CPP INVESTMENT BOARD

# BUILDING A DIVERSIFIED CPP PORTFOLIO

ANNUAL REPORT 2003

## TABLE OF CONTENTS



**What's available on our web site : www.cppib.ca**

- Meet Our Team
- Our Governance
- Our Policies
- Canada Pension Plan
- Our History
- Our Legislation
- Our Regulations
- Our Investment Challenge
- Investment Considerations
- Return Expectations
- Risk Management
- Public Market Investments
- Guidelines for Public Market Investments
- Private Market Investments
- Guidelines for Private Market Investments
- Measuring Total Fund Performance
- Social Investing
- Proxy Voting
- Partnering Opportunities
- Results
- Holdings
- News Releases
- Quarterly Reports
- FAQs
- Public Meetings
- Annual Reports
- What's New

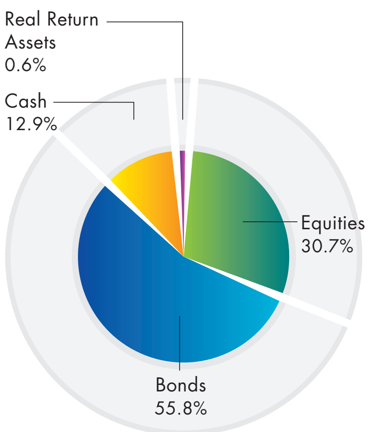
# PROFILE


The CPP Investment Board is a Crown corporation created by an Act of Parliament in December 1997. Its long-term goal is to contribute to the financial strength of the Canada Pension Plan by investing in the best interests of 16 million CPP contributors and beneficiaries and by maximizing returns without undue risk of loss.

The CPP Investment Board invests in capital markets the funds not needed by the Canada Pension Plan to pay current pensions and is not expected to be required to contribute investment earnings to the CPP to help pay pensions until 2021. In order to build a diversified portfolio of CPP assets, the CPP Investment Board is currently investing in public equities, private equities and real estate to balance the cash and bonds owned by the CPP.

Our disclosure policy states that: "Canadians have the right to know why, how and where we invest their Canada Pension Plan money, who makes the investment decisions, what assets are owned on their behalf and how the investments are performing."

**CONSOLIDATED CPP ASSETS**
Fiscal year ending March 31, 2003




By increasing the long-term value of funds available to the Canada Pension Plan, the CPP Investment Board will help the plan to keep its pension promise to Canadians.

Based in Toronto, the CPP Investment Board is governed and managed independently of the Canada Pension Plan and at arm's length from governments.

For more information on the CPP Investment Board, visit our web site at www.cppib.ca.

# CHAIR'S REPORT: BUILDING ON THE GOVERNANCE PLATFORM

GAIL COOK-BENNETT

The CPP Investment Board is anticipating fundamental developments that will shape its investment strategy and organizational structure for many years. Since the organization was created four and a half years ago, it has diversified Canada Pension Plan assets beyond the large long-term bond and cash portfolio owned directly by the plan. Today, CPP assets include public and private equities, as well as real estate assets.

Starting in fiscal 2004, the CPP Investment Board is expected to assume responsibility for managing all CPP assets, which currently total $55.6 billion. This major development was approved recently by Parliament and is subject to the consent of the provinces. With this approval, the transfer of the bonds from the federal government in Ottawa to the CPP Investment Board in Toronto would occur over three years. The cash portion of the portfolio would be transferred begining in fiscal 2004 and the CPP Investment Board would then be responsible for providing the Canada Pension Plan with cash so it can pay its benefit obligations.

These pending changes coincide with the expected rapid growth in cash flows from CPP contributions in excess of those required to pay current pensions. In response, increased focus is being placed on long-term investment strategy and the organizational structure and resources best able to achieve long-term success.

The foundation of the organization is the governance platform created by the federal and provincial governments to provide oversight of how the national pension plan's assets are managed. The platform carefully balances two principles that underlie the CPP Investment Board's powers and accountabilities.

The first principle is that the investment professionals make their decisions independently of governments, though consistent with legislation and regulations. For this reason, the board of directors was given responsibilities similar to those of a corporate board in the private sector. The board of directors (rather than government) appoints the chief executive officer, approves investment and operating policies, approves the annual business plan and budget, appoints external and internal auditors and approves the engagement of external investment managers.


The second principle is full accountability and reporting by the CPP Investment Board to Parliament, the provinces and the people of Canada. Part of the mandated reporting is to hold a public meeting in every participating province once every two years. The second series of coast-to-coast public meetings was held in June 2002. While public meetings provide personal contact with directors and management, we also survey public opinion semi-annually and initiate and accept meetings with key stakeholder groups. As a visit to our web site will confirm, the CPP Investment Board has chosen to be a leader on pension fund disclosure. A full listing of investments is provided quarterly along with considerable policy and investment information.

Widely publicized examples of poor governance practices and unethical conduct have led to considerable public distrust. Since the growing assets of the CPP Investment Board come from employee and employer contributions, governance practices and ethical conduct, as well as long-term investment performance, are important to earning and maintaining trust.

Early last year we invited three specialists to review our governance policies and procedures: David Bonham, who chaired the Canadian Institute of Chartered Accountants' task force on conflicts of interest for audit firms; Purdy Crawford, who has served on securities industry committees examining conflicts and corporate governance; and Ted Hughes, a former superior court judge and ethics commissioner to federal and provincial governments. They suggested appropriate enhancements, which have been incorporated into our practices. One of the most interesting was to consider a part-time external advisor on conflicts and ethical conduct. We plan to appoint such an advisor within the next year.

In exercising its responsibilities, the board uses techniques gaining popularity in the corporate sector, such as sessions without management present and performance evaluations of the board itself and individual directors. These approaches facilitate consensus and enable the board to speak with one voice in dealing with change.

The board's responsibility for management oversight includes evaluating the performance and setting the compensation of management. Senior executives can receive annual bonuses for achieving corporate objectives approved by the board.  They are also eligible for long-term incentives that are deferred and paid out after three years. The subsequent payout from the long-term incentive is adjusted by the absolute performance of the CPP Investment Board assets. In fiscal 2003, for example, the accrued incentives for prior years diminished by the same proportion as the decline in the organization's investment returns.

Effective accountability requires experienced directors whose expertise aligns well with the CPP Investment Board's strategic direction. An external nominating committee, appointed by the federal and provincial finance ministers and chaired by an experienced private sector chief executive and corporate director, is responsible for replenishing the board as the terms of members expire. As a result of their efforts we welcomed Germaine Gibara and Ronald Smith to the board late last fiscal year.

On his retirement from the board, I thank Dick Thomson for his enormous contribution as a founding director and Chair of the Human Resources and Compensation Committee. I also thank John MacNaughton, our chief executive officer, for his constructive dialogue with me as Chair and the board during the past year.

Gail Cook-Bennett

**Gail Cook-Bennett,** *Chairperson*

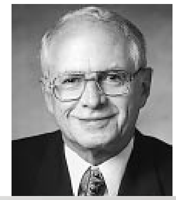
The process by which directors are appointed is a departure from the traditional practice for crown corporations. An external nominating committee appointed by federal and provincial finance ministers, and chaired by an individual from the private sector, nominates candidates. The federal minister selects candidates from the committee's nominating list in consultation with provincial counterparts.

# A BOARD WITH BROADLY BASED EXPERTISE

**Chairperson**

GAIL COOK-BENNETT
Economist.
Corporate director.
Former professor.

DALE G. PARKER
Corporate director.
Former financial executive.



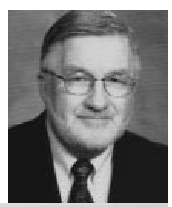
MARY C. ARNOLD
Chartered accountant.
Management consultant.
Corporate director.

M. JOSEPH REGAN
Retired bank executive.

GERMAINE GIBARA
Chartered financial analyst. Management consultant.
Corporate director.

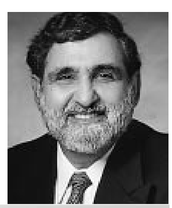
HELEN SINCLAIR
Financial executive.

GILBERT GILL
Chartered accountant.
Former provincial deputy finance minister.

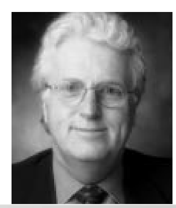


RONALD SMITH
Chartered accountant.
Chief financial officer.

JACOB LEVI
Actuary.



DAVID WALKER
Business consultant.



HELEN M. MEYER
Chartered business valuator.

*For a fuller description of board and committee responsibilities and membership, see governance section on pages 35-38.*

## PRESIDENT'S REPORT: LONG-TERM INVESTING IN CHALLENGING TIMES

JOHN A. MACNAUGHTON

The year ended March 31, 2003 was difficult for pension fund fiduciaries around the world. Global equity markets continued their punishing slump, producing some of the worst returns in a century, while fixed income markets delivered solid returns, as interest rates fell.

Because a relatively high percentage of Canada Pension Plan assets was invested in fixed income securities, losses were mitigated but not eliminated. The overall consolidated investment loss for the year was approximately $1.1 billion for a return of minus 1.5 percent, compared with a $2.3 billion gain in the previous fiscal year for a positive 5.7 percent return.

At March 31, 2003 the assets of the Canada Pension Plan consisted of $38.1 billion in fixed income securities administered by the Department of Finance in Ottawa and $17.5 billion in equities and real estate managed by the CPP Investment Board in Toronto.

The fixed income securities, representing approximately 69 percent of total CPP assets, consisted of $31.0 billion in federal and provincial government bonds and $7.1 billion in an interest bearing cash deposit. These assets earned $3.0 billion for a positive return of 8.4 percent, compared with income of $2.0 billion and 5.0 percent in 2002.

CPP Investment Board assets at March 31, 2003 were 31 percent of CPP assets, consisting of 89 percent public equities, nine percent private equities and two percent real estate. This portfolio lost $4.1 billion during the year for a negative 21.1 percent return, compared with income of $316 million and a positive 3.4 percent return in the previous year.

The discouraging equity markets did not distract us from advancing in a variety of areas important to our future:

- Public equities were transferred from pooled and mutual index funds managed by external investment firms to our own segregated account at a new custodian; a trade order management system was selected and is in the process of being installed; and internal cash and derivatives trading capabilities were developed.


• Transition managers were retained to assist us in investing large amounts of cash in domestic and foreign markets with minimal market impact.

• Responsibility for investing our passive public equity portfolio was transferred from external managers to internal management, saving potentially millions of dollars in fees on a sustainable basis each year.

These foundation-building initiatives enable us to undertake different approaches to passive equity management or to mitigate costs and to introduce active management strategies where we identify opportunities to add value.

Other important accomplishments during the year included:

• The documentation of investment beliefs shared by our directors and management as the foundation for consistent and integrated decision making.

• The continued diversification of CPP assets into private equities and the acquisition of our first private real estate investments.

• The preliminary modification of our passive Canadian equity portfolio to include a broader selection of stocks than those listed in the S&P/TSX Composite Index and other index weighting adjustments.

• Development of our proxy voting principles and guidelines, available on our web site at www.cppib.ca. We vote shares in support of resolutions judged likely to increase the long-term value of CPP investments and stimulate disclosure of information relevant to assessing the possible impact of corporate behavior on long-term investment prospects.

• The strengthening of our operational and investment teams with the hiring of nine new professionals and support staff, bringing our human resources to 35 people.

In the year ahead, we will focus on three areas:

First, the CPP bond and cash portfolio is scheduled to be transferred to the stewardship of the CPP Investment Board. This new responsibility will require

some additional staff. It will also influence our investment and organizational strategies as we manage assets to ensure the Canada Pension Plan has access to cash required to meet benefit payments.

Second, identifying and implementing successful active investment strategies is becoming more important as return expectations for both equity and debt markets are lower than the realized returns of the last 20 years of the twentieth century.

Third, the assets we are directly responsible for will quadruple from approximately $17.5 billion today to almost $80 billion over the next three years, necessitating our giving ongoing priority to long-term total portfolio design, the development of new benchmarks and risk management, and the continued diversification of the portfolio.

We expect the years ahead to be difficult ones for investors due to the uncertain global economic and geopolitical outlook. We expect market returns below those enjoyed during the 1980s and 1990s. Still, we continue to believe that the investment environment will be constructive for the CPP Investment Board. We will receive substantial cash flows for investment over the next two decades. As a result, we can build and diversify our portfolio steadily and patiently, while remaining focused on the long term. Investing during declining markets requires fortitude. Capital markets history gives us confidence that we are right in staying the course.

I thank our management team and employees for their dedication and hard work. On their behalf, I thank our board of directors for its support and wise counsel as we work together to serve the interests of the 16 million Canadians who are counting on us to help secure the promise of the Canada Pension Plan.

**John A. MacNaughton,** *President and Chief Executive Officer*

# MANAGEMENT'S DISCUSSION AND ANALYSIS

*The annual report contains forward-looking statements reflecting management's objectives, outlook and expectations as of the date of this report. These statements involve risks and uncertainties. Our investment activities may therefore vary from the strategies outlined in these forward-looking statements.*

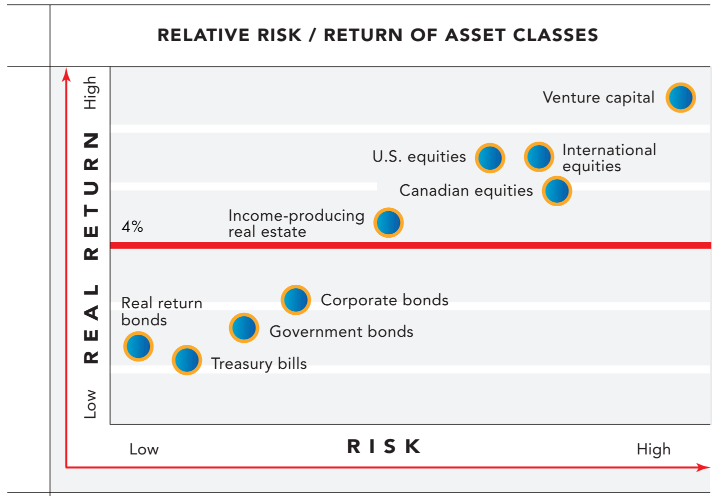
The CPP Investment Board invests cash not required by the Canada Pension Plan to pay current benefits. Our legislated mandate is to achieve a maximum rate of return without undue risk of loss, having regard to the factors that may affect the funding of the Canada Pension Plan and its ability to meet its financial obligations.

The funding of the Canada Pension Plan is determined by the federal and provincial finance ministers, who meet every three years to review contribution rates, benefit levels, funding policy and other aspects of the plan. As of January 1, 2003, the combined contribution rate of Canadian workers and their employers was 9.9 percent of pensionable earnings (to a maximum of $39,900 for 2003).

The Chief Actuary for the Canada Pension Plan has estimated that the 9.9 percent contribution rate could be sustained for the foreseeable future if CPP assets earn a four percent annual real rate of return over the long term. (The real rate of return excludes inflation. If inflation averaged three percent per annum, the nominal rate of return required would be seven percent.) In the opinion of the Chief Actuary, a review panel of independent actuaries, and the finance ministers, the plan is financially sound until the year 2075.

**Our investment challenge** In seeking to maximize returns without undue risk of loss, our minimal goal is to achieve a four percent real rate of return. This can be a difficult target to match every year, based on an historical analysis of the investment performance of such standard assets as bonds and stocks.

When the CPP Investment Board became operational in October 1998, the Canada Pension Plan's only assets were government bonds and cash. As the accompanying chart shows, government bonds do not produce the level of real returns required by the Canada Pension Plan.




To achieve higher returns than bonds, we must acquire assets that have greater risk. Our most logical choice, at least initially, was publicly traded equities. History indicates that, over the long term and despite greater volatility including short-term periods of negative performance, equities should provide higher returns than bonds to compensate for the greater risk assumed. Other assets produce different expected returns in relation to risk. For example, private equities offer potentially higher returns than publicly traded equities to compensate for their lower liquidity. Real estate has a risk/return profile somewhere between government bonds and equities.

"DIVERSIFYING INTO A BROADER RANGE OF ASSETS WILL HELP MEET THE LONG-TERM RETURN TARGETS NEEDED TO SUSTAIN THE CPP, WHILE MANAGING OVERALL PORTFOLIO RISK."

VALTER VIOLA,
Vice President, Research and Risk Management

The diversification of CPP assets remains a continuing priority to spread portfolio risk among more asset classes and to ensure an asset mix that earns a real return that exceeds four percent.

The following table offers a snapshot of all CPP assets as of March 31, 2003. The assets are grouped according to those managed by the CPP Investment Board in Toronto and those administered on behalf of the Canada Pension Plan by the federal government in Ottawa. Starting in fiscal 2004, all CPP assets not held by the CPP Investment Board are expected to be transferred to it on a phased basis over three years. By fiscal 2007, all CPP assets, including cash, should be carried on our balance sheet.

**Government Bonds** The bond portfolio consists of provincial government bonds as well as some federal bonds. These securities are non-marketable and non-tradeable. Details of their maturities are posted on our web site. The provinces and territories have one opportunity to renew maturing bonds issued

| TOTAL CPP ASSETS<br>As at March 31, 2003 | $ Billions | % of Total |
|---|---|---|
| **Canada Pension Plan** | | |
| Government Bonds | 31.0 | 55.8 |
| Cash | 7.1 | 12.8 |
| Subtotal | 38.1 | 68.6 |
| **CPP Investment Board** | | |
| Public Equities | 15.6 | 28.0 |
| Private Equities | 1.5 | 2.7 |
| Real Estate | 0.3 | 0.6 |
| Money Market Securities | 0.1 | 0.1 |
| Subtotal | 17.5 | 31.4 |
| **Total Assets** | 55.6 | 100.0 |

prior to 1998 for a further 20 years at market rates. Should bonds not be renewed, the principal amount will be invested by the CPP Investment Board.

More than three-quarters of the bond portfolio matures within the next 10 years. If provinces choose to roll them over, the last of the bonds may not mature until 2033.

**Public Equities** Since inception, we have invested excess CPP funds in equities, principally publicly traded stocks, with the expectation of earning a long-term premium over bonds. According to the Chief Actuary's assumptions, on an annual basis, CPP contributions should exceed pension payments until 2021. This means that investment earnings are not expected to be required to help pay pensions for 18 years. We can, therefore, take advantage of poor markets to accumulate equities at current prices in the expectation of higher values in future decades.

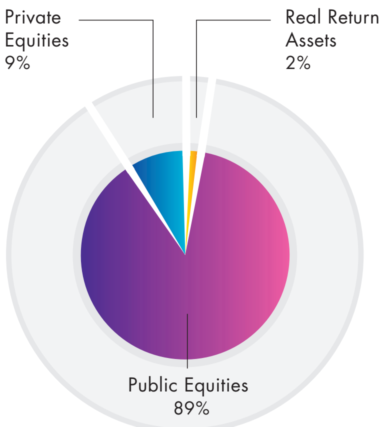
The other reason we invest in public equities is to diversify total CPP assets. Stocks and bonds tend not to move in the same direction in the same magnitude at the same time, thereby reducing portfolio risk and somewhat stabilizing returns.

Until fiscal 2003, our investment in public equities was primarily in index funds managed by outside specialists. These index funds are designed to replicate the stocks included in the S&P/TSX Composite Index in Canada, the S&P 500 Index in the United States, and the MSCI EAFE Index of stocks for Europe, Australasia and the Far East. In total, the indexes contain approximately 1,700 stocks.


"WHILE BEING A LARGE INVESTOR CREATES SOME CHALLENGES, IT ALSO CREATES SIGNIFICANT OPPORTUNITIES – ECONOMIES OF SCALE TO NAME THE MOST OBVIOUS."

DONALD M. RAYMOND,
Vice President, Public Market Investments

CPP INVESTMENT BOARD ASSETS
Fiscal year ending March 31, 2003




In fiscal 2003, we brought the management of these passive portfolios in-house to reduce costs and to facilitate the future implementation of our active program on a global basis. We then took our first steps to customize the passive portfolio. For example, when the TSE 300 Composite Index in Canada was replaced by the S&P/TSX Composite Index, we retained ownership of companies deleted from the new index. At year end, our passive portfolio contained 85 small-cap companies not included in the new S&P/TSX index. We believe these smaller companies will do well over the long term. We also reduced our weighting in financial services stocks below their representation in the S&P/TSX index. This risk management initiative reduced the concentration in the financial services sector of the portfolio, much as we did two years ago when we reduced our Nortel Networks position when it dominated the Canadian market.

As a result of these modifications, we expect the performance of our public equity portfolio to start experiencing greater variances to widely recognized broad market benchmarks, such as the S&P/TSX index.

We retained transition managers to help us invest large amounts of capital received from the Canada Pension Plan while attempting to minimize market disruption and cost. These initiatives were the prelude to a different passive investing approach that will emerge in fiscal 2004.

**Private Equities** While private equities are a small component of total CPP assets, they can contribute exceptional returns over the long term for the extra risk involved. However, these specialized investments need time to deliver full value. Our ultimate goal is to invest as much as 10 percent of CPP assets in private equities, subject to the availability of opportunities with acceptable risk/return profiles.

We made our first commitments to private equity in July 2001. Our approach involves selecting investment specialists, known as general partners, who are experienced in developing and managing portfolios of private companies. Usually they focus on specific industries and deploy a range of management techniques, including strategic advice, operating expertise, financial restructuring, and initiating mergers and acquisitions. We commit funds with like-minded investors under a limited partnership agreement, and the general partner draws down the funds as suitable investments are identified.

By the end of fiscal 2003, we had committed $5.1 billion to private equity, including $1.1 billion in Canada. These funds were pledged to 34 pooled funds managed by 29 general partners in Canada, the U.S., the United Kingdom and Europe. Of these commitments, $1.5 billion had actually been invested. The remaining commitments will be drawn down over the next few years.

Our largest transaction in fiscal 2003 was the acquisition with other institutional investors of a private equity portfolio from Deutsche Bank. The portfolio has equity interests in more than 80 late-stage private companies in Europe and the U.S. It is being managed through a new limited partnership established by the former senior managers of Deutsche Bank's private equity arm. Our commitment was just over $400 million.

"Private equity investing requires patience to maximize value because higher returns are typically not generated until seven or eight years after capital is invested."

MARK A. WEISDORF,
Vice President, Private Market Investments

**Real Estate and Infrastructure Assets** The final component of our asset diversification strategy to date is real estate. Coupled with infrastructure assets, they may comprise as much as five percent of total CPP assets in the future. Real estate and infrastructure assets tend to be inflation sensitive and at least partially hedge the inflation exposure of CPP benefits to changes in the Consumer Price Index.

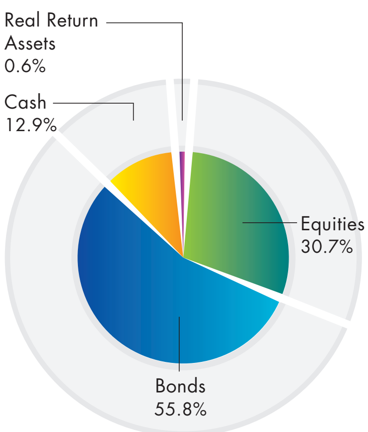
We initiated our exposure to real estate through investments in publicly traded securities, including those of Trizec Canada where we acquired approximately 30 percent of the company. The year-end real estate portfolio included shares in three publicly traded real estate companies.

In January 2003, we committed up to $300 million to two real estate investment firms for future asset acquisitions. Our strategy is to co-own properties with value-added growth potential over normal real estate cycles of five to ten years. One of our partners completed our first co-owned direct investment, for a total purchase price of $300 million, in five Canadian regional shopping centres. Over time, we will develop a diversified portfolio of industrial, office, retail and multi-family residential properties that generate rental income and appreciate in value through restructuring and refinancing, new lease arrangements, changes in property use, redevelopment and renovation, and changes in tenant mix.

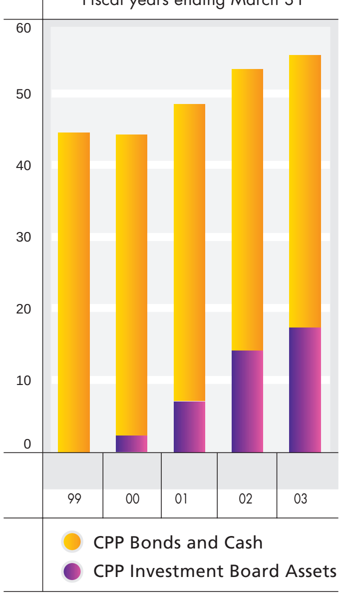
While we examined a number of infrastructure opportunities during fiscal 2003, none of them met our investment criteria.

# PERFORMANCE REVIEW

CONSOLIDATED CPP ASSETS
Fiscal year ending March 31, 2003




CONSOLIDATED CPP ASSETS ($ billions)
Fiscal years ending March 31




The following discussion reviews the performance of total CPP assets, recognizing that the CPP Investment Board must take all the assets and liabilities of the Canada Pension Plan into consideration in making investment decisions. However, only the CPP assets managed by the CPP Investment Board are currently included in our financial statements. The market value and rates of return for fixed income securities are estimates by the CPP Investment Board.

**Asset growth** In fiscal 2003, total assets available to the Canada Pension Plan grew by $2.0 billion to $55.6 billion. The asset distribution is shown in the adjacent pie chart. The CPP Investment Board received $7.3 billion in cash flows from the Canada Pension Plan, compared with $6.8 billion in fiscal 2002. These cash flows from excess CPP contributions and bonds were invested in equities and real estate.

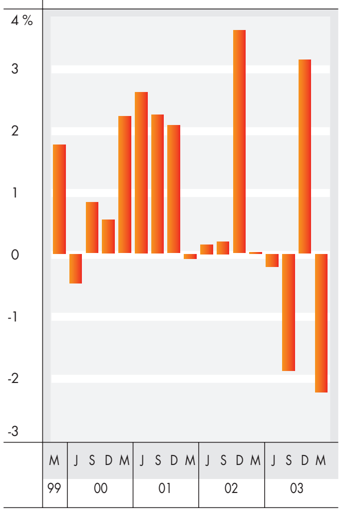
Since 1999, the consolidated CPP assets have grown by more than $11 billion, of which approximately half was from excess contributions and half from investment income.

**Overall Performance** Total CPP assets incurred a $1.1 billion loss in fiscal 2003, compared with a $2.3 billion gain in fiscal 2002. The estimated nominal rate of return was a negative 1.5 percent, versus a positive 5.7 percent the previous year. The fiscal 2003 performance was well below the long-term real return actuarial assumption. However, it was somewhat better than most other Canadian public sector pension funds because CPP assets include a much higher proportion of fixed income securities and a much lower proportion of equities than most other large pension funds.

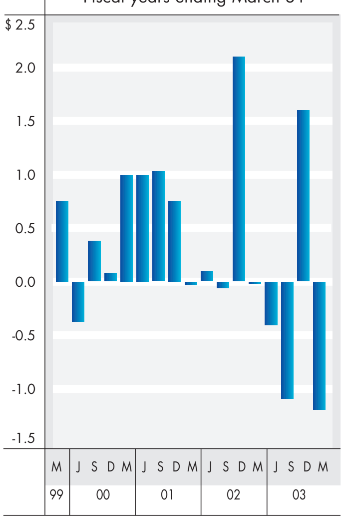
The fixed income portfolio performed well in a falling interest rate environment. (When interest rates fall, bond values increase. Conversely, when interest rates rise, bond values decline). Combined with the cash deposits, which earn interest similar to short-term government securities, the fixed income assets generated income of $3.0 billion, compared with $2.0 billion in fiscal 2002. The rate of return on fixed income assets was 8.4 percent, compared with 5.0 percent during the previous year.

The bond performance helped to offset equity and real estate losses, which totalled $4.1 billion in fiscal 2003 for a negative 21.1 percent rate of return.

CONSOLIDATED CPP RETURNS (%)
Fiscal years ending March 31




CONSOLIDATED CPP RETURNS ($ billions)
Fiscal years ending March 31




In fiscal 2002, equities earned $316 million producing a 3.4 percent rate of return. Global stock markets have experienced their longest and steepest deterioration in a century after peaking in 2000. Since investing the first CPP dollar in March 1999, our cumulative equities and real estate loss is approximately $4.1 billion. Given our very long-term investment horizon, and our expectation that we will not need to contribute investment earnings to the Canada Pension Plan for at least 18 years, we have ample time to build the equity portfolio at advantageous prices during this difficult period in capital markets. Despite the disappointing short-term results, this is a good time for an organization with large and regular cash flows to invest. Most of these investments are in well-managed companies with profitable growth strategies. Consequently, they are likely to remain in the portfolio for decades.

On a quarterly basis, consolidated returns have been highly volatile, as the adjacent charts confirm.

**Performance versus Benchmarks** The performance of Canadian and non-Canadian equities are measured against composite benchmarks that are based on the returns for market indexes for publicly traded equities. Real estate is measured against the Consumer Price Index (a measure of inflation) plus 4.5 percent. The performance of our portfolios versus their benchmarks for the first four full fiscal years that the CPP Investment Board has been investing is described in the following table. (We do not benchmark the government bond and cash portfolio because these securities are not managed by the CPP Investment Board.)

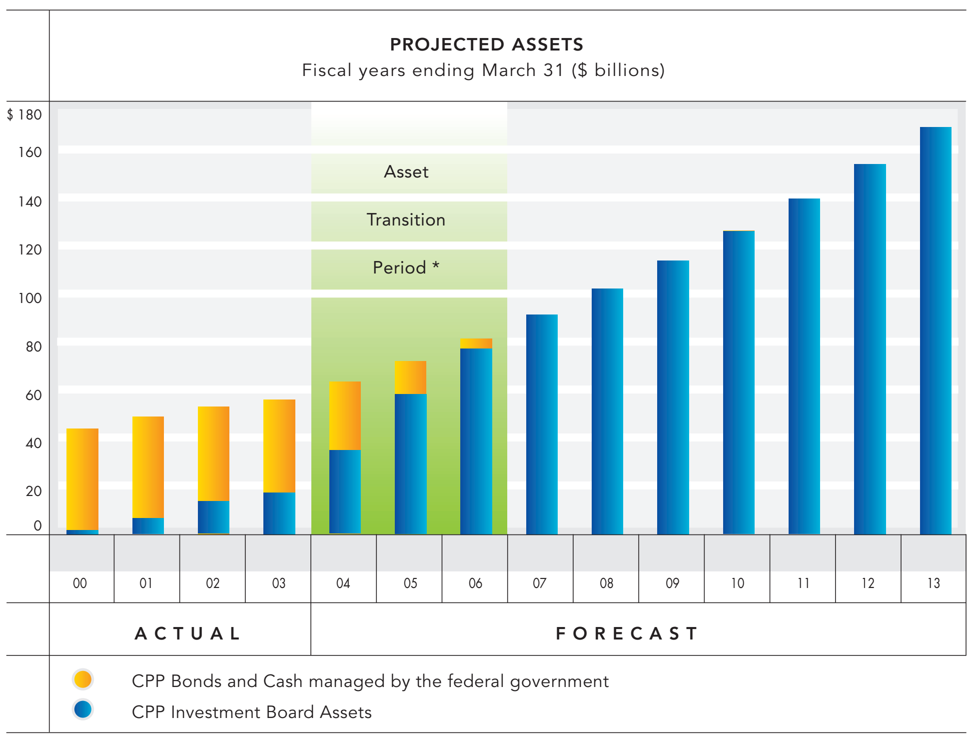
| **EQUITY AND REAL ESTATE RETURNS** (%) Fiscal years ended March 31 | **2003** Actual | BM* | **2002** Actual | BM | **2001** Actual | BM | **2000** Actual | BM |
|---|---|---|---|---|---|---|---|---|
| Canadian Equities | (17.3) | (17.5) | 5.9 | 4.7 | (7.7) | (18.6) | 45.3 | 45.5 |
| Non-Canadian Equities | (27.6) | (28.0) | (2.3) | (2.8) | (17.5) | (18.2) | 16.6 | 16.1 |
| Real Estate | (50.7) | 9.2 | 2.6 | 1.1 | – | – | – | – |
| Total | (21.1) | (20.3) | 3.4 | 2.4 | (9.4) | (17.8) | 40.1 | 39.3 |

* *Benchmark*

Our legislation requires us to comply with the foreign property rule and invest at least 70 percent of assets at cost in Canada, which we strictly adhere to. The remaining 30 percent was divided last year between U.S. and non-North American equities, most notably in Europe. On a market value basis, 68 percent of assets were invested in Canada.

The CPP Investment Board portfolio underperformed the benchmark in fiscal 2003 because our real estate holdings lost half their value as a result of the change in the market's near-term outlook for Trizec Canada, in which we have made a large strategic investment. The impact of the reduction in the value of our real estate holdings on the CPP Investment Board portfolio was approximately 106 basis points. This was partially offset by an outperformance of 26 basis points on other parts of the portfolio resulting in an 80 basis points overall underperformance.

**Looking Ahead** We expect that equity returns will be more modest in the next 10 years than they were in the past two decades. With interest rates near 40-year lows, the return on fixed income assets over the next few years is also




* CPP Bonds and Cash currently managed by the federal government are expected to be transferred to the CPP Investment Board during this period

likely to be moderate. In other words, the market outlook for both stocks and bonds will be challenging, making it difficult to consistently achieve a four percent real return for the Canada Pension Plan.

We expect the three-year process of transferring the government bond portfolio to our balance sheet to begin in fiscal 2004. Bonds will continue to form an important part of CPP assets for the foreseeable future.

We also expect to assume responsibility in fiscal 2004 for providing cash to the CPP so it can meet benefit payments. Cash not required to pay benefits will be invested to maximize returns without undue risk of loss.

The transfer of all CPP assets to the CPP Investment Board will increase our Canadian investment content and provide increased latitude in making investments outside Canada in compliance with the foreign property rule.

"WE USE AN ENTERPRISE-WIDE APPROACH TO IDENTIFY KEY RISKS OF THE ORGANIZATION AND TO MANAGE AND MONITOR THESE RISKS EFFECTIVELY."

JANE NYMAN,
Vice President, Finance and Operations

In fiscal 2004 we will begin to implement a new strategy for publicly traded equities, moving from traditional index investing to a sectoral approach, which will reflect the make-up of the global economy. From the global perspective, Canada is under-represented in some sectors, such as health care and technology, and over-represented in others, such as energy, financial services and basic materials. A sectoral investment approach will facilitate more efficient asset allocation and take into account factors that affect the long-term funding of the CPP.

We will continue to allocate funds to private equity and real estate. In addition to our current value-added real estate portfolio, we will develop a second real estate strategy to build a portfolio of high-quality core properties that will be held for the long term. We will be patient in creating this portfolio, recognizing that premier properties in Canada and elsewhere are available infrequently and even then not necessarily at acceptable prices.

We hope to expand our real return assets beyond real estate to include infrastructure assets as well as real return bonds if we can find investments that meet our disciplined criteria. Infrastructure assets may include pipelines, electrical utilities, roads, bridges, schools and hospitals. Real return bonds are a good match with pension liabilities because they are indexed to inflation, but are currently unavailable in meaningful amounts.

INVESTMENT PARTNERS AND EXTERNAL SERVICE PROVIDERS

Advent International
Apollo Management
Barclays Global Investors
The Blackstone Group
Bloomberg L.P.
Borealis Capital
Brascan Financial Corporation
Bridgepoint Capital
Candover Investments
The Carlyle Group
Celtic House
Clairvest Group Inc.
Cleary, Gottlieb, Steen & Hamilton
Coller Capital
DST International Ltd.
Davies Ward Phillips & Vineberg LLP
Deloitte & Touche LLP
Edgestone Capital Partners
Fairvest Corporation - An ISS Company
Frank Russell Securities, Inc
GM Asset Management
Goldberg Lindsay & Co.
Goodmans LLP
Heartland Industrial Partners
JPMorgan Partners
KPMG LLP
Kensington Capital Partners
LaSalle Investment Management (Canada)
Lexington Capital Partners
Matlin Patterson Global Opportunities Partners
McCarthy Tétrault LLP
MidOcean Partners
MDS Capital Corp.
MPM Capital
NIB Capital Private Equity
Norton Rose
Osler, Hoskin & Harcourt LLP
Osmington Inc.
PAI Management
Paul Capital Partners
Schroder Ventures Life Sciences
Skypoint Capital
State Street
Stikeman Elliott LLP
TD Quantitative Capital
Thomas Weisel Partners Merchant Banking
Testa, Hurwitz & Thibeault, LLP
Torys LLP
XBase Technologies

**CPP Investment Board Operations** The CPP Investment Board is a lean organization. We ended fiscal 2003 with a staff of 35, an increase of nine since the previous year end. The cost of running the organization totalled $12.9 million in fiscal 2003, compared with $11.4 million in the prior year. The 2003 expenses were 7 basis points, or 7 cents per $100 of invested assets, compared with 9 basis points, or 9 cents per $100 of invested assets, in fiscal 2002.

The increased expenses reflected the hiring of new staff, expanded operations, increased technical, data and analytical services, and the transparency of custody fees as a result of the transfer from externally managed pooled funds to a segregated account.

Our small and highly focused organization is augmented by relationships with more than 49 external firms that implement components of our investment and operating strategies. A key component of our enterprise-wide approach to managing risk is the on-going monitoring of the performance of outside partners in implementing our strategies. Outsourcing provides the CPP Investment Board with access to a greater pool of experienced talent than would be possible to hire solely as staff. In most cases, our investment partners put their own capital at risk when making our investments.

Investment and administrative fees are expected to rise as the assets under management grow. Investment and administrative expenses are detailed in the financial statements on pages 32-34.

**Corporate Objectives** The regulations in our legislation require the CPP Investment Board to publish in the annual report a statement of objectives for the past year and the extent to which those objectives were met, as well as a statement of objectives for the next year and the foreseeable future.

For fiscal 2003, we set out four objectives. One was to adjust our passive equity investing strategy to enhance long-term returns. We did this by moving the management of three index funds from external to internal management and pooling the funds in a single passive portfolio. We also began a derivatives program to improve our cash liquidity and enhance risk-adjusted returns. A second objective was to initiate active public market investment programs to


"EXPERT LEGAL ADVICE HELPS US DISCHARGE OUR STATUTORY AND FIDUCIARY DUTIES, AS WELL AS STRUCTURE COMPLEX TRANSACTIONS THAT HELP ACHIEVE OUR INVESTMENT OBJECTIVES."

JANE BEATTY,
Vice President, General Counsel and
Corporate Secretary

complement our active private equity investing. The foundation for this program was substantially advanced during the year and it will be completed in 2004. We established the infrastructure and other controls to initiate active public investment programs, although implementation was deferred while we focused on other priorities.

A third fiscal 2003 objective was to implement an internal audit function to augment the external audit function within an enterprise-wide risk management approach. The Audit Committee of the board of directors appointed KPMG as our internal auditor. The firm is actively discharging its duties. The fourth objective was to enhance performance measurement and attribution reporting. We implemented new processes to prepare the organization for increased activities in fiscal 2004.

For fiscal 2004 and beyond, we have identified six corporate objectives. One is a full review by management with the board of directors of our strategic direction. In part, this will be driven by the pending transfer of all CPP assets to our care. A related objective is to provide cash liquidity to the Canada Pension Plan so that it can meet its payment obligations. This objective is contingent on the CPP cash deposits being transferred to the CPP Investment Board as proposed in federal legislation passed by Parliament and now requiring provincial consent.

Two further objectives relate to our public equity investing. Subject to the approval of the board of directors, we propose to move from traditional passive index investing on a regional basis, such as Canada, the United States and non-North American markets, to one based primarily on economic sectors, recognizing our legislated foreign property restrictions. This approach should enhance long-term risk-adjusted returns. We also plan to expand the active management of public equities by retaining outside specialists.

A fifth objective is to search for attractive real return assets, such as real estate, infrastructure assets and real return bonds.

Finally, we will strengthen our enterprise-wide risk management system by expanding controls over and monitoring of external service providers.

# MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The consolidated financial statements of the Canada Pension Plan Investment Board (the "CPP Investment Board") have been prepared by management and approved by the Board of Directors. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The financial statements include certain amounts based on management's judgments and best estimates where deemed appropriate. Management is responsible for the integrity and reliability of the financial statements and the financial information contained within the annual report.

The CPP Investment Board develops and maintains systems of internal control and supporting procedures. They are designed to provide reasonable assurance that assets are safeguarded, records are properly maintained and transactions are properly authorized and are in accordance with the *Canada Pension Plan Investment Board Act* and the accompanying regulations and the by-laws and investment policies of the CPP Investment Board. These controls include the establishment of an organizational structure that provides a well-defined division of responsibilities and accountability, the selection and training of qualified staff, and the communication of policies and guidelines throughout the organization. Internal controls are reviewed and evaluated by both internal and external auditors in accordance with their respective annual audit programs approved by the Audit Committee.

The Audit Committee assists the Board of Directors in discharging its responsibility to approve the annual financial statements. The Committee meets regularly with both management and the internal and external auditors to discuss the scope and findings of audits and other work they may be requested to perform from time to time, to review financial information and to discuss the adequacy of internal controls. The Committee reviews and approves the annual financial statements and recommends them to the Board of Directors for approval.

The CPP Investment Board's external auditors, Deloitte & Touche LLP, have conducted an independent examination of the consolidated financial statements in accordance with Canadian generally accepted auditing standards, performing such tests and other procedures as they consider necessary to express an opinion in their Auditors' Report. The external auditors have full and unrestricted access to management and the Audit Committee to discuss any findings related to the integrity and reliability of the CPP Investment Board's financial reporting and the adequacy of internal control systems.

**JOHN A. MACNAUGHTON**
*President and Chief Executive Officer*

**JANE NYMAN**
*Vice President – Finance and Operations*

## 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 CPP Investment Board held during the year were in accordance with the Act and the CPP Investment Board's investment policies, standards and procedures. Accordingly, the Investment Certificate follows.

The investments of the CPP Investment Board, held during the year ended March 31, 2003, were in accordance with the *Canada Pension Plan Investment Board Act* and the CPP Investment Board's Investment Statement and Investment Policies.

Mary C. Arnold

**MARY C. ARNOLD, FCA**
*Chair of the Audit Committee on behalf of the Board of Directors, May 8, 2003*

## AUDITORS' REPORT

**TO THE BOARD OF DIRECTORS**
**CANADA PENSION PLAN INVESTMENT BOARD**

We have audited the consolidated balance sheet and the consolidated statement of investment portfolio of the Canada Pension Plan Investment Board (the "CPP Investment Board") as at March 31, 2003 and the consolidated statements of income/(loss) and accumulated net loss from operations and of changes in net assets for the year then ended. These consolidated financial statements are the responsibility of the CPP 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 Canadian 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 consolidated financial statements present fairly, in all material respects, the financial position of the CPP Investment Board and the investments held as at March 31, 2003 and the results of its operations and changes in its net assets for the year then ended in accordance with Canadian generally accepted accounting principles.

Further, in our opinion, the transactions of the CPP 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 CPP 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.

Deloitte & Touche LLP

**CHARTERED ACCOUNTANTS**
Toronto, Ontario, May 2, 2003

# CONSOLIDATED BALANCE SHEET

| *As at March 31, 2003 ($000's)* | **2003** | 2002 |
|---|---|---|
| **ASSETS** | | |
| Investments (Note 2) | **$ 17,861,767** | $ 14,289,378 |
| Investment receivables (Note 2c) | **40,624** | — |
| Due from brokers | **35,005** | 2,343 |
| Premises and equipment | **1,112** | 1,278 |
| Other assets | **980** | 79 |
| **TOTAL ASSETS** | **17,939,488** | 14,293,078 |
| **LIABILITIES** | | |
| Investment liabilities (Note 2) | **449,757** | — |
| Due to brokers | **34,497** | 3,382 |
| Accounts payable and accrued liabilities | **4,490** | 4,730 |
| **TOTAL LIABILITIES** | **488,744** | 8,112 |
| **NET ASSETS** | **$ 17,450,744** | $ 14,284,966 |
| **NET ASSETS, REPRESENTED BY** | | |
| Share capital (Note 4) | **$ —** | $ — |
| Accumulated net loss from operations | **(4,238,916)** | (86,626) |
| Accumulated Canada Pension Plan transfers | **21,689,660** | 14,371,592 |
| **NET ASSETS** | **$ 17,450,744** | $ 14,284,966 |

On behalf of the Board of Directors

*Gail Cook-Bennett*
*Chairperson*

*Mary C. Arnold, FCA*
*Chair of the Audit Committee*

See accompanying Notes to the Consolidated Financial Statements

## CONSOLIDATED STATEMENT OF INCOME/(LOSS) AND ACCUMULATED NET LOSS FROM OPERATIONS

| *Year ended March 31, 2003 ($000's)* | **2003** | 2002 |
|---|---|---|
| **INVESTMENT INCOME/(LOSS)** (Note 6) | **$ (4,139,424)** | $ 316,034 |
| **INVESTMENT AND ADMINISTRATIVE EXPENSES** | | |
| Salaries and benefits (Note 7a) | **4,796** | 4,283 |
| General operating expenses (Note 7b) | **4,835** | 3,204 |
| External investment management fees | **1,809** | 2,951 |
| Professional and consulting fees (Note 7c) | **1,426** | 970 |
| | **12,866** | 11,408 |
| **NET INCOME/(LOSS) FROM OPERATIONS** | **(4,152,290)** | 304,626 |
| **ACCUMULATED NET LOSS FROM OPERATIONS, BEGINNING OF YEAR** | **(86,626)** | (391,252) |
| **ACCUMULATED NET LOSS FROM OPERATIONS, END OF YEAR** | **$ (4,238,916)** | $ (86,626) |

## CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

| *Year ended March 31, 2003 ($000's)* | **2003** | 2002 |
|---|---|---|
| **NET ASSETS, BEGINNING OF YEAR** | **$ 14,284,966** | $ 7,154,169 |
| **CHANGES IN NET ASSETS** | | |
| Canada Pension Plan transfers (Note 5) | **7,318,068** | 6,826,171 |
| Net income/(loss) from operations | **(4,152,290)** | 304,626 |
| **INCREASE IN NET ASSETS FOR THE YEAR** | **3,165,778** | 7,130,797 |
| **NET ASSETS, END OF YEAR** | **$ 17,450,744** | $ 14,284,966 |

See accompanying Notes to the Consolidated Financial Statements

# CONSOLIDATED STATEMENT OF INVESTMENT PORTFOLIO

The CPP Investment Board's investments, before allocating derivative contracts and associated money market securities and other investment liabilities and receivables to the asset classes to which they relate, are as follows:

| | Fair Value | |
|---|---|---|
| *As at March 31, 2003 ($000's)* | **2003** | 2002 |
| **EQUITIES** (Note 2) | | |
| Canada | | |
| Public markets | **$ 11,050,810** | $ 9,824,428 |
| Private markets | **260,609** | 144,207 |
| | **11,311,419** | 9,968,635 |
| Non-Canada | | |
| Public markets | **4,245,184** | 3,832,505 |
| Private markets | **1,264,851** | 316,051 |
| | **5,510,035** | 4,148,556 |
| **TOTAL EQUITIES** | | |
| (Cost: $20,335,762; 2002 – $14,546,009) | **16,821,454** | 14,117,191 |
| **REAL RETURN ASSETS** (Note 2b) | | |
| Public markets real estate | **218,488** | 145,141 |
| Private markets real estate | **246,484** | — |
| **TOTAL REAL RETURN ASSETS** | | |
| (Cost: $644,914; 2002 – $144,442) | **464,972** | 145,141 |
| **NOMINAL FIXED INCOME** | | |
| Money market securities[1] | | |
| (Cost: $575,377; 2002 – $27,046) | **575,341** | 27,046 |
| **TOTAL INVESTMENTS** | **17,861,767** | 14,289,378 |
| **INVESTMENT RECEIVABLES** (Note 2c) | | |
| Dividends receivable[2] | **40,272** | — |
| Accrued interest | **352** | — |
| **TOTAL INVESTMENT RECEIVABLES** | | |
| (Cost: $40,716; 2002 – $Nil) | **40,624** | — |
| **INVESTMENT LIABILITIES** | | |
| Due to private equity partnerships (Note 2d) | **(171,972)** | — |
| Debt on real estate properties (Note 2b) | **(152,000)** | — |
| Credit facility (Note 3) | **(125,000)** | — |
| Derivative liabilities (Note 2a) | **(785)** | — |
| **TOTAL INVESTMENT LIABILITIES** | | |
| (Cost: $452,067; 2002 – $Nil) | **(449,757)** | — |
| **NET INVESTMENTS** | **$ 17,452,634** | $ 14,289,378 |

[1] As described more fully in Note 2a, at March 31, 2003, $250 million of money market securities, together with Canadian equity index swaps, provide additional exposure to Canadian public market equities.

[2] At March 31, 2002, the CPP Investment Board held units of pooled and mutual funds and did not receive dividends directly in respect of these investments.

See accompanying Notes to the Consolidated Financial Statements

# CONSOLIDATED STATEMENT OF INVESTMENT PORTFOLIO

The CPP Investment Board's investments, after allocating derivative contracts and associated money market securities and other investment liabilities and receivables to the asset classes to which they relate, are as follows:

| *As at March 31, 2003 ($000's)* | **2003** | | 2002 | |
|---|---|---|---|---|
| | **Fair Value** | **(%)** | Fair Value[5] | (%) |
| **EQUITIES** | | | | |
| Canada[1] | **$ 11,560,652** | **66.2%** | $ 9,968,635 | 69.8% |
| Non-Canada[2] | **5,510,035** | **31.6%** | 4,148,556 | 29.0% |
| **REAL RETURN ASSETS** | | | | |
| Real estate[3] | **312,972** | **1.8%** | 145,141 | 1.0% |
| **NOMINAL FIXED INCOME** | | | | |
| Money market securities[4] | **68,975** | **0.4%** | 27,046 | 0.2% |
| | **$ 17,452,634** | **100.0%** | $ 14,289,378 | 100.0% |

[1] Includes derivative contracts and associated money market securities as described more fully in Note 2a.

[2] Includes private equity liabilities offset by money market securities held to discharge those liabilities.

[3] Net of mortgage debt on real estate properties as described more fully in Note 2b.

[4] Includes credit facility liability, accrued interest and dividends receivable.

[5] For the year ended March 31, 2002, there were no derivative contracts or investment liabilities or receivables and therefore no allocations were required.

See accompanying Notes to the Consolidated Financial Statements

# NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

*Year ended March 31, 2003*

**ORGANIZATION**

The Canada Pension Plan Investment Board (the "CPP Investment Board") was formed pursuant to the *Canada Pension Plan Investment Board Act* (the "Act"). The CPP Investment Board is responsible for managing amounts that are transferred to it under Section 111 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 CPP Investment Board has a fiscal year end of March 31.

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

(A) BASIS OF PRESENTATION

These financial statements present the consolidated financial position and operations of the CPP Investment Board and its wholly-owned subsidiaries. The financial statements 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 Canadian generally accepted accounting principles and the requirements of the Act and the accompanying regulations.

Certain comparative figures have been reclassified to conform with the current year presentation.

(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 investments is determined as follows:

(i) Quoted market prices for publicly traded equities and unit values for pooled funds are used to represent fair value for these investments. Unit values reflect the quoted market prices of the underlying securities.

(ii) In the case of private equity investments, where quoted market prices are not available, fair value is determined annually, commencing after the first year of ownership, based on carrying values and other relevant information reported by external managers of the limited partnerships in which the investments are made. These carrying values are determined by the external managers using accepted industry valuation methods. These methodologies include considerations such as earnings multiples of comparable publicly traded companies, discounted cash flows and third party transactions, or other events which suggest material impairment or improvement in the fair value of the investment. On a quarterly basis, when there is evidence of a significant change in fair value, the valuation is adjusted, as appropriate. In the first year of ownership, cost is generally considered to be an appropriate estimate of fair value for private equity investments, unless there is an indication of permanent impairment of value.

(iii) The fair value of private market investments in income producing properties is determined annually, commencing after the first year of ownership, using accepted industry valuation methods, such as discounted cash flows and comparable purchase and sales transactions. In the first year of ownership, cost is generally considered to be an appropriate estimate of fair value for real estate. Debt on real estate investments is valued using discounted cash flows based on current market yields for instruments with similar characteristics.

(iv) Fair value for over-the-counter derivatives such as swaps is determined based on discounted cash flows and market prices for underlying assets with similar characteristics.

(v) Money market securities are recorded at cost which, together with accrued interest income, approximates fair value.

### (C) INVESTMENT INCOME RECOGNITION

Investment income is recorded on the accrual basis and includes realized gains and losses on disposal or transfer of investments, unrealized gains and losses on investments held at the end of the year, dividend income (recognized on ex-dividend date), interest income, distributions from mutual and pooled funds, and net operating income from private market real estate investments.

Realized gains and losses on investments sold during the year represent the difference between sale proceeds and cost, less related costs of disposition. Unrealized gains and losses represent the year-over-year change in the difference between fair value and cost of investments.

### (D) TRANSLATION OF FOREIGN CURRENCIES

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

### (E) CANADA PENSION PLAN TRANSFERS

Amounts received from the CPP are recorded on a cash basis.

### (F) INCOME TAXES

The CPP 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 CPP Investment Board are owned by Her Majesty in right of Canada. The CPP Investment Board's subsidiaries are exempt from Part I tax under paragraph 149(1)(d.2) of the *Income Tax Act (Canada)* on the basis that all of the shares of the subsidiaries are owned by a corporation whose shares are owned by Her Majesty in right of Canada.

### (G) USE OF ESTIMATES

In preparing these financial statements, management makes certain estimates and assumptions which can affect the reported values of assets and liabilities, related income and expenses and note disclosures. Actual results could differ from these estimates.

## 2. INVESTMENTS

The CPP Investment Board has established investment policies which set out the manner in which assets shall be invested. In determining the asset mix, the CPP Investment Board takes into consideration certain assets of the CPP which are held outside of the CPP Investment Board. As at March 31, 2003, these assets totalled approximately $33.7 billion at cost (2002 – $35.0 billion) and consisted primarily of provincial debt obligations.

The Consolidated Statement of Investment Portfolio provides information on the investments and related receivables and liabilities held as at March 31, 2003.

### (A) DERIVATIVE CONTRACTS

A derivative is a financial contract, the value of which is derived from the value of underlying assets, indexes, interest rates or currency exchange rates.

As at March 31, 2003, the CPP Investment Board had equity swap contracts outstanding to exchange money market interest payments for the return on a Canadian equity index. The contracts had a notional amount of $250 million and a term to maturity of one year. Notional amounts are used to compute the cash flows and for determining the fair value of the contracts. Notional amounts of derivative contracts are not recorded as assets or liabilities on the balance sheet.

The fair value of derivative contracts is $(785,000) at March 31, 2003 (2002 – $Nil) and is recorded as a liability on the balance sheet. Consistent with the investment policies, the swap contracts are fully covered by cash and cash equivalents. The economic impact on the total investment asset mix is to increase Canadian public market equities exposure by 1.4%, with a corresponding decrease in money market securities exposure.

### (B) REAL RETURN ASSETS

The CPP Investment Board obtains exposure to real estate through investments in publicly traded securities and privately held real estate. Private real estate investments are held by a subsidiary and are managed on behalf of the CPP Investment Board by external advisors and managers through co-ownership arrangements. As at March 31, 2003, the CPP Investment Board's share of these investments include $246,484,000 of assets primarily related to properties (2002 – $Nil) and $152,000,000 of liabilities related to short-term mortgage debt (2002 – $Nil), which will be replaced with permanent financing within one year of the initial financing date.

### (C) INVESTMENT RECEIVABLES

Investment receivables include dividends receivable on public market equities of $40,272,000 (2002 – $Nil) and accrued interest of $352,000 (2002 – $Nil) on term deposits.

### (D) DUE TO PRIVATE EQUITY PARTNERSHIPS

Amounts due to partnerships represent the second installment owing to a limited partnership relating to the purchase by the partnership during the year of a portfolio of private equity investments.

### (E) MANAGEMENT FEES

Private equity investments are generally made by taking interests in limited partnerships with a typical term of 10 years. The limited partnerships' underlying investments represent equity ownerships or investments with the risk and return characteristics of equity.

The CPP Investment Board advances capital to the limited partnerships, a portion of which, commonly referred to as management fees, is used by the general partners to select and provide ongoing management support to the underlying companies. Management fees generally vary between 1.5% and 2.0% of the total amount committed to the limited partnerships, and are included as part of the CPP Investment Board's cost of the investments. As discussed more fully in Note 1b, the carrying values of these investments are reviewed at least annually and any resulting adjustments are reflected as gains or losses. During the year ended March 31, 2003, management fees totalling $47 million (2002 – $9 million) were included in the capital advanced to the limited partnerships.

### (F) COMMISSIONS

Commissions are paid to brokers on purchases and sales of publicly traded equities. Commissions on purchases are included as part of the cost of publicly traded equities. Commissions on sales are deducted from realized gains and losses as a cost of disposition. During the year ended March 31, 2003, the CPP Investment Board paid total brokerage commissions of $6 million (2002 – $4 million).

### (G) FOREIGN CURRENCY RISK

The CPP Investment Board is exposed to currency risk through holdings of Non-Canadian investments and investment receivables. Investments are not hedged against changes in foreign exchange rates. The underlying currency exposures as at March 31, 2003 are as follows:

| *($000's)* | **2003** | | 2002 | |
|---|---|---|---|---|
| Currency | **Fair Value** | **% of Total** | Fair Value | % of Total |
| United States Dollar | **$ 3,091,739** | **56%** | $ 2,163,954 | 52% |
| Euro | **1,020,149** | **19%** | 697,552 | 17% |
| British Pound Sterling | **577,369** | **10%** | 542,765 | 13% |
| Japanese Yen | **448,268** | **8%** | 388,170 | 9% |
| Swiss Franc | **166,886** | **3%** | 156,826 | 4% |
| Other | **237,265** | **4%** | 199,996 | 5% |
| | **$ 5,541,676** | **100%** | $ 4,149,263 | 100% |

### (H) CREDIT RISK

The CPP Investment Board limits credit risk by dealing with counterparties that have a minimum credit rating of A or R-1 (short term) as determined by a recognized credit rating agency, where available, or as determined through an internal credit rating process. Credit exposure is limited to maximum amounts approved by the Board of Directors.

## 3. CREDIT FACILITY

The CPP Investment Board maintains a $300,000,000 unsecured credit facility to meet potential liquidity requirements relating to investment activities. As at March 31, 2003, the total amount drawn on the credit facility was $125,000,000 (2002 – $Nil). Consistent with the investment policies, the credit facility will be repaid within 45 days of draw date.

## 4. SHARE CAPITAL

The issued and authorized share capital of the CPP 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

Section 111 of the *Canada Pension Plan* provides for the transfer to the CPP Investment Board of funds not required by the CPP to pay current benefits. The funds come from both employer and employee contributions to the CPP, proceeds of maturing and redeemed government bonds held in a portfolio administered by the federal government, and interest income generated from this portfolio. During the year, a total of $7,318,068,000 (2002 - $6,826,171,000) was transferred to the CPP Investment Board.

## 6. INVESTMENT INCOME/(LOSS)

### (A) INVESTMENT INCOME/(LOSS)

Investment income/(loss) consists of the following, after giving effect to derivative contracts and investment receivables and liabilities. During the current year, the CPP Investment Board sold units held in index pooled and mutual funds and purchased the individual securities underlying the funds. The sale of these units resulted in realized gains or losses representing the difference between the market price of the securities and the cost of the index pooled fund units.

| *($000's)* | **2003** | 2002 |
|---|---|---|
| Net gain/(loss)[1] | | |
| Canada | **$ (2,688,743)** | $ 405,763 |
| Non-Canada[2] | **(1,747,865)** | (111,867) |
| | **(4,436,608)** | 293,896 |
| Dividend income | | |
| Canada | **218,388** | 12,153 |
| Non-Canada | **69,767** | — |
| | **288,155** | 12,153 |
| Other income[3] | **9,029** | 9,985 |
| Total investment income/(loss) | **$ (4,139,424)** | $ 316,034 |

[1] Includes unrealized losses of $3,264,646 (2002 – unrealized gains of $459,247), realized losses of $1,532,754 (2002 – realized losses of $378,669), and distributions of capital gains and dividends from public equity pooled and mutual funds of $360,792 (2002 – $213,318).

[2] Includes foreign exchange losses of $244,697,000 (2002 – foreign exchange gains of $43,259,000).

[3] Includes private market real estate operating income of $786,508 (2002 - $Nil), which is net of debt interest of $3,013,847 (2002 – $Nil).

### (B) INVESTMENT PERFORMANCE

Portfolio returns and benchmark returns are as follows:

| | 2003 | | 2002 | |
|---|---|---|---|---|
| | **Portfolio Returns** | **Benchmark Returns** | Portfolio Returns | Benchmark Returns |
| Canadian equity investments | **(17.3)%** | **(17.5)%** | 5.9% | 4.7% |
| Non-Canadian equity investments | **(27.6)%** | **(28.0)%** | (2.3)% | (2.8)% |
| Real return assets | **(50.7)%** | **9.2%** | 2.6% | 1.1% |
| Total | **(21.1)%** | **(20.3)%** | 3.4% | 2.4% |

The CPP Investment Board uses a variety of metrics over the short, medium and long term to evaluate investment performance. Benchmark returns are based upon the S&P/TSX Composite for Canadian equity investments, a combination of the S&P 500 and the MSCI EAFE for Non-Canadian equity investments, and CPI + 4.5% for real return assets. The total portfolio benchmark return aggregates the asset class benchmark returns according to the weights specified in the investment policies.

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

## 7. INVESTMENT AND ADMINISTRATIVE EXPENSES

### (A) EXECUTIVE COMPENSATION

The CPP Investment Board determines executive compensation based on compensation principles approved by the Board of Directors.

Compensation earned by the five most highly compensated executive officers of the CPP Investment Board during fiscal 2003 amounted to $1,684,254 (2002 – $1,752,580) and consisted of the following:

| Name | Year | Salary | Annual Bonus[2] | Long-Term Bonus[2] | Benefits[3] |
|---|---|---|---|---|---|
| John A. MacNaughton | **2003** | **$ 400,000** | **$ 90,000** | **$24,875** | **$ 55,944** |
| *President and Chief Executive Officer* | 2002 | $ 363,650 | $ 181,825 | $ 31,526 | $ 52,419 |
| Mark Weisdorf | **2003** | **$ 215,000** | **$ 80,500** | **$ —** | **$ 30,452** |
| *Vice President – Private Market Investments* | 2002 | $ 185,000 | $ 148,000 | $ — | $ 25,191 |
| Donald Raymond[1] | **2003** | **$ 185,000** | **$ 74,000** | **$ —** | **$ 24,278** |
| *Vice President – Public Market Investments* | 2002 | $ 106,019 | $ 84,815 | $ — | $ 8,564 |
| Valter Viola | **2003** | **$ 180,600** | **$ 69,500** | **$ —** | **$ 21,266** |
| *Vice President – Research and Risk Management* | 2002 | $ 170,000 | $ 132,940 | $ — | $ 19,043 |
| Jane Nyman | **2003** | **$ 170,000** | **$ 41,000** | **$ 4,039** | **$ 17,800** |
| *Vice President – Finance and Operations* | 2002 | $ 160,000 | $ 62,880 | $ 5,120 | $ 15,588 |

[1] Commenced employment on September 4, 2001.

[2] Bonus awards include an annual and a long-term component and are based on the achievement of agreed objectives. The long-term bonus reflects amounts payable for the current year. Additionally, long-term bonuses awarded but not yet paid include approximately $305,946 for payment in 2004, $539,653 for payment in 2005, and $501,000 for payment in 2006. These amounts are adjusted annually by the total portfolio return. The payment of long-term bonus is subject to executive officers meeting certain conditions of employment.

[3] Benefits include pension contributions in connection with a defined contribution registered pension plan and a defined contribution supplementary pension plan, life insurance, club dues, and other miscellaneous non-cash remuneration.

### (B) GENERAL OPERATING EXPENSES

General operating expenses consist of the following:

| *($000's)* | **2003** | 2002 |
|---|---|---|
| Office rent, supplies and equipment | **$ 1,537** | $ 1,314 |
| Custodial fees | **876** | 213 |
| Communication expenses | **673** | 572 |
| Technology, data and analytical services | **625** | 160 |
| Travel and accommodation | **421** | 272 |
| Directors' remuneration | **373** | 325 |
| Other operating expenses | **330** | 348 |
| | **$ 4,835** | $ 3,204 |

Directors' remuneration includes an annual retainer for each director of $14,000 (2002 – $12,000), board and committee meeting fees of $1,000 per meeting (2002 – $900), plus an additional annual retainer of $3,250 for each committee chair (2002 – $3,000). Separate fees are not paid for investment committee meetings when they are held on the same day as board meetings, which is the usual custom. Commencing April 1, 2002 the Chair of the Board of Directors receives $85,000 in annual compensation but is not eligible to receive annual or committee chair retainers or meeting fees unless the fees relate to public meetings. In fiscal 2003, the Chair received a total of $96,000 (2002 - $62,900).

In fiscal 2003, the Board of Directors held 8 board and investment committee meetings (2002 – 10) and 15 other committee meetings (2002 – 17).

### (C) PROFESSIONAL AND CONSULTING FEES

Professional and consulting fees consist of the following:

| *($000's)* | | **2003** | | 2002 |
|---|---|---|---|---|
| Professional accounting and external audit[1] | **$** | **550** | $ | 270 |
| Legal | | **467** | | 261 |
| Consulting[2] | | **409** | | 439 |
| | **$** | **1,426** | $ | 970 |

[1] Includes audit fees of $370,000 (2002 - $172,000) and other audit-related fees of $180,000 (2002 - $98,000).

[2] Includes non-audit-related fees of $Nil (2002 – $40,022) that were paid to the external auditors of the CPP Investment Board.

## 8. COMMITMENTS

The CPP Investment Board has committed to enter into private equity and real estate investment transactions, which will be funded over the next several years in accordance with the agreed terms and conditions. As at March 31, 2003, these outstanding commitments totalled $3.9 billion (2002 – $2.0 billion).

## 9. LEGISLATIVE AMENDMENT

Legislation to amend the *Canada Pension Plan* and the *Canada Pension Plan Investment Board Act* was passed by Parliament on April 3, 2003, and is now subject to provincial approval. The provisions of the amending legislation contemplate a transfer of the CPP assets currently managed by the federal government. If the legislative change is approved by the provinces, these assets will be transferred to the CPP Investment Board over a period of three years. The CPP assets consist of a bond portfolio and a cash operating balance and as at March 31, 2003 totalled approximately $33.7 billion at cost.

# GOVERNANCE PRACTICES OF BOARD OF DIRECTORS

*Canada Pension Plan Investment Board Regulations* require disclosure in the annual report of the governance practices of the board of directors. More extensive governance information is posted at www.cppib.ca.

### DUTIES, OBJECTIVE AND MANDATE OF THE BOARD OF DIRECTORS

The board is responsible for the stewardship of the CPP Investment Board, including oversight of management.

As fiduciaries, directors are required to act honestly and in good faith in the best interests of CPP contributors and beneficiaries. 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 and are subject to higher standards of care in areas that relate to their expertise.

Among other duties, the directors review and approve investment policies, standards and procedures; appoint the chief executive officer and annually review his performance; determine with management the organization's strategic direction; review and approve the annual business plan and budget; identify principal risks and implement appropriate systems to manage them; appoint independent internal and external auditors; establish procedures to identify and resolve conflicts of interest; establish codes of conduct for directors and employees; assess the performance of the board itself; and review and approve the stakeholder communications strategy including material disclosure such as quarterly and annual financial statements.

### COMPOSITION, MANDATES AND ACTIVITIES OF BOARD COMMITTEES

The board has four committees. The Investment Committee consists of the full board. The membership of other committees is shown on the inside back cover.

The Investment Committee reviews and recommends our Investment Statement to the board for approval; and reviews, approves and monitors the CPP Investment Board's investment program. It also reviews portfolio risk tolerance and approves the engagement of external investment managers and new or large market mandates and custodians.

The Audit Committee oversees financial reporting, the external and internal audit, information systems, and internal control policies and practices. It also oversees aspects of the employee pension plans and advises the board in connection with any statutorily mandated special examinations. The Audit Committee regularly meets with both external and internal auditors without management present. Responsibility for enterprise-wide risk management is shared with the board and other committees.

The Human Resources and Compensation Committee administers a performance evaluation process for the Chief Executive Officer, reviews and recommends the compensation philosophy, reviews organizational structure and ensures succession planning. It also oversees employee benefits and human resource policies, aspects of the employee pension plans and directors' compensation.

The Governance Committee monitors application of the code of conduct and conflict of interest guidelines; recommends governance initiatives; makes recommendations to the board to improve the board's effectiveness; reviews criteria for new directors; establishes and recommends a performance evaluation process for the Chief Executive Officer, and assumes other duties at the board's request.

# GOVERNANCE PRACTICES OF BOARD OF DIRECTORS

### DECISIONS REQUIRING PRIOR BOARD APPROVAL

Management's discretion in making operational and investment decisions is established in board-approved policies. The board is required to consider and approve the majority of the recommendations made by management to board committees. In particular, board approval is required for the strategic direction for the organization, and the annual business plan and budget. Annual and incentive-based compensation, as well as officer appointments, require board approval.

### PROCEDURES FOR THE ASSESSMENT OF BOARD PERFORMANCE

Soon after its inception in October 1998, the board established an annual process for evaluating its own performance and that of its committees. The assessments are conducted through confidential questionnaires that are summarized by an independent consultant. The summaries are reviewed by the full board and help to focus the directors on their fiduciary duties in representing the best interests of CPP contributors and beneficiaries. The board also conducts a confidential annual peer review to assist each director in identifying self-development initiatives and to provide the external nominating committee with guidance when it considers individual re-appointments.

### BOARD EXPECTATIONS OF MANAGEMENT

Management is expected to comply with the *Canada Pension Plan Investment Board Act* and the *Canada Pension Plan Investment Board Regulations* as well as all policies and procedures approved by the board. Management develops, with involvement from the board, the strategic direction of the organization in response to its growing asset management responsibilities and the changing dynamics and expectations of capital markets. The strategic response incorporates risk management policies and controls as well as monitoring and reporting mechanisms.

Management is charged with developing benchmarks that objectively measure the performance of markets and asset classes in which CPP assets are invested. Benchmarks assist the board in evaluating management's investment performance and structuring performance-based compensation incentives.

Management is expected to make full and timely disclosure to the board and the public of all material activities, including new investments, the retention of operational and investment partners, quarterly and annual financial results, and developments that may affect the CPP Investment Board's reputation.

### TOTAL COMPENSATION OF DIRECTORS AND EXECUTIVE OFFICERS

The total compensation of directors is summarized in note 7(b) to the financial statements. Board compensation is based on the 1999 median compensation for directors of the 300 companies that formed the previous TSE 300 Composite Index on the Toronto Stock Exchange.

The total compensation of the five mostly highly paid officers of the corporation is detailed in note 7(a) to the financial statements. Officer compensation is partially incentive-based and is reviewed annually by the board.

### RESULTS OF SPECIAL AUDIT OR SPECIAL EXAMINATION

Under the *Canada Pension Plan Investment Board Act,* the Minister of Finance can order a special audit at any time, and must initiate a special examination of the CPP Investment Board's systems and practices at least once every six years. No special audit has been ordered. It is expected that a date for the first special examination will be set within the next year.

# GOVERNANCE PRACTICES OF BOARD OF DIRECTORS

## CONFLICT OF INTEREST PROCEDURES

Conflicts of interest were anticipated in the CPP Investment Board's legislation as a result of the federal and provincial governments' desire to require directors with financial and investment expertise and to engage employees with financial expertise. Procedures have been established to manage and where possible eliminate such conflicts. These procedures are designed to ensure that directors and employees do not profit or otherwise benefit from a transaction by or with the CPP Investment Board. Stringent disclosure of any personal or business interest that might lead to a real, potential or perceived conflict is required. The process for identifying, reporting and discussing such conflicts culminates with the board's Governance Committee recommending a resolution to the full board.

## CODES OF CONDUCT

Codes of conduct for directors and employees are designed to create a corporate culture of trust, honesty and integrity and conflict of interest procedures deal with such matters as relations with suppliers, personal investments, and confidentiality of proprietary information. For example, the codes establish strict pre-clearance procedures for personal trading in securities issued by companies. They also deal with the acceptance by directors and employees of entertainment, gifts or favours that could create or appear to create a favoured position for contractors or suppliers.

## BOARD ATTENDANCE: FISCAL 2003

The board held eight meetings in fiscal 2003. The Investment Committee is a committee of the full board. The table below reflects the number of meetings attended by each director relative to the total meetings that director could have attended by virtue of the date of his or her appointment to the board or the particular board committee. Richard Thomson completed his final term as a director during the year and Germaine Gibara and Ronald Smith joined the board just prior to year end.

| | Board & Investment Committee | Audit Committee | Governance Committee | HR & Compensation Committee |
|---|---|---|---|---|
| Mary Arnold | 8/8 | 5/5 | | |
| Gail Cook-Bennett | 8/8 | 5/5* | 5/5 | 3/3 |
| Germaine Gibara | 1/1 | | 1/1 | |
| Gilbert Gill | 8/8 | 5/5 | | |
| Jacob Levi | 7/8 | 5/5 | 2/2 | 1/1 |
| Helen Meyer | 8/8 | 5/5 | | 4/4 |
| Dale Parker | 8/8 | | 5/5 | |
| Joseph Regan | 8/8 | 5/5 | | 4/4 |
| Helen Sinclair | 8/8 | | 5/5 | 1/1 |
| Ronald Smith | 1/1 | 0/1 | | |
| Richard Thomson | 5/8 | | | 4/4 |
| David Walker | 8/8 | | 3/3 | 4/4 |

* The Chairperson is not a member of the audit committee but attends its meetings.

# CORPORATE INFORMATION

**Chair, Board of Directors**

Gail Cook-Bennett

**Board of Directors and Investment Committee**

Gail Cook-Bennett *(Chair)*
Mary C. Arnold
Germaine Gibara
Gilbert Gill
Jacob Levi
Helen M. Meyer
Dale G. Parker
M. Joseph Regan
Helen Sinclair
Ronald Smith
David Walker

**Audit Committee**

Mary C. Arnold *(Chair)*
Gilbert Gill
Jacob Levi
Helen M. Meyer
Ronald Smith

**Human Resources and Compensation Committee**

M. Joseph Regan *(Chair)*
Jacob Levi
Helen M. Meyer
Helen Sinclair
David Walker

**Officers**

John A. MacNaughton
*President and Chief Executive Officer*

Jane Beatty
*Vice President - General Counsel and Corporate Secretary*

Ian M.C. Dale
*Vice President - Communications and Stakeholder Relations*

Jane Nyman
*Vice President - Finance and Operations*

Donald M. Raymond
*Vice President - Public Market Investments*

Valter Viola
*Vice President - Research and Risk Management*

Mark A. Weisdorf
*Vice President - Private Market Investments*

**Governance Committee**

Dale G. Parker *(Chair)*
Gail Cook-Bennett
Germaine Gibara
Helen Sinclair
David Walker

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