

The Canada Pension Plan Goes to Market

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Since it began investing Canadian workers' public pension money on the stock market in March 1999, the Canada Pension Plan Investment Board (CPPIB) had lost \$3.1 billion dollars by the end of 2002 (CPPIB, 2003b). Despite this record, the federal Ministry of Finance is now moving to shift all Canada Pension Plan assets to the control of the CPPIB through legislation currently working its way through Parliament.

With little fanfare and in the midst of a turbulent market, the federal government is shifting vast assets to an independent board that is moving to an increasingly aggressive strategy of investing in public and private companies and real estate. This plan deserves greater public scrutiny of the potential risks and volatility, relevant ethical questions and the ideological impact.

Background

The CPP was established in 1966 as a "pay-as-you-go" plan, meaning that benefits are paid out of funds contributed by current workers and employers. Due to economic and demographic changes, the CPP was faced in the 1990s with the prospect of major contribution rate increases to avoid a future shortage of funds. Negotiations among the federal and provincial governments led to a package of reforms in 1997 (Townson, 2001). Among the changes, contribution rates were raised quickly and significantly, though less than previously forecast, and the CPPIB was established. Over a period of seven years, from 1997 to 2003, the contribution rate has been increased from 5.85 per cent of ensured earnings to 9.9 per cent. This rapid increase in contribution rates was designed to build up a nest

egg that could be invested in the stock market. These funds are not expected to be needed for another twenty years.

The CPPIB began investing in equities in 1999. Its legislated mandate is “to act in the best interests of CPP contributors and beneficiaries, to maximize investment returns without undue risk loss, and to take into consideration the CPP’s funding status and ability to meet its obligations” (CPPIB, 2002a, p. 9). The share of CPP assets managed by the CPPIB was relatively small at first. The CPPIB invested \$12.1 million in capital markets in March 1999 (CPPIB, 2002b). By the end of December 2002, the CPPIB had investments of \$18.4 *billion* (CPPIB, 2003a).

Initially, the Board was required to adopt a passive investment program, meaning that it invested in stock index funds that match the overall performance of a given stock index such as the S&P/TSX 300. The CPPIB received permission to engage in active investment of up to 50 per cent of its domestic portfolio in August 2000. The following November, the Board was allowed to actively invest its entire domestic portfolio (HRDC, 2002: 8). This allows the CPPIB to take a more aggressive strategy of trying to pick winning stocks in the hope of outperforming the stock indexes. It initiated a private equity strategy in June 2001, and announced its first direct real estate investment in January 2003.

As of March 2003, Parliament has before it bill C-3 which will transfer control over the entire CPP reserve funds to the CPPIB over three years. The CPPIB is expected to maintain a significant holding of government bonds and a small cash reserve alongside its expanding portfolio of investments in public and private companies and real estate.

Market Volatility

The CPPIB is rolling the dice with Canadians’ pension money and it is pouring billions of dollars into the stock market to grease the wheels of the financial sector. The potential increase in volatility could have implications for the entire economy.

An element of market risk has been introduced into the CPP. In the last nine months of 2002, the Canada Pension Plan lost \$3 billion on the stock market. That’s a negative 15.9 per cent return on investment (CPPIB, 2003a). John MacNaughton, president of the CPPIB, (and former president of Nesbitt-Burns, brought in as a high profile personality from the private sector to run a public sector investment fund) has downplayed concerns by pointing out that, “as a long-term investor, with substantial annual cash inflows for the next twenty years, a continuation of lower equity prices would be to our advantage as we build a broad-based portfolio” (CPPIB, 2003a). While it is true that over the long haul, stock markets have outperformed public sector bonds, equities have occasionally experienced extended bear markets.

A more difficult question to address is the impact of the CPPIB upon the markets and the economy. The fund will grow steadily and is expected to become the largest institutional investor in Canada. The CPPIB expects to receive between \$6 billion and \$8 billion of new cash every year over the next decade, from employer and employee contributions (CPPIB, 2002a, p. 7). At the end of 2002, CPP assets were worth \$54.8 billion, including \$18.4 billion invested in equities and real estate (CPPIB, 2003a).

The CPPIB adds to the concentration of share ownership among institutional investors (pension funds and mutual funds). This concentration and a herd tendency among investors can lead to violent over-reactions in the market (Harmes, 2001). This potential danger has been magnified because of the move to an active investment strategy. In September 2000, they dumped half of their holding in Nortel (CPPIB, 2002a, p. 14). If a major player like the CPPIB sells off a particular stock then the downward pressure can turn into an avalanche.

Shareholder Value or Ethical Investing

According to CPPIB President John MacNaughton (2000), in general, pension funds “are becoming increasingly active as shareholders,” and the CPPIB itself “expect[s] to develop our own proxy voting policies and become proactive where we believe circumstances warrant.” Shareholder activism has nothing to do with championing workers’ rights or saving the planet, it’s all about increasing shareholder value or short-term stock performance. Often this takes the form of placing pressure on company executives to aggressively downsize and shed excess workers and plants with the goal of getting lean and mean. There are obvious social costs to this strategy. The CPPIB move into private equity seems likely to involve further dangers. According to the CPPIB’s 2002 Annual Report, it now “invest[s] in buyout funds that make capital available to companies undertaking a new business plan, as well as acquisitions and financial restructuring, to generate growth and improve financial performance” (11). Many Canadian workers have learned from direct experience what ‘buyouts,’ ‘acquisitions’ and ‘restructuring’ mean for their job security.

While mainstream shareholder activism has been directed toward shareholder value, many workers and social activists have become interested in ethical investing. Pressure is bound to be placed upon the CPPIB. In the spring of 2000, MacNaughton admitted to the Canadian Labour Congress that the CPPIB invested in Talisman Energy, which was under the spotlight for its controversial investments (recently dropped) in war-torn Sudan (Drohan, 2000). In December 2002, anti-smoking groups demanded that the CPPIB stop investing in tobacco companies (Cordon, 2002). NDP Members of Parliament have backed the demand for ethical screening in the parliamentary debates over Bill C-3. For its part, the

CPPIB's "social investment policy" simply states that as long as a business is lawful in Canada and exists in a country with which Canada maintains normal financial, trade and investment relations, it is an acceptable investment.

The Investment Ideology

The rise of defined-contribution pension funds, RRSPs and mutual funds have increased the number of Canadians with a stake in the stock market. Since the establishment of the CPPIB, all future recipients of the CPP have an interest in the market's growth. This has a potential impact upon how people view the market. According to Wally Seccombe (1999), "wage earning investors...have conflicted class interests" due to their investments (pp. 91, 94). Adam Harmes (2001) has described how the prevalence of stock ownership and the omnipresence of market and financial information has contributed to the development of a "new investment culture" that portrays the interests of all Canadians as congruent with the interests of the financial sector.

The corporate sector has embraced this theme. MacNaughton (2000), the current CPPIB president, has explained that

pension funds are becoming leading owners of corporate Canada. For the directors and management teams of companies the good news in this development is that it inextricably aligns the retirement income of Canadians with the financial well-being of the private sector. The better Canadian firms perform financially over the long term, the better off Canadians will be in their retirement years.

For their part, the Canadian Bankers Association cites the CPPIB's holding in the major Canadian banks to back its claim that "all Canadians now have a direct interest in ensuring a strong and profitable banking industry" (CBA, 2001: 5). Increasingly, what's good for the Toronto Stock Exchange (or the Canadian Bankers Association or Talisman Energy or Rothmans Tobacco) is depicted as what's good for Canadians.

Conclusion

One clear beneficiary of the formation of the CPPIB is Bay Street. Beyond the general boost to the stock market and the hegemony of the investment ideology, specific investment firms benefit directly from the CPPIB. As noted by a *Globe and Mail* reporter back in 1997, "[t]he investment industry stands to profit from the new strategy through commissions earned on the trading of stocks and other securities" (Carrick, 1997: B2). In 1999, TD Bank and Barclays Global Investors Canada Ltd.

won the roles of investing the CPPIB portfolio in stock indexes. The CPPIB is currently moving toward managing these passive index portfolios internally and hiring external firms to engage in active management of public equities. The CPPIB's private equity investments have been made through various fund managers in Canada, the US and the UK.

From a different vantage point, Daniel Benedict of the Ontario Coalition of Senior Citizens' Organizations has reminded the House Standing Committee on Finance that:

The Canada Pension Plan exists ... because Canadians want to assure adequate incomes to our elderly, not as a playground for investment. That major goal should be accompanied by fair contribution levels, by the sensible and socially useful employment of the multi-billion dollar investment funds, and by public participation in the decision-making process. (Canada, 2002)

This provides a useful warning that the CPP Investment Board deserves careful scrutiny and should be judged according to different criteria than that developed by the Ministry of Finance, its appointees to the Board and its partners on Bay Street.

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