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Commentary by Erik Andersen

Pension Funds Need Reform

If the Canada Pension Plan Fund, begun in 1966, had continued its initial policy of investing contributions only in government securities, its value at the end of the last fiscal year, March 31, 2009, might be some 21% higher than what can be expected with its current diversified investment strategy.

The Move Towards Equity Investment

In 1998, spurred by opposition critics of the then Liberal government who said that the CPP Fund was being used as a 'slush fund' for government spending, that Parliament made reforms allowing the Canada Pension Plan Investment Board (CPPIB) to invest in other than cash and government bonds. Change started slowly with the CPP Fund being 5% invested in equities in 2001. But by 2008, 57% of the Fund was investment in equities.

Recent Investment Losses

According to the CPPIB Annual Report, the asset value of the Fund at the end of the fiscal year, March 31, 2008, was \$122.7 billion. In fact, the 2008 fiscal year was the occasion of the first annual reported net investment loss in the history of the CPPIB, some \$300 million. But the annualized yield has been declining almost every year since 2000. This decline had, of course, been particularly severe in the last fiscal year.

From April 1, 2008, the CPPIB reported investment losses on 'public equity' of some \$18 billion up to the end of the third quarter, December 31, 2008. I estimate that they will have sustained further losses on this asset category of \$3.5 billion up to the end of the 2009 last fiscal year.

The CPPIB has made no estimate of their losses last year on 'private equity', infrastructure, and real estate; these could have amounted to \$14 billion for the entire fiscal year 2009. There are distinct problems with asset valuation for these three categories; in my opinion, the CPPIB should not make investments that are not tradable in public markets.

By my calculations, the total losses for the fiscal year may be in the region of \$35.5 billion for the year. Assuming net contributions to the fund for the fiscal year of \$6 billion (as in recent years), the total of the fund on March 31, 2009 would be \$93.2 billion.

The Alternative: Government Bonds

Had the CPPIB not diversified its investments, but remained

100% invested in Canadian government bonds (as it was at the start of the 2000 fiscal year), I estimate that the total of the fund on March 31, 2009 would be \$113 billion, including the 2009 net contributions of \$6 billion. This is some 21% more than what we may expect under the current 'diversified' investment policy.

I quote from a letter from the Office of the Chief Actuary, December 2007: '...the CPP is financially sound, but this soundness is not only due to the fact the net contributions to the CPP are currently positive. The investment income earned by the CPPIB plays a very important role in guaranteeing the financial sustainability of the CPP.'

Presumably in turn that means that the losses currently experienced by the CPPIB seriously compromise sustainability. But contributions are expected to exceed benefits through to the end of 2019. According to David Denison, CEO of the CPPIB, 'the assets we are managing today are not required to help pay pensions for another 11 years.'

I believe the citizens of Chile have a feature for what is their equivalent of our CPP Fund whereby they can individually select an investment portfolio. Perhaps it is about time the government of Canada incorporated this option for Canadians.

Corporate Pension Plan Reforms

Beneficiaries of pension plans of any stripe place greatest importance upon plan solvency and plan capacity to pay benefits as described in various agreements and representations. Therefore, any 'reforms' should incorporate defences to safeguard these objectives.

We have seen examples of companies neglecting to make a financial priority of maintaining adequate pension plan funding; and of pension plans primarily invested in company shares, with the result that the pension plan cannot survive the failure or bankruptcy of the company.

It should become a condition in law that corporations have no management involvement whatsoever with the pension accounts of their employees and that securities of that corporation be prohibited from such accounts. That would probably require the formation of a public trustee office for pensions.

Secondly, it should become a condition of all pension

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accounts that obligations as to funding agreements be framed so that these accounts rank equally with 1st mortgage bonds having a sinking fund provision. Release from such obligations would only be allowed where the individual beneficiary signs away these privileges to enable the pursuit of a riskier or different investment strategy than used by the majority of beneficiaries.

Ed's Footnote: Erik's reforms seem even more pressing since moves in March by the CPPIB to actually borrow money to make new investments. The borrowed money is to be used for investments in 'real estate, infrastructure and private debt' rather than government bonds. Many corporate and personal (RRSPs) pension funds have lost considerable value with the market crash. There is and has been no need for the CPP fund to do this.

The fund has never borrowed money before. While the fund should not have to draw on its investment assets for some years yet since it can pay current pension obligations out of current contributions received, this is not a justification for speculating with borrowed money, particularly in assets which cannot be easily valued or sold.

Borrowing may require an amendment to legislation. It is questionable why any government (particularly a conservative one) would let the Fund borrow money, unless this initiative is being driven by people who make money out of trading stocks.

In defence of the new move, the CPPIB states that now is a great time to make new investments. However, borrowing to invest moves the Fund further from its original investment concept, which emphasized safety, and closer to a leveraged 'margin' investment account, with inherently greater risk. ☞