

Annual Report 2006

Corporate Profile

The Canada Pension Plan 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 on behalf of 16 million CPP contributors and beneficiaries and by maximizing returns without undue risk of loss.

The CPP Investment Board invests the funds not needed by the CPP to pay current benefits. It is not expected to be required to contribute investment earnings to the CPP to help pay pensions until 2022. In order to build a diversified portfolio of CPP assets, the CPP Investment Board is currently investing cash flows in publicly traded stocks, private equities, real estate, inflation-linked bonds and infrastructure to balance the legacy government bond portfolio.

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.”*

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

With a mandate from the federal and provincial governments, the CPP Investment Board is accountable to Parliament and to the federal and provincial finance ministers who serve as the stewards of the CPP. Based in Toronto, the CPP Investment Board is governed and managed independently of the CPP and at arm’s length from governments.

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

Chair's Report

The growing focus on accountability finds the CPP Investment Board well grounded in two ways: first, a strong governance model that allows investment professionals to operate successfully in the private sector world of financial markets, subject to the oversight of an independent board and strong public sector accountability; and second, a strong internal accountability framework for the performance of the portfolio and for the development of the organization.



"Fiscal 2006 was a year of transformation in which the CPP Investment Board took major steps forward in setting our long-term strategic direction, in identifying and enhancing our capabilities and in defining successful performance – all in support of the effective management of the pension assets of 16 million Canadians."

GAIL COOK-BENNETT
CHAIRPERSON

Shareholders are demanding more information from the companies in which they invest. Taxpayers want greater disclosure and openness by governments and their agencies. And stakeholders, of all kinds, want to know that those charged with safeguarding their interests perform this task effectively and with appropriate accountability. The CPP Investment Board supports these developments.

In an environment characterized by greater emphasis on accountability, the CPP Investment Board is well positioned. Almost a decade ago, the federal and provincial finance ministers structured the CPP Investment Board with a strong governance framework that was tailored to our mission and provided both our organization and governments with the tools for effective accountability.

The CPP Investment Board governance model allows us to fulfill our mandate as a professional investment management organization, operating in the private sector world of financial markets, with high levels of accountability. Three types of broad accountability are addressed below, each of which was enhanced by developments that occurred this year:

- The CPP Investment Board's accountability as fiduciaries to ensure the strength, growth and development of the CPP fund
- The accountability of independent investment professionals to an independent board of qualified directors
- The accountability of the CPP Investment Board to the federal and provincial finance ministers who serve as stewards of the Canada Pension Plan

FIDUCIARY ACCOUNTABILITY

The principal way we are accountable as fiduciaries is through our numbers – that is, the returns on our investments after adjusting for the risk taken. The positive investment results of 2006 strengthen the CPP fund significantly. Moreover, the organization significantly advanced the CPP Investment Board's objective of diversifying the portfolio and reducing risk by completing several major transactions with a total value of more than \$7 billion. These are noteworthy accomplishments in their own right but are also symbolic of the expected future evolution of the portfolio.

Fiscal 2006 was a year of transformation in which significant advances were made toward identifying the strategy, people and processes required to position the portfolio for the continued investment performance required to help sustain the CPP fund for the long term.

Management, ably led by David Denison in his first full year as president and chief executive officer, initiated a fundamental and detailed strategic review of the portfolio and the organization, with the board of directors participating at key stages. The planning process resulted in a comprehensive and shared view of how to grow the portfolio effectively over the next few years and build the capability to deliver results.

The review culminated in a framework designed to maximize the opportunities for future growth of the fund. It encompassed the full scope of portfolio and risk-management strategies, as well as an articulation of organizational goals and requirements. The strategy also responded to a change in the external landscape which involved the elimination of two regulatory constraints – the foreign property rule and a regulation affecting fixed income investments. Both changes allow management to position the portfolio better from both a return and a risk perspective.

The board and management made important decisions as a result of this review process, two of which have particular relevance for our accountability as fiduciaries.

The first was a simple but profound commitment to designing a portfolio to capture risk-adjusted returns in excess of passive market returns, and to measure that added value against a reference portfolio invested passively within traditional asset classes. This decision reflected the view that future passive returns from traditional asset classes may well be insufficient to meet the requirements of the fund and that talented management investing in a broader set of strategies could achieve higher returns.

The second significant decision involved a renewed commitment to managing the CPP fund by focusing on the total portfolio. Since to truly meet this objective requires substantial additional portfolio and organizational complexity, a detailed approach to effective management was agreed upon. Both these choices are discussed further in the remainder of this report.

2006 was also a year of building organizational strength with the additions of experienced and talented leaders for our Portfolio Design and Risk Management, Private Investments, Real Estate Investments and Human Resources departments. Equally important was the commitment to expansion of strategic partnerships with external investment managers, as an important way of adding to the investment talent working on our behalf.

While we will monitor and adjust the individual elements of the strategy over time as needed, we believe this framework will contribute to the CPP Investment Board's long-term performance and accountability.

MANAGEMENT ACCOUNTABILITY

Effective management accountability to a board of directors makes demands on both the board and management. Directors must be engaged and knowledgeable in order to provide effective oversight and make a substantive contribution. The board of directors has committed the time for continuous learning about the organization's developing investment strategies and risks associated with them. This education is provided by both internal and external experts.

Management accountability to the board of directors has been enhanced this year through the direction outlined in the strategic review process. The CPP Reference Portfolio, described in the Management's Discussion and Analysis section of this report, provides the potential for significant clarity to investment, performance evaluation and incentive compensation proposals and decisions. Clarity, in turn, enhances accountability.

The changes in management accountability that took place this year are possible because our original governance platform defined management's accountability solely to an independent board of directors with investment, financial and governance experience, rather than to a cabinet minister or other government officials. As intended, our investment professionals operate at arm's length from governments, which is critical to our ability to compete in the private sector. Combined with the board of directors' accountability to its stewards, as described later, a careful balance between independence and accountability is achieved.

Other decisions by our stewards were designed to ensure that focus and accountability reside at the level of the board of directors and are not diffused through less precise accountability frameworks. The board, rather than a cabinet minister, appoints, evaluates and has the power to dismiss the chief executive officer. The audit committee has the same powers and jurisdiction with regard to the external auditor. In short, the board was given the tools it required in order to be held accountable for the organization's performance – a fundamental principle underlying governance best practices.

Finally, the ministers decided that the board should be accountable to them in their capacity as stewards of the Canada Pension Plan, as described on the next page.

ACCOUNTABILITY TO OUR STEWARDS

The CPP Investment Board is accountable to its stewards. This past year, management participated in the federal/provincial Triennial Review of the Canada Pension Plan, appearing before the 10 stewards of the CPP last September. Against the background of the review of governance practices of Crown corporations by the Treasury Board, the federal Justice Department and the Gomery Inquiry, management was able to demonstrate that our governance model, policies and practices are equal to or stronger than a variety of proposals to strengthen Crown governance. This merely confirms the extraordinary foresight of the CPP reformers in designing the organization in 1997 and the work done by our board and management to build on this strong foundation.

While the Triennial Review is one of the most visible forms of accountability to the stewards, other forms include the quarterly reporting of results and the ability of the federal finance minister to call a special audit at any time and to commission a special examination by an external auditor every six years.

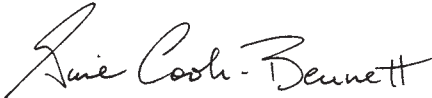
Accountability is facilitated by good disclosure. The CPP Investment Board chose to go further than our legislation requires and disclose substantive information to help Canadians understand where and how we invest the portfolio, the financial performance of the fund and how we manage the organization. We voluntarily disclose more than any other pension fund in Canada on our website, which currently contains over 1,200 pages of information.

Accountability is deeply ingrained in our legislation and our governance model and in the policies and practices of the board, officers and employees.

INTEGRITY AND CONDUCT

On behalf of the board of directors, I wish to thank Mr. Justice Ted Hughes Q.C. for acting as our external conduct review advisor. His direct experience in this field, familiarity with the public sector and stature in the legal community benefited us on a number of occasions even before he agreed to serve as our advisor. More recently, we welcomed the Honourable Frank Iacobucci, whose experience as a justice of the Supreme Court of Canada, a senior public servant and long-time legal scholar is an ideal fit for external conduct review advisor.

On behalf of the board of directors, I wish to recognize David Denison and his management team for their outstanding work in formulating the strategic direction for the next five years and defining the organization and the accountabilities of the investment professionals required for effective implementation. I thank my fellow directors for their dedication to the work of the CPP Investment Board, which serves the 16 million Canadians contributing to and benefiting from the Canada Pension Plan.



Gail Cook-Bennett
Chairperson

KEY CORPORATE OBJECTIVES OF FISCAL 2006

We publish a statement in the annual report of our objectives for the past year and the extent to which they have been met. We also publish our objectives for the coming year and the foreseeable future. You will find the Corporate Objectives for Fiscal 2007 on page 32.

CPP FUND DIVERSIFICATION

Further diversify the portfolio with increased focus on real return assets

INVESTMENT CAPABILITIES

Expand investment capabilities in key areas including trading, portfolio management, private markets, research and risk management

TECHNOLOGY AND BUSINESS PROCESSES

Define and begin implementation of the technology and business processes required to support expanding activities

HUMAN RESOURCES

Augment HR systems and processes

CORPORATE STRATEGY

Revisit corporate strategy in light of repeal of the foreign property rule

Highlights

- Increased real return assets from 1.2 per cent of portfolio to 8.7 per cent
 - Invested \$3 billion in high-quality real estate and \$4 billion in inflation-linked bonds
 - Completed first infrastructure co-investment
 - Increased global equity exposure while maintaining sizeable portfolio commitment to Canada
- Appointed vice-presidents for Portfolio Design and Risk Management, Private Investments and Real Estate Investments
 - Developed the CPP Reference Portfolio
 - Created internal team to invest alongside private equity partners
 - Prepared to launch active internal management of U.S. equities
 - Added 10 investment partners
 - Created external mandates for global REITs and inflation-linked bonds
 - Expanded active overlay program for passive public equity portfolio
- Developed integrated data repository
 - Began implementing permanent IT structure and business processes keyed to organization's planning horizon and total portfolio approach
- Appointed the first vice-president, Human Resources
 - Added 63 staff, many with international experience
- Transitioned public equity portfolio from complex structure no longer needed to meet foreign content constraints
 - Reaffirmed use of global diversification and total portfolio approach to enhance returns and reduce risk
 - Decided to base accountability on creating value above returns that would be achieved by the CPP Reference Portfolio

President's Message

Our accomplishments this year were focused on three themes: investing in a broader range of asset classes to further diversify the portfolio by risk/return attributes and by geography; enhancing the investment expertise and capability of the organization to support the management of an increasingly complex portfolio; and developing a clear longer term strategy and business plan designed to drive implementation.



"Canada's Chief Actuary estimates that the CPP fund will approximate \$250 billion by 2016. With this growth trajectory in mind, we have designed a long-term strategy and a comprehensive business plan to build the expertise and capability, both internally and through strategic partnerships, to manage the CPP fund for the years and decades to come."

DAVID F. DENISON

PRESIDENT AND CHIEF EXECUTIVE OFFICER

BUILDING A RECORD OF ACHIEVEMENT

At the outset of fiscal 2006, we established the following five key corporate objectives for the Canada Pension Plan Investment Board:

- to further diversify the CPP fund
- to expand our investment capabilities
- to define and implement new business processes and technology
- to augment our human resources systems
- to revise our corporate strategy

I am pleased to report that we made significant progress in each of these areas during the year.

With respect to diversification, our key investment goal was to increase significantly the proportion of assets within the portfolio that have inflation related attributes in light of the CPP's inflation-indexed liabilities.

Accordingly, we established a near-term target allocation of 10 per cent for real return assets such as real estate, infrastructure investments and inflation-linked bonds to complement our 60 per cent allocation for equities and our 30 per cent target for fixed income. Over the course of fiscal 2006, we were successful in increasing our real return assets to \$8.5 billion or 8.7 per cent of the overall portfolio from just \$1 billion or 1.2 per cent at the beginning of the year.

We are particularly pleased with our acquisition of core Canadian real estate assets in the office and retail sectors during the year. Of particular note was our 50 per cent participation in the joint venture that purchased the \$2 billion portfolio of Olympia & York (O&Y) office buildings, as well as our \$1 billion partnership with Oxford Developments in a collection of core office towers in major cities across Canada. We invested \$660 million to acquire an 80 per cent interest in two major retail malls in the province of Quebec. Outside of Canada, we made our first investments in European real estate through the LaSalle French Fund, which owns office and industrial properties in France, and the ING Britannica Fund, which focuses on retail properties in the United Kingdom.

We also acquired substantial holdings of inflation-linked bonds during fiscal 2006 that totalled \$4.0 billion at year end. Until this year, Regulation 9 of the *Canada Pension Plan Investment Board Act* constrained our ability to invest in these and other marketable bonds by effectively limiting our bond holdings to non-marketable federal and provincial debt. We concluded successful negotiations with the federal and provincial finance departments in June 2005 that led to the elimination of Regulation 9 and provided additional flexibility to the provinces with respect to the terms of their existing bonds that we hold. This change enabled us to acquire the inflation-linked bonds previously mentioned and, importantly, allows us to invest in other categories of fixed income in the future.

In the public equities component of our portfolio, our diversification goal for 2006 was to increase the proportion of our international holdings. We believe that international investments help reduce concentration risk, enhance returns and avoid over-dependence of the CPP on the domestic economy. Accordingly, we invested new contributions from the CPP into international equity markets this past year, while beginning to reduce the proportion of our substantial holdings in Canadian public equities, which at year end totalled \$28.5 billion or 29.1 per cent of the total portfolio.

Another aspect of our diversification objective for 2006 was to expand our private equity investments. Over the course of the year, we committed an additional \$5.2 billion to funds with external investment management partners, bringing our total committed and drawn investment amounts to approximately \$13.3 billion and \$5.5 billion respectively. Canada represents 13 per cent of this total commitment, making us one of this country's largest private equity and venture capital investors.

The ultimate goal of these multiple aspects of portfolio diversification is to allow us to generate improved risk-adjusted returns for the CPP fund. Looking back to fiscal 2006, the fund grew by \$16.7 billion to end the year at \$98.0 billion. Within that growth, investment returns were \$13.1 billion, representing a 15.5 per cent rate of return. This compares to the median performance for Canadian pension plans of 14.9 per cent during the same period.

Our second objective for fiscal 2006 was to expand our investment capabilities. To that end, we appointed three new investment vice-presidents this year who have brought us a wealth of Canadian and international experience:

- John Ilkiw now heads our Portfolio Design and Risk Management department; John has over 30 years of pension related work experience within Canada, the United Kingdom and the United States.
- Graeme Eadie heads our new Real Estate Investments department; Graeme has more than two decades of experience as a senior officer in the real estate, retail and manufacturing sectors.
- Mark Wiseman heads our Private Investments department; Mark previously led the private equity fund and co-investment program at one of Canada's largest public sector pension funds and previously worked in the United States and France.

These three are partnered with Don Raymond, vice-president of Public Market Investments, who joined the CPP Investment Board in 2001, following a number of years spent in the financial services industry both in Canada and the United States.

In addition to expanding our internal investment resources, we also expanded our relationships with top-tier private equity, real estate, infrastructure, venture capital and public equity managers around the world. We now have relationships with 62 external managers who complement our internal capabilities and assist us in achieving our investment diversification and performance goals.

We also extended our capabilities in other important aspects of our organization last year. Our third key objective was to define and begin implementation of the business processes and technology required to support our expanding investment and operational activities. To this end, our Finance and Operations area launched a comprehensive review of all our various processes and began implementing an enterprise technology architecture that will support the growing complexity of our investment activities in the years to come.

Investment management is largely a people business and the CPP Investment Board is a rapidly growing organization. We believe that our ability to attract, develop and retain high-calibre staff in a globally competitive marketplace is crucial to our success, and hence our fourth objective for 2006 was to augment our human resources systems. During the year we implemented a new incentive compensation plan that promotes accountability for investment and other results, revised our performance management system and successfully recruited 63 new colleagues, drawing from such diverse locations as the U.K., Australia, the U.S. and South Africa, as well as, of course, here in Canada. To bring increased focus to the critical role of managing our human capital, we appointed David Wexler as our first vice-president, Human Resources. David joined us from a Canadian software company with global operations and previously held senior positions with several large Canadian financial services organizations. Human resources will remain a key focus for us in fiscal 2007.

Our final key objective for 2006 was to revise our corporate strategy. The management team and board of directors examined a wide range of options for how we could organize ourselves and conduct our investment activities to manage the assets of the rapidly growing CPP fund. As a consequence of this review we made a number of decisions that will guide our activities over the next three to five years.

One of these decisions was the formulation of the CPP Reference Portfolio as the key benchmark for measuring the investment performance of the CPP Investment Board. Another was our commitment to manage the assets of the CPP fund within a total portfolio approach. This approach places risk/return decision-making at the portfolio level rather than in each asset class; it also leads us to assess the contribution of investments to the overall portfolio by their risk and return characteristics versus their traditional asset labels. Both of these important concepts are described in greater detail in the Management's Discussion and Analysis section of this report.

These and our other strategic management choices focus increased emphasis on performance and accountability for the CPP Investment Board. Shaping and nurturing this focus will continue to be one of our primary challenges in the years ahead as we strive to help improve the long-term sustainability of the Canada Pension Plan.



David F. Denison
President and Chief Executive Officer