\$12,674,000,000	\$32,766,000,000
2008	-\$422,000,000	\$32,344,000,000
2009 *	-\$17,542,000,000	\$14,802,000,000
<i>Data compiled from Annual Reports of the CPPIB, 2000-2008.</i>		
<i>*2009 data current as of 3rd Quarter Report of the CPPIB.</i>		

Poor performance relative to past practice: underwhelming returns

The risky operations of the CPPIB must be put in context and compared to the previous investment strategy of the Canada Pension Plan. The previous investment mechanism was solely government bonds, where the provinces purchased the majority of the CPP's assets and the federal government bought the excess capacity. To illustrate the previous investment scheme, Figure 1 compares the results of the CPPIB's actual portfolio performance to a hypothetical portfolio of the same contributions invested in entirely new Canada Savings Bonds over the same ten-year period.¹⁵

Figure 1: CPPIB Portfolio vs. Canada Premium bond performance, 1999-2009



For the first five years of operations, the CPPIB was unable to even outperform the Premium Bond market via its predominantly passive investment strategy in index funds in Canada and the global economy. The final result is that, as of the third quarter

¹⁵ This study assumes that Canada Premium Bonds are the only bonds available to the CPP for the purposes of a simplistic illustration. Provincial bond rates may be different than that available via Canada Premium Bonds. However, the purpose of this illustration is to show that bonds, even generating low annual rates of interest, may still have matched the performance of the CPPIB's diversified strategy over the ten year period. This comparison ignores that the CPP held bonds in a relatively high performing portfolio of high interest rates, which likely, under this hypothetical scenario, would have increased, rather than decreased, the performance test of the hypothetical portfolio.

2009 report, the gains made by the CPPIB have been \$14.8 billion, whereas a comparable investment of CPP premiums into the bond market at fairly low interest rates would have resulted in gains of \$13.2 billion. The differential is approximately \$1.6 billion. Current economic projections by the IMF and World Bank for global recession are all but certain to erode this differential completely by the end of the 4th quarter.¹⁶ Now that the CPPIB is embarking on “selling debt” of between \$2 and \$5 billion in 2009, even less of these returns are available to pay benefits in the near future. (Mazurkewich March 27 2009) Given the Secretariat’s assumption in 1996 that performance of the investment fund would neither result in substantially decreased premiums nor would it necessarily result in guaranteed substantial gains for the pension plan assets, this study illustrates a lack of economic responsibility on behalf of the CPPIB’s management. The CPPIB was expected in its creation to vastly outperform the previous investment strategy, but this study demonstrates this has not been the case.

Poor performance is a result of the asset allocations of the portfolio

The reason for the failed investment strategy is in the portfolio design of the CPPIB and the risk management that accompanies such a portfolio. The three decades prior to the CPPIB’s introduction had been met with government regulations at the federal and provincial levels to steer private pension plans towards a prudent portfolio approach that stressed diversification. (Little 2008, 190) Diversification within the CPPIB has meant a substantial shift away from secure bonds to an active portfolio of

¹⁶ The IMF, as of this writing, is expected to revise its current projections of 0.5% growth in the world economy in 2009 to a negative number. The World Bank on March 8 2009 projected a 1% negative decline in growth of the global economy. See Wearden March 10 2009.

investing explicitly “to obviate the need for a future increase in contributions or a reduction in benefits.” (Vittas 2008, 18) The diversification of the portfolio was expected by CPPIB management to result in substantial gains.

However, as described above, the CPPIB did not make those substantial gains because its assets have not been returning positive investments, predominantly because of the shift in asset allocation to poorly performing market-based investments. Table 3 demonstrates precisely how the assets have shifted in their allocations within the CPPIB’s managed portfolio.

Table 3: Asset types of the CPPIB Portfolio, 2000-2008

Asset Type	2000	2002	2004	2006	2008
Bonds *	95%	60.80%	42.90%	27.70%	23.40%
Publicly traded stocks	5%	25.79%	42.70%	58.50%	51.80%
Private equities		0.81%	2.50%	4.50%	10.90%
real estate and infrastructure			1.00%	4.30%	7.80%
Cash		12.50%	10.60%	0.60%	
Money market securities		0.00%	0.30%		
Inflation-linked bonds				4.00%	3.90%
Hedge funds					1.30%
Other					0.90%
<i>Data from CPPIB Annual Reports 2000-2008. * Bonds were originally entirely government sourced in 2000, but now include corporate bonds in this calculation.</i>					

When the CPPIB started investing the new assets of the Canada Pension Plan, it focused predominantly on index-based investments. This has changed in a very short period of time: the CPPIB increased its holdings of private equities to 10% of its assets

as of 2008. Publicly traded stocks have increasingly made up a larger portion of the assets of the CPPIB, and these stocks are now predominantly foreign investments. Bonds, originally the entirety of the investments of the CPP, now compose less than one quarter of the entire portfolio of the CPPIB. New high-risk investments such as hedge funds make up a small fraction of the portfolio at 1.3%, but nevertheless represent over \$1 billion in assets. Because the guaranteed income bonds are a diminishing fraction of the portfolio, the performance of the plan has been mostly reliant on market success for positive returns. Since the market is not generating positive returns, the majority of the portfolio is not doing well, and the CPPIB is losing assets rapidly.

Table 4: Assets as percentage of portfolios, CPPIB vs. Statistics Canada "average"

Investment type	CPPIB Portfolio	Stats Can avg. portfolio
Bonds	23.4	34.8
Stocks	62.7	36.3
Mortgages	0.0	1.6
Real Estate	7.8	7.5
Short-term	0.0	3.0
Cash / assets under \$10 million	0.0	0.3
Other	6.1	16.5
<i>Data for CPPIB from 2008 Annual Report, 63. Data for Statistics Canada from The Daily, December 11 2008.</i>		

The plan's performance is lower than expectations precisely because the asset allocation of the CPPIB's portfolio is heavily weighted to private equities compared to the average public or private pension plan in Canada. Table 4 illustrates that, compared to Statistics Canada's reference data of the average Canadian pension plan asset weights

as of 2008, the CPPIB's ratio of bonds to public and private equities is quite low. The trend over twenty years of tracking the data demonstrates that, while the allocations of bonds have decreased in the average portfolio as measured by Statistics Canada, it has nevertheless remained higher than what the CPPIB has shifted to in its allocations.¹⁷ While the projections of the Secretariat in 1996 showed the likely performance of the CPPIB to be large, the opposite has come true. The lack of balance between investment risk and actual returns highlights the risky policies of the CPPIB.

As this information demonstrates, "the current operations of the CPPIB are very different from those envisaged by its original creation as a single-purpose corporation dedicated to increasing the long-term value of CPP assets through prudent investments." (Vittas 2008, 45) The CPPIB even sought to gauge Canadians' attitudes towards its asset allocations via a public opinion poll. In the 2002 poll, only 46% of respondents believed equity positions in the stock market should be taken by the CPPIB, while 29% did not agree and 25% had "no opinion." (CPPIB October 29, 2002) While some contributors believed this strategy was the best way to increase the economic value of public pensions, the poll demonstrates Canadians are not in agreement that the current investment strategy is the appropriate one for their pensions.

The high cost of operating the Investment Board

The current risky investment strategy of the CPPIB is not one without substantial cost. The low cost of publicly operating the investment fund was one of the key factors mentioned in the Secretariat's consultations for keeping the CPP as a public

¹⁷ In 1998, Statistics Canada found the average percentage of bonds to be 33.1%, a decrease from 46.1% in 1988. (Statistics Canada September 16 2001)

system. (Secretariat June 1996, 42) With a \$6 million start-up fund provided by the Canada Pension Plan, the CPPIB cost \$1.07 million to fund its first year of operation, including salaries, operating expenses and investment broker fees. (CPPIB 2000, 25) This grew to \$3.65 million in its first full year of operation and rapidly escalated. (Ibid.) By 2006, operation costs reached \$54 million, doubling by 2007 to \$114 million. (CPPIB 2007, 57) Costs have escalated by approximately \$50 million each year since 2006. In total, since commencing operations the CPPIB has cost \$547 million. Salaries and benefits have accounted for just over 57% of costs, at \$312.75 million. At \$166 million, Crown corporation operations costs account for 30% of expenses. Transaction and investment fees account for 12%, at \$68.2 million, mostly because a substantial portion of the investments of the CPPIB are outsourced to various fund managers for their indexation in global economic markets and for management in private equity firms. (Scanlan March 12 2004) Overall, this \$547 million of operations and management has created \$14.8 billion in new assets - a ratio of 3.7% - something that CEO Denison explains has been rising in recent years “as the scope and complexity of our investment activities have increased.” (CPPIB 2008, 42) These costs illustrate that the portfolio performance needs to be very high to justify such a high operating expense. The risky portfolio design demonstrates the strategies the CPPIB employs are increasing, rather than decreasing, the cost of operating the Investment Board.

The Board’s management, of course, has been rewarded well for the returns the CPPIB has generated, even when the returns in the previous year have not been positive. The CPPIB pays its top executives lucrative bonuses each year that are not congruent to the performance of the portfolio as a whole. In the CPPIB’s 2008 annual report, the Board’s then-chair, Gail Cook-Bennett, notes, “although this year’s overall

investment return was slightly negative, this year's executive compensation reflects strong four-year performance above market-based benchmarks." (CPPIB 2008, 4)

Table 5: Bonuses of top four CPPIB employees vs. Performance of portfolio, 2000-2008

Year	Portfolio Performance	CEO	CFO	VP Private Markets	VP Public Markets
2000	\$460,135,638	\$100,962	\$37,589	*	*
2001	-\$851,590,000	\$175,000	\$49,603	\$68,308	*
2002	\$304,626,000	\$181,825	\$62,880	\$148,000	\$84,815
2003	-\$4,152,290,000	\$90,000	\$41,000	\$80,500	\$74,000
2004	\$7,209,707,000	\$250,000	\$60,125	\$211,849	\$131,200
2005	\$4,982,209,000	\$329,907	\$146,575	*	\$285,000
2006	\$12,139,000,000	\$562,500	\$140,000	\$900,000	\$330,000
2007	\$12,674,000,000	\$1,840,000	\$320,000	\$1,360,000	\$1,077,000
2008	-\$422,000,000	\$1,246,875	\$300,000	\$1,050,000	\$828,750
<p><i>Data collected from CPPIB Annual Reports 2000-2008</i> * Years in which these positions were not staffed, and thus no bonuses or salaries were paid.</p>					

While the general trajectory of bonuses appears to be similar to the performance of the CPPIB's portfolio, Table 5 demonstrates the payment of bonuses to the CEO, Chief Financial Officer, VP Private Market Investments and VP Public Market Investments has been generous in years with poor performance. In three years, 2001, 2005 and 2008, when the CPPIB's portfolio suffered from substantial drops in investments, the executives still received large bonuses. While these compensation rates may be competitive with the private sector, Canadians will be alarmed to see these public employees rewarded for poor performance of their pension's investment portfolio. The bonuses demonstrate the CPPIB spends far more to operate than the CPP ever did, accentuating rather than masking the lackluster performance of the portfolio.

Risk assessment flawed: performance not meeting expectations

Because responsible investing should mean reliable, secure and safe growth of the pension plan funds, the CPPIB's current risk assessments are not appropriate and have not been financially responsible. The CPPIB internally designed a "reference portfolio" to compare a hypothetical benchmark to its own performance, but based this reference portfolio on relatively the same asset allocation that the CPPIB uses currently. (CPPIB 2008, 16) Their goal for this reference portfolio is to generate returns of at least 4% above inflation, which requires a lower allocation of bonds than the average Canadian pension portfolio referenced by Statistics Canada. (Pasternak 2004) By striving for higher returns than even its internal reference benchmark determines are feasible, the CPPIB invests the pension funds with ever-increasing risk. By using such high level of market volatility in its risk assessments, the CPPIB invests contrary to a balance of risk and performance.

There are good reasons for investment strategies focused on stability and greater risk management of the CPP's funds. First, because Canada's aging population will require more resources in the pension system to provide for the retiring baby boom demographic, the need for a growing capacity in the plan is apparent. Second, stable income leads to a better-planned dispersion of the resources. Third, the global recession of 2008 and 2009 will shake up any preconceived notions of globalization's ability to stabilize shocks from one market to another, especially when evidence points to US-style capitalism as the main culprit of the global aftershocks. The International Actuarial Association, in a February 2009 report, stated the global economic financial crisis demonstrates serious concerns about management and oversight of financial services industries. They stated that risk must be better communicated, because the

consequences of uncertain risk leads to an improper understanding of the value of assets. (IAA 2009, 5) This assessment certainly applies to the CPPIB, where the value of Canadians' pension contributions should be taken to be simply "new assets" to gamble with on high-risk market-based investments. All of these reasons demonstrate that, if the CPPIB's portfolio is not managed with strong risk management focus, the future of a Canadian public pension plan is in jeopardy.

Actuary Reports on the CPP: High expectations for continued market success

There is evidence in Canada's Chief Actuarial reports reviewing the CPPIB that the risk of such economic shocks has always been a potential threat to the solvency of the plan. The Chief Actuary's 17th report on the CPP assumed a 4% average return rate on the funds in the CPPIB's portfolio. (Actuary 1997, 25) Even with this average return rate, the Actuary noted contribution rates would not be affected at all, causing a 0.00% change in the steady-state rate of contribution. (Ibid, 32) Further, the report also notes, in its sensitivity tests of risk assessment scenarios and models, the real rates of return of the investment policy of the CPPIB still might lead to the need for greater contribution rates compared to the previous investment strategy.¹⁸ (1997, 42) By the 21st Actuary report, this projection came true, when changes in investment assumptions due to declining CPPIB investment performance caused a 0.028% increase in contribution rate. (Actuary 2004, 38) Contrary to the original plans for the investment portfolio, performance has not facilitated a decrease in contribution rates.

¹⁸ Explicitly, the report states the real rates of return "impact on the ultimate contribution rate is greater under the higher funding levels projected as a result of Bill C-2 [the legislation that created the CPPIB changes] than was previously the case." (Actuary Ibid, 40)

The latest Actuary review of the CPP demonstrates current projections for the future sustainability of the plan require much higher returns than the CPPIB is currently achieving. The report highlighted that, although equity returns over the last ten years have been higher than bonds, this is not the case for the last 25 years, where bond performance has been higher than equities. (Chief Actuary 2007, 48) The report also assumed an unemployment rate of 6.3% (Ibid, 96) which has already increased to 7.7% as of February 2009. (Statistics Canada March 13 2009) Third, it assumed that 2009 would see a 0.6% increase in average earnings for Canadians (Actuary Ibid, 102) an unlikely scenario given current economic conditions. These assumptions show the CPPIB foresaw market failure as a small liability rather than a potentially huge problem in their investment plans. Because the CPPIB's portfolio has fallen frequently in value in the Investment Board's ten years of investing, this problem indicates lax assessments of true economic conditions.

Net result of poor performance: contribution rates may increase

These true economic conditions demonstrate that the CPP contribution rates may have to increase in the near future. The Chief Actuary's report shows that the real rate of return, as in the expected earnings,

“have an impact on the minimum contribution rate. Beginning in 2020 when net cash flows of the Plan are projected to turn negative, a portion of investment earnings will be required to pay Plan benefits. Sufficient real rates of return are required to produce investment earnings large enough to cover the necessary portion of Plan benefits while still increasing the assets of the Plan.” (Ibid, 57)

The Actuary also noted that lower anticipated rates of return on investments have already put upward pressure on the minimum contribution rate, countering the benefits of relatively high economic performance in the 2004-2006 period and relatively high labour force participation. (Ibid, 61) Because the real rates of return have been below expectations and have dropped substantially in the last three quarters, the investment earnings of the CPPIB are not likely large enough to cover benefits needed paying within only a few years. If performance of the plan is not solid and the governments cannot agree on changes to increase contribution rates, there will be a freeze on the inflation adjustments of benefits, resulting in a loss to pensioners while governments fight over contributions. (Ibid, 73) As of December 31 2006, there is also a \$619.9 billion unfunded liability of the CPP under the current plan. (Actuary 2007, 66) This liability is threatened to be a government expense problem when the performance of the plan decreases.

Entrenched ideological underpinnings preventing reform

The point of this discussion of the lack of economic responsibility of the CPPIB has been to illustrate the poor results the portfolio has generated are entirely a result of a forced, ideologically-driven market-based strategy to reform the CPP's investments. The entrenched nature of the ideology behind the CPPIB's creation implies even these results may not sway decision making by the CPPIB or by government policy makers to make reforms. As Bob Baldwin of the CLC states, "there has been little impetus for change" (Baldwin 2004, 27) in the way the CPPIB operates precisely because of this embedded ideology. The tilt towards market-based investments is inherent throughout the CPPIB's structure and operating systems, a trend prevalent across social

programming in Canada following extensive welfare state reform in the 1990s. This embedded operations style leads Canada, not just the CPPIB, further down a marketization agenda of policy making, one which fuels particular beneficiaries in the private sector. (Drover 2002, 92) Shifting away from the CPP's original design as a secure buyer of government bonds demonstrates the enhanced structural power investment, in a general sense, has been given by globalization and increased capital mobility. This is one of many introduced "sweeping measures" that widens the scope of private business in social life, one which is now entrenched even in the public pillar of the Canadian retirement income system. (Carroll & Shaw 2001, 196) As a result, the CPPIB is likely unwilling to make changes because of its entrenched high valuation of the private marketplace as the ideal source of investment. The failure to recognize its risky investing strategies demonstrates the Investment Board does not follow its mandate to act responsibly.

5. Assessing the CPPIB's market-based approach and opposition to corporate social responsibility

What is the social responsibility function of the CPPIB?

The greatest social responsibility of the CPPIB, at its most basic level, is an economic responsibility to ensure Canadians have their public pensions as part of their retirement income. To do so, its mandate is to guarantee public pensions are protected, generating positive returns, and invested with an adherence to its own Policy on Responsible Investing (PRI). As demonstrated, this core social responsibility to grow pension asset has been lost; this is in contravention of the PRI. Contrary to conceptions of how the PRI might be implemented, the policy arguably allows the CPPIB to reject mechanisms of socially responsible investing. This section will explain that the

responsibility of the CPPIB to engage its investments on environmental, social and governance (ESG) criteria of corporate social responsibility has been avoided precisely because the CPPIB does not believe it has a duty to do so. I will demonstrate the policy has changed in recent years, but it has not advanced the implementation of socially responsible investing by the CPPIB because its actions have not changed. Because this appears to be an inherent contradiction between policy and practice, I will analyze what corporate social responsibility means to the CPPIB and explain why the failure of economic responsibility contradicts this policy at a fundamental level.

The duty of the CPPIB to invest ‘responsibly’ has not always been the intention or design of the Investment Board. The CPPIB’s original design, as illustrated previously, was to avoid any investing practice using ESG criteria because of political opposition by the governments of Alberta and Ontario and by members of the Reform Party.¹⁹ This thinking is evident in the Act and regulations that created the crown corporation.²⁰ This original plan to avoid using ESG criteria reflects in the first policy on social responsibility implemented in 2002 by the CPPIB. Titled the “Social Investing Policy,” it vaguely references the notion of making responsible investment choices, stating:

“the CPP Investment Board believes that social investing means different things to different people; and that, while it might be easy for individuals or small groups of like-minded people to agree on criteria for including or

¹⁹ The primary feedback the Secretariat received was to prevent the CPPIB from ever taking on a socially responsible mandate such as promoting economic development within Canada. (Secretariat June 1996, 57)

²⁰ While the Canada Pension Plan Investment Board Act (C40) does not explicitly prevent “responsible investing,” the thrust of the act is clearly to avoid it. Under its objectives, the act states the Investment Board is “to invest with a view of achieving a maximum rate of return, without undue risk or loss.” The implication the CPPIB makes, as evidenced in its PRI, is responsible investing might cause undue risk or loss.

excluding certain investments, the CPP Investment Board cannot reflect the divergent religious, economic, political, social and personal views of millions of Canadians in its investment decisions.” (CPPIB March 6, 2002, 4)

The policy further elaborated that the CPPIB would “not give preference to or consider as ineligible for investment the securities of any issuer based on non-investment criteria.” (Ibid.) In effect, the preliminary operating philosophy and guiding policy restricted the CPPIB from undertaking a socially responsible investment strategy at all.

There has been some evolution in the CPPIB’s thinking, however, potentially because of the hiring of a new CEO. In October 2005, the CPPIB revised its social investing policy and entitled it the Policy on Responsible Investing, with further minimal revisions in 2008 and 2009. However, the basic premise of the policy has not evolved even though the language is more complicated and thought out. In general, the CPPIB’s revised PRI states it will “generally support shareholder proposals that request the reasonable disclosure of information related to ESG criteria. We also support, where relevant, proposals requesting the review or adoption of environmental or social policies, such as those addressing human rights.” (Ibid.) These references to ESG criteria are, at minimum, an improvement in the operational thinking of the CPPIB as to what impacts ESG criteria make on the financial bottom line of the pension funds.

The PRI is essentially a description of how the CPPIB will invest regarding corporate social responsibility. Corporate social responsibility means, in general, the implementation and reporting of ESG criteria in a company’s business practices.

(Quarter et al 2001, 96) The Organization for Economic Cooperation and Development states the understanding of ESG criteria is evolving precisely because some corporations take them seriously while others believe any decisions made outside

of what affects the financial bottom line have a negative impact on the business.

(Industry Canada February 7 2009)²¹ The CPPIB, in referencing ESG criteria in its policy, must define to Canada Pension Plan contributors what exactly it does with these criteria in its operations and how their inclusion makes the CPPIB a responsible investor.

Socially responsible investing: Is it all about “engagement”?

The CPPIB’s use of responsibility as a descriptor for its investment philosophy is at odds with standard ways of implementing ESG criteria into investment policy and practice. Quarter, Carmichael, Sousa and Elgie describe social investment practices as a challenge to conventional corporate behaviour. Challenging investing practices means “investment decisions are not simply based on the rate of return (the typical standard), but also social criteria (for example, impact on the community) that may interact with the rate of return.” (Quarter et al 2001, Ibid.) These criteria describe methods for handling the assets of investors and what actions, if any, should be applied to the assets as a result of the applied criteria. (Ibid.)

However, the CPPIB’s investment strategies have not demonstrably challenged corporate behaviour; the policy is explicit that it will “engage” its investments on matters of ESG criteria. (CPPIB February 2009, 3) The CPPIB’s policy uses the term engagement rather than any other qualifier of social responsibility because it believes, “portfolio constraints either increase risk or reduce returns over time.” (CPPIB Ibid, 1) In effect, engagement will, in the CPPIB’s view, result in new levels of disclosure of investments’ business practices to CPPIB portfolio managers. “Disclosure is the key,”

²¹ See Industry Canada’s overview of the Historical Context and Diversity of Perspectives on CSR on its website. http://www.ic.gc.ca/eic/site/csr-rse.nsf/eng/h_rs00094.html (Current as of April 8 2009)

the policy states, “that allows investors to better understand, evaluate and assess potential risk and return.” (Ibid.) Thus, the policy concludes, “consistent with the CPP Investment Board’s belief that constraints decrease returns and/ or increase risk over time, we do not screen stocks.” (Ibid.) As will be demonstrated, this view of the implementation of ESG criteria is neither congruent with a general understanding of socially responsible investing nor has it demonstrably resulted in the economic returns the CPPIB states it will deliver by simply ‘engaging’ its investments on matters of corporate social responsibility.

Rather than the CPPIB’s model of engagement, the primary use of ESG criteria in investment is asset screening. Asset screening involves positive or negative screens to either choose or reject particular investments based on their business practices.²² In general, there is a normative approach to this investment process because not all social screens are the same. For example, CalPERS, the California public employees retirement system, has adopted the Global Sullivan Principles²³ as a basis for asset screening, while some smaller investment companies use conservative social issues to screen out companies.²⁴ The CPPIB’s Report on Responsible Investing, released for the first time in 2008, demonstrates the CPPIB’s only divestments have been from assets that are no longer prohibited in Canada. Because Canadian legislation prohibits investments in businesses that do not comply the *Convention on Cluster Munitions*, the CPPIB sold assets in four companies. (Report 2008, 8) The CPPIB’s operations, as

²² The Norges Bank-managed Government Pension Fund, the sovereign wealth fund of Norway, uses this type of asset screening in its investment of oil and gas royalties of that country. See Vittas (2008) for a full discussion on the investment criteria, assessment of performance of this fund. Most importantly, this fund has an asset allocation ratio of approximately 60-40, 60% being fixed income assets and 40% being equities.

²³ Available at <http://www.thesullivanfoundation.org/gsp/principles/gsp/default.asp>.

²⁴ An example of this type of social screen is the Timothy Plan, a US-based company that screens mutual funds and retirement plans “to avoid investing shareholders’ money in any company that has a pattern of contributing to the cultural degradation of our society.”

evidenced by their own reporting, do not constitute asset screening because they continue to purchase all legal assets available to them in the private market.

Asset targeting is also a well-used and well-known type of integrating ESG criteria into investment. The targeting implies specific investment goals, such as focusing on regional economic development or social housing development, are sought by the investor rather than particular business practices of the investment. In Canada, asset targeting already exists in the Quebec Pension Plan. The Caisse, the plan's manager, uses asset targeting to invest in broadly the same types of bonds, equities, real estate and corporate security investments as the CPPIB, but it also functions with a particular attention to economic development in the province of Quebec. This means the fund has the financial ability to work in partnership with other private sector investment firms in the province to prevent foreign takeovers of key stakeholders of the Quebec economy (Brooks and Tanguay 1985, 105) As a form of asset targeting, Rosentraub and Shroitman found social investing in core city neighbourhoods to be particularly beneficial to the social good of the community, as the investments would improve neighbourhoods which housed statistically greater number of minorities, impoverished people and had declining home values. The CPPIB's real estate portfolio, however, which has performed poorly in the economic recession,²⁵ invests solely in business districts and suburban developments that provide little social utility to impoverished neighbourhoods.²⁶

The only targeting the CPPIB uses is the targeting of 10 to 15 companies for

²⁵ Mazurkewich (February 14 2009) states the real estate assets of the CPPIB's portfolio are part of the decline in its returns in the last year.

²⁶ The CPPIB's real estate assets are located solely in Canada, the UK and the United States, and are predominantly business office towers and shopping malls.

direct engagement, rather than specific functions of economic output.²⁷ While the CPPIB undertakes substantial targeted investments, such as its recent acquisition of Macquarie Communications Infrastructure Group, these targeted investments satisfy specific sector rather than a particular social agenda of the CPPIB.²⁸ In other words, asset targeting exists in Canada and has been used for particular economic development goals of governments, but the CPPIB has not used asset targeting in any substantial way.

A third form of social investment is asset management, which also differs from what the CPPIB describes as its engagement activities. Asset management seeks to use shareholder actions to become more actively involved in corporate discussions around responsible business practices. In particular, asset management investors use shareholder actions to raise issues of discussion and propose strategies to the management of corporations, and may lead to the desire of these shareholders to become directly involved in the management of the corporation.²⁹ This may involve the investors seeking seats on management boards or improving issues related to governance. (Quarter Ibid, 97) Shareholder activism is in particular associated with this type of investing, but is something that institutional investors have rarely used in Canada because of concern over the financial impact of this measure.³⁰ Rather than using asset management investing, the CPPIB's policy states the Investment Board will

²⁷ The 2008 Report on Responsible Investing shows companies are targeted "for direct engagement and set specific engagement objectives," (8) which means the disclosure of company operations, rather than for particular economic sectors. This is not, by other standards, what asset targeting implies.

²⁸ The Macquarie investment is interesting because it is worth \$1.16 billion, or over 1% of the entire CPPIB portfolio. This type of strategic investment demonstrates the incredible shift of the CPPIB into the private investment market from even its public investments of stocks of 1999.

²⁹ In Canada, one such asset management company is Inhance Investment Management, owned by VanCity Credit Union. It votes on and leads shareholder actions on issues of corporate social responsibility.

³⁰ Quarter et al found labour union trustees, in particular, who might be inclined to use asset management tools usually deferred to management on contentious issues. (Quarter et al 2001, 97)

only engage management in private on specific issues, “because we [the CPPIB’s management] believe this is more effective than publicly disclosing these activities. The names of companies which we have engaged, therefore, are not typically disclosed publicly.” (CPPIB February 2009, 4) Further, the Report on Responsible Investing makes it clear that the CPPIB uses proxy voting predominantly to endorse management decisions and supported shareholder resolutions only when they felt the proposals were not “overly prescriptive” or “deceptive” in the CPPIB’s classification. (Report 2008, 10 & 11) This behaviour is contrary to the main focus of asset management to report on and publicly target investments. The CPPIB’s engagement policy prohibits this type of socially responsible investing from happening, and its proxy voting record demonstrates a clear bias against substantive shareholder proposal engagement.

No impetus to practice social responsibility has meant poor performance

The CPPIB’s normative position that its investments have no political biases ignores, for example, that investments in the weapons and military supplies businesses help support the Iraq war through the manufacturing of ammunition for the US military, (Harden 2006, 11) while investments in tobacco manufacturers invariably lead to the proliferation of smoking-related diseases. Canadian observers have noticed these investments; the Canadian Medical Association called for a divestment of tobacco-related investments in the CPPIB’s portfolio, but the CPPIB defended them as ‘financially attractive’. (MacNaughton September 9 2004) In an Op-ed in the *Globe and Mail* then-CEO MacNaughton argued,

“Were it acceptable to prohibit investments for non-investment reasons, then it might also be acceptable to require the CPP Investment Board to commit capital

to financially unattractive but politically opportune or socially justifiable investments. The result: The securities of legal businesses would be deemed illegal investments; poor investments would become required investments.(Ibid.)

In effect, MacNaughton's comments imply the CPPIB's senior staff viewed socially responsible investments as poor investment choices that would all but guarantee poor returns. In calling ESG criteria "non-investment" reasons for purchasing assets, the CPPIB underscores a clear mentality that only financial considerations are valid investment criteria. Disregarding SRI entirely means the CPPIB has effectively taken a political stance that investments of Canadians' pensions must be entirely about the bottom line, a stance that is not congruent with many Canadians' views, and is in fact a position grounded in ideology rather than free from it.

In order to finance its investment strategies, the CPPIB is now the one selling, rather than buying, bonds.³¹ Their explicit purpose is to allow the Investment Board "additional flexibility" in its strategy. The irony, of course, is had the performance of the CPPIB been strong, it would not need to boost its financial outcomes through this manner. While the CPP's portfolio is no longer a majority of bonds, the Investment Board sees fit to build a track record as an issuer of debt. Thus, bonds are now viewed as a solid tool to boost the financial outcomes of the CPPIB, albeit in a completely reworked strategy of selling rather than buying them. It is unclear how precisely the CPPIB will justify that selling debt, effectively mortgaging the assets of the Canada

³¹ The CPPIB announced its intentions to sell debt in March 2009. When asked about this new activity, Keith Ambachtsheer of the University of Toronto, one of the original consultants of the reforms of the CPP, stated, "I think it is that only institutions that really have solid risk-management discipline should be doing this. We don't want every pension fund in the country to think this is a good thing." (Mazurkewich March 27 2009 FP1)

Pension Plan, is a responsible business practice, while purchasing government bonds are not.

The CPPIB states throughout its policies and annual reports that overly prescriptive responsible investing will hurt its financial outcomes. The net result of following this strategy, however, has in fact been poor financial outcomes. In effect, the CPPIB took a position that social investing is impossible to manage while watching a single financial bottom line, but believed that positive benefits to its financial picture would develop if companies in its portfolio engaged in responsible business practices. This section demonstrates the PRI has not been used to advance responsible business practices. Rather, the CPPIB justifies its market-based approach of risky investments on the grounds that it follows a responsible strategy, a strategy that has been shown to not serve Canadians well.

6. Conclusion: poor performance, market risk and pension instability

The poor performance of the CPPIB's portfolio demonstrates the risk-laden approach of the Investment Board has not been satisfactory. The market-based strategy uses unstable and risk-prone investments that have resulted in substantial declines in assets of the Canada Pension Plan, meaning the pension system may no longer be guaranteed to be solvent. It has shifted its assets to risky investments that may not be appropriate for the stability required for a public pension fund. Compared to the guaranteed returns of the previous portfolio strategy at the CPP, the current strategy does not carry a prudent level of risk. New purchases of private equities, the issuing of debt and no foreseeable change in investment strategy exemplify the risks. By continuing to shift its assets into investments involving substantial 'principle investor' risks (Vittas 2008, 18) the CPPIB loses focus on the long-term health of the Canada

Pension Plan. The CPPIB's attitude that it will generate high returns from its investment activities demonstrates a clear misunderstanding of the main objective of the Investment Board to ensure its performance targets are met.

The evidence also demonstrates that, while not every Canadian appreciated the reforms, the limited resistance to the reformed structure and operations of the pension plan has allowed this failure of performance to occur. Given the CPPIB holds bi-annual meetings across Canada, it seems the lack of Canadians' involvement in the outcomes of the CPPIB's decisions fuels, rather than dilutes, the Investment Board's ability to perform this way. Such a lack of resistance to the market-based reforms may illustrate a system-wide adherence and acceptance of the role of private retirement savings in Canada, something that may demonstrate low confidence in the ability of the Canada Pension Plan to provide an acceptable level of retirement-age economic security. (Brooks June 2002, 500) It is not readily apparent whether the CPPIB's failure to make substantial returns will further or lessen this confidence in the public pension system. If contribution rates must increase or benefits are reduced again, it may be assumed that Canadians will have even less assurance of sustainability of the public portion of their retirement savings.

This research also illustrates the CPPIB has acted as an agent of embedding neo-liberal policy into the heart of the Canadian retirement system. Given the CPPIB's strong rebukes and reluctance to enforce a strong Policy on Responsible Investing, it effectively acts as an agent of laissez faire corporate dominance over investment. In effect, the CPPIB's continued existence results in "valorizing market-based solutions to pension provision". (Condon 2001, 92) The market-focused approach of the CPPIB entrenches the legitimacy of private wealth creation as the only policy option for

providing secure retirement income for Canadians in both the publicly financed and the privately created pillars of retirement income. Demonstrably, the CPPIB's Policy on Responsible Investing is not, as the CPPIB tries to present it, a serious effort at introducing environmental, social or governance factors into the investment considerations of the Investment Board. If the PRI was taken seriously, the CPPIB might have revised its risk management strategies, divested of questionable assets, and focused on other types of investments including the building up of its bond portfolio. Even as a public institution, the CPPIB does not act in the best interests of its shareholders to make investments that benefit Canadians either financially through bottom-line performance or socially through a ingenuous investment strategy.

There are plenty of questions remaining for future analysis. The growing absence of the Canada Pension Plan from the market of available bond purchasers for provincial governments may have an impact on future regional economic development in Canada. This is because there was a measurable spin-off effect from the CPP's original investment portfolio, because the CPP's funds were used to finance the capital requirements of the crown sector in Canada's prairie provinces. (Richards 1979, 225) This deserves further study, especially given the rekindling of public debt-financed infrastructure projects currently being undertaken as a result of the economic recession and subsequent stimulus packages. The potential opportunities of the CPPIB to assist in the financing of these projects need to be analyzed. Second, investigating precisely what will come of the "selling of debt" by the CPPIB will be interesting to gauge whether the CPPIB has learned from its poor risk management or has amplified it. These questions deserve further scrutiny.

The design of the Canada Pension Plan Investment Board has always been to shift away control, oversight and investment responsibility from the state to the private sector. In order to accomplish this goal, the management of the CPPIB deemed it necessary, after testing Canadian public opinion, to introduce the marketing concept of “responsible” investing practices into their public image rather than substantively changing their operating style or investing behaviour. Their investing practices are not sufficient to protect and guarantee pensions from market failure, and thus, at a base, fiduciary economically sustainable level, they are not acting responsibly.

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