



2001 ANNUAL REPORT

T H E P U B L I C S E C T O R P E N S I O N I N V E S T M E N T B O A R D



Investissements  Investments

C O R P O R A T E P R O F I L E

The Public Sector Pension Investment Board (PSP Investments) is a crown corporation created to invest in capital markets the net contributions received from the pension plans of the federal Public Service, Canadian Forces, and Royal Canadian Mounted Police. Separate accounts are maintained for each plan and their individual financial statements are published in this annual report.

Our statutory objectives are to manage funds in the best interests of the contributors and beneficiaries of the plans and to maximize investment returns without undue risk of loss. We commenced operations on April 1, 2000 and concluded our first fiscal year with \$2.5 billion of assets under management.

On March 31, 2001, approximately 39 percent of these assets were Canadian bonds and cash equivalents, 34 percent Canadian equities, and 27 percent foreign equities. Assets under management are expected to grow rapidly with annual cash inflows exceeding \$2.5 billion for the foreseeable future. These assets will be managed internally and externally.

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OUR ANNUAL OBJECTIVES

OUR LEGISLATION REQUIRES THE ANNUAL REPORT TO INCLUDE OUR OBJECTIVES FOR THE PAST FISCAL YEAR AND TO WHAT EXTENT THEY WERE MET, AS WELL AS OBJECTIVES FOR THE COMING FISCAL YEAR. PAST AND FUTURE OBJECTIVES ARE SUMMARIZED BELOW.

FISCAL YEAR 2001

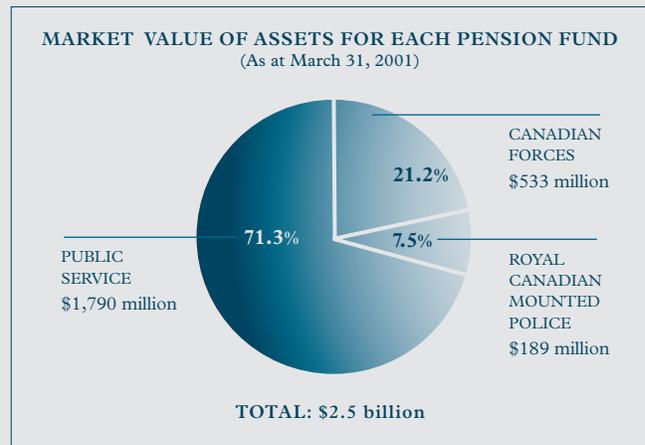
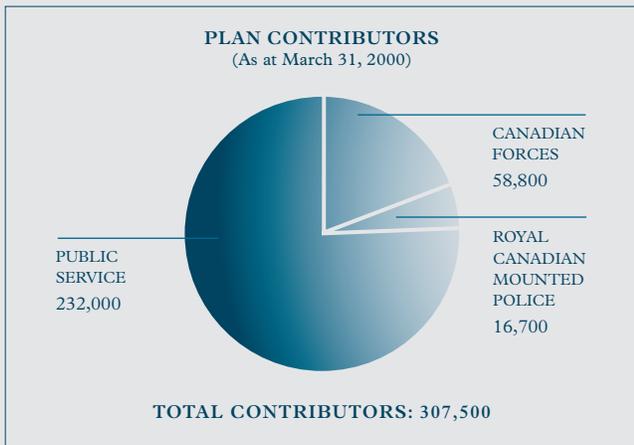
In our first fiscal year, we accomplished the following key objectives:

- development of a decision structure specifying the responsibilities of the Board of Directors and management, and the mandates of the Chair and the President and Chief Executive Officer;
- establishment of committees of the Board of Directors and their terms of reference;
- development and implementation of an interim investment policy for the start-up period;
- development of governance policies, including conflict of interest guidelines, a code of conduct, and a procedure for assessing the performance of the Board of Directors, in compliance with legislated requirements;
- recruitment of the President and Chief Executive Officer; and
- approval of the long-term asset mix policy and investment policy recommended by the President and Chief Executive Officer.

FISCAL YEAR 2002

Objectives for the fiscal year 2002 are to:

- develop operating policies and procedures;
- initiate the hiring of internal investment expertise and external fund managers;
- initiate active investment programs that can add value above the returns of market indices; and
- recruit staff for administration, investment accounting, risk management and performance measurement.





*William R.C. Blundell,
Chairperson*

CHAIRPERSON'S REPORT

It is my pleasure to introduce the first annual report of Public Sector Pension Investment Board. It explains our mandate, policies, and start-up activities in assuming responsibility for investing net contributions received since April 1, 2000 from the pension plans of the federal Public Service, the Canadian Forces and the Royal Canadian Mounted

Police. While we maintain a separate account for each plan, we are implementing the same investment policy for all three because of their similarities.

Among key accomplishments during fiscal year 2001 were the formation of the Board of Directors, the development of essential policies for managing PSP Investments and, of course, the appointment of our first President and Chief Executive Officer.

SELECTING THE RIGHT BOARD OF DIRECTORS

The process for appointing directors is described in the section "Legislated Mandate and Governance" on page 7. While we are a crown corporation, the federal government used an arm's length process to identify suitable directors. The process started with a nominating committee, chaired by Claude Lamoureux, the highly respected President and Chief Executive Officer of the Ontario Teachers' Pension Plan Board. His committee searched for candidates with experience and expertise relevant to our investment mandate. The committee submitted a panel of qualified candidates from which the President of the Treasury Board made recommendations to the Governor in Council. Following consultations with the Board of Directors members and the ministers responsible for the RCMP and Canadian Forces plans, the President of the Treasury Board recommended to the Governor

in Council my appointment as the first Chair of the Board of Directors.

The result is a Board with experience in business, investment, law, accounting, human resources, labour and actuarial science. Collectively, we have the quality of expertise that contributors and plan members should expect at the governance level. If you would like to meet the Directors, their biographies and photographs start on page 8.

DEVELOPING APPROPRIATE POLICIES

A priority for the Board of any start-up organization is policy development. We spent a good deal of time, with the assistance of outside consultants, putting in place appropriate governance and operating policies. These are explained in the section starting on page 7.

Early on, we worked on the decision structure to specify responsibilities of the Board of Directors and management, and the mandates of the Chair and the President and Chief Executive Officer.

The Board of Directors approved an interim policy to invest the net contributions that began to arrive in the first few days after we opened for business. Requests for proposals were sent to appropriate investment firms and we selected State Street Global Advisors (SSgA) as the manager to invest cash flows in Canadian and foreign index-based equity funds as well as a Canadian index-based bond fund.

Our goal in all this policy work was to create a disciplined and productive investment organization that can deliver the investment returns expected.

SELECTING OUR FIRST PRESIDENT AND CEO

A highlight of the fiscal year was the recruitment of our first President and Chief Executive Officer. A search committee appointed at our first Board of Directors

*An
organization
with clear policies
and a disciplined
approach*

meeting led the process and the Board appointed Adel Sarwat in September 2000.

Mr. Sarwat had been a senior investment executive at Caisse de Dépôt et Placement du Québec since 1987, where he was responsible for \$22 billion of global equities and a 14-member team of portfolio managers and analysts. He started his career in 1977 as an economist for Bell Canada and subsequently worked as a financial analyst for CN Investments and the Abu Dhabi Investment Authority. A chartered financial analyst, he holds a bachelor's degree in mathematics, and master's degrees in mathematics, economics, and business administration.

Mr. Sarwat's job is to lead PSP Investments, including the development of policies and procedures for the Board of Directors' review and approval. He moved quickly to refine the initial investment policy and prepared an asset/liability study so that we could better understand the relationship of our investment activities to the needs of the pension plans. He is responsible for building the organization, investing the assets and hiring staff and external resources.

The role of the Directors, by contrast, is one of oversight and guidance to ensure that management has the necessary policies and procedures in place to run PSP Investments efficiently in fulfilling its legislated mandate.

ACCOUNTABILITY AND REPORTING

Management is accountable to the Board of Directors. The Directors are accountable to Parliament through the President of the Treasury Board, who is responsible for our legislation and regulations and is required to table our annual report in Parliament.

Our reporting requirements are rigorous. We are required to provide quarterly financial statements and

the annual report to the President of the Treasury Board, the Minister of National Defence and the Solicitor General of Canada. Furthermore, we are required to make the annual report available to contributors. We are also required to meet annually with the advisory committees of the three plans to discuss the most recent annual report. I am delighted to report that our new President and CEO held a joint "get acquainted" meeting with the three advisory committees in January 2001.

ACKNOWLEDGEMENTS

I would like to single out two individuals for special thanks. Claude Lamoureux, a leader in pension fund governance, was instrumental in giving the federal government the range of choices that produced an outstanding founding Board. Carl Haller, retired treasurer of GE Canada, was our first staff member as Executive Vice President. He proved invaluable in the roles of Chief Executive, Financial and Investment Officer during the start-up period prior to the arrival of Mr. Sarwat.

Finally, I thank the Directors for their unselfish dedication and strong views as we set about assuming a new role in overseeing what will emerge as one of Canada's largest pension fund pools.



WILLIAM R.C. BLUNDELL
Chairperson



*Adel Sarwat,
President
and Chief Executive Officer*

PRESIDENT'S REPORT

It is a great privilege for me to have been selected as the first President and Chief Executive Officer of the Public Sector Pension Investment Board. I formally assumed my duties on September 11, 2000.

This is an exciting time to be involved from the ground floor in something entirely new. PSP Investments will emerge over the next few years as one of Canada's largest public sector pension fund investors.

INVESTMENT PHILOSOPHY AND POLICY

One of my first orders of business was to reflect on our investment policy: where should we invest the contributions so that the money can earn the level of returns needed over the long haul?

We have positive cash flows of more than \$2.5 billion annually and do not expect withdrawals to pay benefits for many years. It makes sense, therefore, to emphasize an asset class that should earn better long-term results than most other asset classes. That choice is equities. Despite short-term market risk, the long-term rewards are persuasive.

We started investing in April 2000 by putting 55 cents of every dollar in equities. In mid-October, we decided to increase our equity commitment gradually over the next few months from 55 to 60 cents. This was accomplished by February 2001. At that time, we decided to once again increase our equity exposure gradually to 65 cents. This target will be reached in June 2001. At the same time, we have diversified by gradually increasing our foreign equity holdings from an initial target of 20 percent of total assets to 27 percent by fiscal year end.

INVESTMENT ACTIVITY

Having decided that emphasizing equities is the right policy, we then had to address how to manage our assets.

In the case of Canadian equities, current federal regulations require us to substantially replicate until March 31, 2003, one or more widely recognized broad-market indices. Replicating an index involves buying the shares of companies in the proportion they are represented in the index. This is known as passive investing. The leading Canadian index that offers market breadth is the TSE 300 Index. To date, we have implemented our policy by buying units in a fund based on this index.

Assets other than Canadian equities can be invested actively or passively. For the first fiscal year, we chose a passive approach for foreign equities by investing in two well known indices, one for the United States and the other for the rest of the world. This gained us efficient global exposure to hundreds of major companies in a variety of markets.

To diversify risk and provide balance in the asset base, we also had 39 percent of assets invested in a Canadian bond indexed fund and short-term securities at fiscal year end. The bond portfolio gave us instant exposure to a wide selection of quality government and corporate bonds.

CREATING VALUE ADDED

One of our goals is to actively manage a portion of our assets to add value above index returns. This should enhance our ability to maximize returns without undue risk of loss. We will do this with either internal or external managers. Our move into active management will be gradual to ultimately encompass portfolios of publicly traded stocks, private equity, real estate, bonds and other asset classes.

*An organization
focused
on generating
investment return and
value added*

BUILDING THE RIGHT INVESTMENT ORGANIZATION

In my years as an investment professional, I have learned that there are many ways to successfully generate value added above passive investing in indexed funds. Despite the virtues of different investment styles (value, growth, momentum and so on), success ultimately reflects the personalities of those you hire and the way they work together. Consequently, we plan to build our organization gradually as we find the right managers with the right talent and right attitude to ensure long-term success.

Initially, we are looking for managers to actively manage portions of our foreign equities in the United States, Europe and the Far East, and fixed-income securities in Canada. As we hire managers in these areas, we will build specialized teams around them. Their responsibility will be to create value above market benchmarks, rather than compete against a peer group.

Overall, our organizational approach will be flexible and cost-efficient in building work modules

around committed personalities, rather than looking for people to fill boxes in a preconceived organizational structure. Over time, intellectual synergies should appear as we put together highly specialized teams in different areas of investment.

It is my firm belief that motivated and highly dedicated professionals can best add value when they work in an environment with clear objectives and where they can express their individuality while sharing their experience with their colleagues. We will work hard to create such an environment.

BUILDING OUR CORPORATE RESOURCES

As a new investor, we need to put the right systems in place and hire senior managers to provide proper financial management. These tasks include risk management procedures, internal controls,

GRADUALLY BUILDING OUR EQUITY EXPOSURE



performance measurement and monitoring, and detailed reporting.

I was pleased to announce just prior to fiscal year end the appointment of Danielle G. Morin as Chief Financial Officer, effective April 9, 2001. A graduate in actuarial science from Laval University and a fellow of the Canadian Institute of Actuaries, Ms. Morin has had an impressive career as a financial executive with Sun Life of Canada, The Laurentian/Imperial Company, Desjardins-Laurentian Life Group and most recently Elantis Investment Management Inc., where she was vice president, finance and operations.

This fiscal year we will move swiftly to build the “back office” infrastructure so that the necessary procedures, systems and people are ready as we hire investment expertise. Our goal is to run a lean and highly efficient investment organization and ultimately to compare our administrative expenses to an objective benchmark for investment organizations of similar size and scope.

FIRST FISCAL YEAR INVESTMENT RESULTS

In our first fiscal year, we were able to take advantage of declining markets to buy equities at ever cheaper prices as the year progressed. After a decade of strong growth, the TSE 300 crested on September 1, 2000, and fell by one-third in the next seven months. Foreign equity markets also declined sharply.

These declines created attractive buying opportunities. Our policy of gradually increasing our commitment to equities could not have happened at a better time. Consequently, while we lost \$270 million on equities in fiscal year 2001, we are building a strong portfolio of equity positions that should show good value appreciation in the years ahead.

Our fixed-income portfolio performed well in fiscal year 2001, earning \$43 million. On a total portfolio

basis, however, we ended fiscal year 2001 with a net loss of \$227 million on investments.

We remain confident that our strategy of allocating 65 percent of assets to equities will pay off handsomely over the long term.

ACKNOWLEDGEMENTS

I want to thank the Directors for their confidence in selecting me as the first President and Chief Executive Officer of PSP Investments. On arriving almost halfway into the first fiscal year, I was impressed by the quality of the Board of Directors and the amount of policy work it had already accomplished. That helped me enormously, and I thank them.

Finally, I assure plan contributors that I am committed to leading PSP Investments as a well managed and successful investment organization focused on maximizing investment returns and operating efficiently.



ADEL SARWAT

*President and
Chief Executive Officer*

LEGISLATED MANDATE AND GOVERNANCE

The Public Sector Pension Investment Board (PSP Investments) was established by the *Public Sector Pension Investment Board Act* in September 1999. This section of the annual report is the statement of corporate governance practices of PSP Investments, as required by our legislation. It includes a review of our legislated mandate, the appointment and duties of the Board of Directors, the role of the President and Chief Executive Officer, and the key policies that guide the organization’s activities and behaviour.

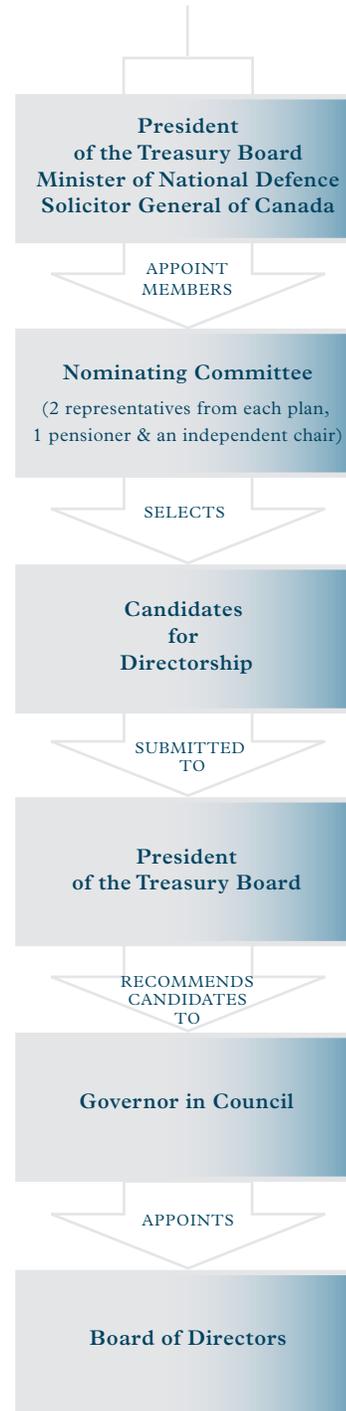
Along with other important documents, we have published on our Web site at www.investpsp.ca our Statement of Investment Policies, Standards and Procedures and our governance policies such as the code of conduct, conflict of interest policy, and terms of reference for the Board, its committees, the Chair and the President and Chief Executive Officer.

RELATIONSHIP TO THE PENSION PLANS

Effective April 1, 2000, the federal government created three new pension funds – one each for the existing Public Service, Canadian Forces and Royal Canadian Mounted Police pension plans. These pension funds receive the employer and employee contributions in respect of each plan to provide for liabilities for service after April 1, 2000. The balances (that is, contributions after payment of benefits accrued since April 1, 2000 and after plan administration expenses) are transferred to separate accounts at PSP Investments to be invested in financial markets.

The government is the sponsor and administrator of the plans. The President of the Treasury Board is responsible for the Public Service plan, the Minister of National Defence for the Canadian Forces plan, and the Solicitor General of Canada for the RCMP plan.

BOARD OF DIRECTORS SELECTION PROCESS



BOARD OF DIRECTORS



William R.C. Blundell, Toronto, Ontario

Former chairman and CEO of GE Canada. Spent most of career with GE Canada. Former president and CEO, Camco and more recently chairman of Manufacturers Life Insurance Co. Serves on several boards, including Alcan Inc. Bachelor's degree in engineering physics, University of Toronto.

Chairperson



Bob Baldwin, Ottawa, Ontario

Director of Social and Economic Policy, Canadian Labour Congress. Professor of political science at University of Western Ontario before joining CLC in 1976. Executive member of Centre for Research on Work and Society at York University. Member Statistics Canada's advisory committee on labour statistics. Former member of Ontario Public Sector Pension Advisory Board. Former chair and member of CPP Advisory Board. Boards include Canada Wide Industrial Pension Plan. Master's degree in political science, University of Western Ontario.



Barbara Bender, Saint John, New Brunswick

Vice President, Spartan Systems Limited, Management Consultants. Former executive director of the New Brunswick Institute of Chartered Accountants. Former member of Board of Trade committees and director of cultural and charitable organizations. Director of New Brunswick Power Corporation. Public representative for College of Physicians and Surgeons of New Brunswick. Bachelor of Commerce degree, University of Calgary. Chartered Accountant.



Jean-Louis Bourbeau, Montreal, Quebec

Former chair of William M. Mercer Limited, 1985 to 1999. Worked for Alliance Mutual Life Insurance for 20 years. Joined Mercer in 1979, rising to CEO. Senior positions at William Mercer Companies with responsibilities for Canada, Latin America and worldwide risk, finance and insurance. Bachelor's degree in science, University of Montreal. Fellow of Canadian Institute of Actuaries.

LEGISLATED MANDATE

Our mandate is defined in legislation:

- to manage funds received “in the best interests of the contributors and beneficiaries” of the three plans; and
- to invest “with a view to achieving a maximum rate of return without undue risk of loss, having regard to the funding, policies and requirements of the pension plans . . . and the ability of those plans to meet their financial obligations.”

The legislation states that we shall not, directly or indirectly, carry on any business or activity, or exercise any power, inconsistent with these objectives.

SELECTING DIRECTORS

PSP Investments is governed by a 12-member Board of Directors, including the Chair. All Board members are appointed by the Governor in Council on the recommendation of the President of the Treasury Board.

Qualified candidates for directorship are selected and recommended to the President of the Treasury Board by an eight-member nominating committee that operates at arm's length from the government. The nominating committee consists of two representatives from each pension plan, a pensioner and an independent chair. The three ministers appointed two members each on the recommendations of their respective plan's advisory committee. The President of the Treasury Board appointed the pensioner and, in consultation with the other two ministers, the independent chair. The nominating committee members are appointed for five years.

In recommending candidates for directorship, the nominating committee is required by legislation to “have regard to the desirability of having on the board of directors a sufficient number of directors with proven financial ability or relevant work experience

such that the Board will be able to effectively achieve its objects.” Directors with special professional or business knowledge or skill are required to employ that particular level of knowledge or skill in discharging their duties.

The current Board consists of corporate executives, investment and finance specialists, lawyers, chartered accountants, an actuary, a labour federation executive, and a human resources specialist.

Our legislation disqualifies as Directors, members of the Senate, the House of Commons or a provincial legislature; federal government employees; and those entitled to benefits from federal public sector pension plans.

Directors are appointed for up to three years and can be re-appointed.

DUTIES OF DIRECTORS

In ensuring that legislative and regulatory objectives are met, the Board of Directors has defined its own responsibilities to include:

- appointing the President and Chief Executive Officer;
- approving a written Statement of Investment Policies, Standards and Procedures for each pension fund;
- approving strategies for achieving investment performance objectives for each pension fund;
- appointing external investment managers;
- appointing the external auditor;
- adopting appropriate policies and procedures for the proper conduct and management of PSP Investments, including a code of conduct, conflict of interest guidelines, and risk management policies;
- approving a human resources policy, including a compensation policy;



Richard Bradshaw, *Vancouver, British Columbia*
Former president and CEO at Phillips, Hager & North Investment Management Ltd. Chair from 1994 to 1999. Current Chair of Vancouver Aquarium & Marine Science Centre. On investment committee of Public Service Pension Board (Alberta). Boards included Vancouver Arts Stabilization Team, Vancouver Foundation, and Vancouver Oral School for Deaf Children. Bachelor of Commerce degree, McGill University.



Paul Cantor, *Toronto, Ontario*
Managing Director, Russell Reynolds Associates for Canada. Former president of investment banking at Canadian Imperial Bank of Commerce. Former chief executive of Confederation Life Insurance Company and National Trust. Founding executive director of Toronto International Leadership Centre. Served on international capital markets committee of Federal Reserve Bank of New York. Boards included CIBC and Torstar. M LL.B. from University of Toronto. Fellow of Institute of Canadian Bankers.



Paul G. Haggis, *Edmonton, Alberta*
President and Chief Executive Officer at Alberta Treasury Branches since 1996, and Director and Chief Executive Officer of Investment Company Inc. Former vice president of corporate finance at City Bank Canada and chief operating officer of Canadian operations at Metropolitan Life Insurance Company. Boards included Metropolitan Life Insurance Company of Canada. Bachelor's degree from the University of Western Ontario.



Donna Soble Kaufman, *Toronto, Ontario*
Corporate Director. Boards include Hudson's Bay Company, BCE Inc., Bell Canada International Inc., Bell Globemedia, TransAlta Corporation and UPM-Kymmene. Began career as broadcast executive. Former partner at Stikeman Elliott. Former chairman and CEO of Selkirk Communications, and director of Southam Inc. and Provigo Inc. B.C.L., McGill University and LL.M., University of Montreal.



Lynn Loewen, Halifax, Nova Scotia
 Vice President, Finance and Administration, Air Canada Regional Inc. Former chief operating officer at Air Nova Inc. and manager with KPMG Peat Marwick Thorne. Former member of Council for Institute of Chartered Accountants of Nova Scotia and Tax Committee of Air Transport Association of Canada. Serves on the Board of Regents of Mount Allison University. Bachelor of Commerce, Mount Allison University. Chartered Accountant.



Keith G. Martell, Saskatoon, Saskatchewan
 Chairman, First Nations Bank of Canada. Senior advisor to Federation of Saskatchewan Indian Nations and Assembly of First Nations. Former executive director of finance for the Federation of Saskatchewan Indian Nations. Boards include North American Native Bankers Association, Saskatchewan Institute of Applied Science and Technology and North West Company Inc. and Institute of Chartered Accountants of Saskatchewan. Commerce degree (accounting), University of Saskatchewan. Chartered Accountant. Certified Aboriginal Financial Manager.



Carl H. Otto, Montreal, Quebec
 President and CEO of IFPT Management Inc., the advisor to the International Finance Participation Trust of Canada. Former managing director of AMI Partners Inc. Chairman of McGill University Pension Investment Board, and member of the Government of Alberta's Investment Operations Committee and of Alberta's Workers' Compensation Board Investment Advisory Group. Member of the Institute of Chartered Financial Analysts. LL.B., Ph.D., Freiburg University, Germany.



Susan Sherck, St. John's, Newfoundland
 Senior human environment consultant at AMEC. Commissioner with Economic Recovery Commission of Newfoundland and Labrador. Former assistant deputy minister of tourism, culture and recreation. Served on Governor General's Canadian Study Conference, provincial Fisheries and Marine Institute, St. John's Board of Trade. Boards include Investors Group and Memorial University's Botanical Gardens. Bachelor's degree, Wheaton College, post-graduate anthropology, Memorial University.

- establishing performance evaluation processes for itself, the President and Chief Executive Officer, and senior management; and
- maintaining separate accounts and records and preparing quarterly and annual financial statements for each pension fund.

Legislation prohibits the Board from delegating its power with respect to by-laws, investment policies, vacancies on Board committees, the appointment and remuneration of officers, and approval of financial statements.

CONFLICTS OF INTEREST FOR DIRECTORS

Conflicts of interest, or at least their appearance, are inevitable considering the diverse backgrounds and interests of our Directors.

The potential for a conflict of interest exists when a Director has a financial interest in, or serves on the Board of, a company in which we are considering an investment; has a direct or indirect financial interest in, or obligation to, a supplier; or has a personal relationship that may appear to compromise the ability to make an impartial and objective decision.

The Board of Directors has developed detailed procedures to identify circumstances where the potential for a conflict of interest exists and how Directors should deal with the situation. The purpose is to ensure that Directors have a full understanding and appreciation of our principles and values to assist them in determining appropriate business practices and behaviour. Directors are required, for example, to fully disclose in writing any material interest in transactions being considered by PSP Investments. In another example, the use of confidential information for personal profit is explicitly forbidden.

If a transaction or proposed transaction occurs in the normal course of business and does not need the

approval of the Board, Directors are expected to disclose in writing any material interests as soon as they become aware of the transaction or proposed transaction.

In the event of a material interest, Directors are prohibited from voting on, or participating in the discussion of, the transaction and must absent themselves from the discussion.

BOARD OF DIRECTORS' COMMITTEES

The Board has established four committees to assist in fulfilling its obligations. Recommendations of Board committees are subject to the approval of the full Board. The Investment Committee consists of the full Board. The composition of other committees is listed in the Corporate Directory on page 42.

The *Investment Committee* is responsible for recommending and annually reviewing the written Statement of Investment Policies, Standards and Procedures for each pension fund. It provides oversight of and monitors investment strategies; discusses with management the effectiveness of the investment policies, performance and procedures; and appoints external investment managers.

The *Audit and Conflicts Committee* monitors the application of the conflict of interest procedures and code of conduct; reviews the adequacy and effectiveness of internal controls, accounting and financial reporting and audit processes; meets with management to discuss the effectiveness of the internal control procedures; meets with the external auditor to discuss the auditors' report; and approves the annual financial statements.

The *Governance Committee* develops the governance policy of PSP Investments; monitors and assesses the relationship between the Board and management, including the limits of management's responsibilities and the ability of the Board to function

independently of management; recommends the members of Board committees; and recommends by-laws and governance-related policies.

The *Human Resources and Compensation Committee* reviews and approves human resources, training and compensation policies; annually reviews the President and Chief Executive Officer's performance for discussion by the full Board; annually reviews employee compensation on an aggregate basis; reviews succession planning; and oversees the disclosure in the annual report of the compensation paid to Directors and executives.

DIRECTORS' COMPENSATION

The Board adopted the policy of compensating Directors on a basis similar to the median compensation received by directors of companies listed in the TSE 300 Index. As a result, each Director receives a \$12,000 annual retainer. Chairs of committees are paid an additional \$3,000 retainer. A \$900 per diem fee is paid for each Board and Board committee meeting attended. However, only a single fee is paid when Board and Investment Committee meetings occur on the same day. (The Board met 11 times in fiscal year 2001 and held 26 committee meetings.)

The compensation paid to Directors, as well as executives, in fiscal year 2001 is summarized in Note 6 to the financial statements for each pension account.

ASSESSMENT OF BOARD PERFORMANCE

Regulations require the Board of Directors to set out in the annual report the procedures in place for the assessment of its own performance. The Board approved a performance evaluation policy in February 2001. The policy focuses on procedures for frank and confidential discussions between the Chair

and individual Directors, as well as the President and Chief Executive Officer.

To facilitate the process, each September a discussion guide for evaluating Board performance will be distributed by the Governance Committee to each Director and to the President and Chief Executive Officer. The guide will generally take the form of a questionnaire. Board members will submit their written responses to the Chair for his use in focusing on concerns and opportunities for improvement in his meetings with individual Directors and the President and Chief Executive Officer.

The Chair will summarize the results of these meetings for review with the Governance Committee in January of each year. Subsequently, the Chair and the Chair of the Governance Committee will report to the Board on the review process, results and recommendations.

ROLE OF THE PRESIDENT AND CHIEF EXECUTIVE OFFICER

The division of responsibilities between the Board of Directors and management is clearly spelled out in the terms of reference for the Board, the Chair, and the President and Chief Executive Officer.

The President and Chief Executive Officer, who is appointed by the Board, provides leadership of the organization, assists the Board in developing policies, is responsible for the management of the funds, and manages the day-to-day operations of PSP Investments. His duties are defined by the Board and include:

- recommending the overall business strategy, annual business plan and budget;
- recommending the Statement of Investment Policies, Standards and Procedures for each pension fund, along with policies and procedures to mitigate risk;

- recommending the basic organizational structure and the employee compensation policy;
- recruiting, hiring and retaining management personnel;
- conducting due diligence on and recommending external investment managers for appointment by the Investment Committee; and
- reporting relevant and timely information to the Board so that it can carry out its monitoring and oversight responsibilities.

CODE OF CONDUCT FOR EMPLOYEES

Our legislation requires that we establish a code of conduct for officers and employees. During our start-up fiscal year, we developed a code that will shape our corporate culture and guide our behaviour.

Besides complying with statutory requirements, the code provides officers and employees with a full understanding of our corporate principles and values to assist them in determining appropriate business practices and behaviour. Among other things, the code deals with honesty and integrity; compliance with the law; use of confidential information; reporting of personal investment transactions; receiving or giving of entertainment, gifts and favours from or to third parties; membership in and public representation of non-profit and professional associations; and personal use of PSP Investments' resources, assets and facilities.

We maintain a restricted list of securities of which PSP Investments has confidential knowledge. Officers and employees are prohibited from trading in securities on the restricted list.

INVESTMENT POLICIES AND PROGRAMS

In this section we look at the evolution of our investment policy and its implementation.

LONG-TERM INVESTMENT OBJECTIVES

Our objectives are to manage funds in the best interests of contributors and beneficiaries of the underlying pension plans and to maximize returns without undue risk of loss. The actuarial reports for the three pension plans incorporate assumptions with respect to the rate of return to meet pension liabilities. Specifically, the plan sponsor assumes a real (that is, above inflation) rate of return of 4.25 percent annually. Combined with an assumed long-term inflation rate of 3 percent per annum, the annual nominal rate of return assumption for the three plans is 7.25 percent.

SIMILARITY OF UNDERLYING PLANS

While not identical, the federal Public Service, Canadian Forces and Royal Canadian Mounted Police pension plans have much in common. They are defined benefit plans. Pensions are fully protected against inflation, are integrated with Canada and Quebec pension plans, and have similar liability profiles. Employee contribution rates are identical based on annual earnings and they are subject to the same review process.

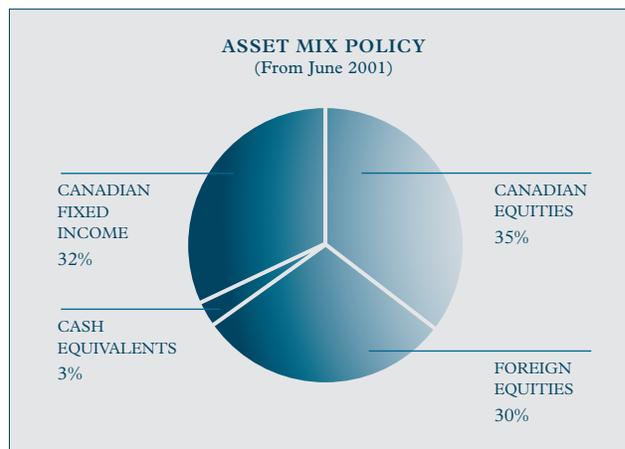
Consequently, while we maintain a separate account for the pension fund of each plan, it makes sense to initially implement one investment policy. As the new pension funds have no liquidity concerns (that is, to liquidate investments to pay current pensions), we can focus on long-term returns.

ASSET MIX POLICY

A key decision is the asset mix policy that should ensure long-term investment returns at least equal to

the actuarial rate of return assumption. We believe that investing a high proportion of assets in equities is most likely to achieve that goal.

Equities are highly volatile and can often produce negative returns in the short term. Recent experience is an example. The extraordinary escalation in stock values to unprecedented levels during the 1990s reflected heavy capital investment in technology that spurred economic growth through productivity gains. Technology stocks in particular were driven to excessive levels. An abrupt change in economic growth and perceptions of equity values led to a market



correction in the last three months of calendar year 2000 and the first three months of 2001. The lower values were by coincidence a timely opportunity for us to build a more reasonably priced asset base.

The three pension funds have a high percentage of cash inflows to assets and we can, therefore, accept the higher risk of equity investing compared with fixed-income securities and afford to wait for equities to produce the long-term returns expected.

A well diversified and globally based equity portfolio should outperform fixed-income investments if the world economy continues its long-term



ASSET MIX POLICY AT MARKET VALUE (From June 2001)			
	TARGET	RANGE	BENCHMARK
Canadian Equities	35%	30%-40%	TSE 300
Foreign Equities	30%	25%-35%*	Customized**
Canadian Fixed Income	32%	27%-37%	SC Bond Universe
Cash Equivalents	3%	0%-10%	SC 91-day T-bill

* Foreign equity exposure cannot exceed 30% at book value, but can be higher at market value.
 **S&P 500 and EAFE indices weighted according to market capitalization (rebalanced monthly). Emerging markets will be included in the benchmark when investments are made in this area. (EAFE is the MSCI Europe, Australasia and Far East Index.)

expansion and there is no serious and sustained economic or financial crisis or a return to extreme over-valuations.

Our move to a higher weighting in equities was implemented gradually during the year. (See graph on page 5.) We started in April 2000 by committing 55 percent of assets to equities. In mid-October, the target was increased to 60 percent to be implemented gradually over the next several months. In February 2001, the asset mix policy was amended to 65 percent equities. By fiscal year end, we had achieved a 61 percent weighting in equities and expect to achieve the 65 percent target early in June 2001. The Board of Directors formally reviews the asset mix policy annually.

INVESTMENT RESTRICTIONS

Pursuant to legislation and current regulations, there are six main restrictions on our investment activities:

- until March 31, 2003, Canadian equity investments must substantially replicate the composition of one or more widely recognized domestic stock market indices;
- foreign investment is limited to 30 percent of total assets at cost, consistent with the foreign property limit provision of the *Income Tax Act (Canada)* for all pension funds and registered retirement savings plans;

- no more than 10 percent of total book value of the assets can be directly or indirectly invested in two or more affiliated companies, any one person, or two or more associated persons (except for an interest in a segregated fund or mutual or pooled fund);
- direct and indirect investments cannot lead to control of a company by exceeding 30 percent of the voting rights to elect the directors of a corporation;
- we can invest in derivative products, such as options and futures, as long as the market exposure is covered by cash or other assets; and
- direct and indirect investments cannot exceed 5 percent of total assets at cost for one parcel of real property or Canadian resource property, 15 percent for all investments in Canadian resource properties, and 25 percent for all investments in real property and Canadian resource properties.

INVESTMENT POLICY IMPLEMENTATION

In fiscal year 2001, our investments were indexed funds that substantially replicated:

- the TSE 300 Composite Index of companies listed on The Toronto Stock Exchange;
- the Standard and Poor’s 500 Index of U.S. companies;

- the Morgan Stanley Capital International EAFE Index of about 1,200 companies in Europe, Australasia and the Far East; and
- the Scotia Capital Bond Universe Index of Canadian governments and corporations.

At fiscal year end, 34 percent of total assets were invested in a TSE 300 indexed fund, 13.5 percent in each of the U.S. and foreign indexed funds, and 39 percent in a Canadian bond indexed fund and other fixed-income securities.

Equity indexed funds are a suitable investment choice for a new organization as they are an efficient way to invest in a wide selection of domestic and foreign companies to produce index-based returns and to diversify risk among different economies and sectors.

In fiscal year 2002, we will actively manage parts of our asset base. For example, we will “de-index” some of our foreign equity funds and manage them both internally and externally to create value added over our customized benchmark return. This customized benchmark weights the market capitalization of the U.S., EAFE and eventually emerging markets in the MSCI all-country index. We will also move forward with our plan to actively manage bonds and, once the regulatory restriction expires, actively manage publicly traded Canadian stocks. Private equities and real estate will also be considered as new asset classes in the future.

VOTING RIGHTS

As the beneficial owner of corporate shares, we have the right to vote on all proposals submitted at a company’s meeting of shareholders. In fiscal year 2001, we invested in units of index funds. Being one of many investors in those funds, we cannot impose a voting policy. Upon review of the external manager’s

voting policy, we are comfortable that it is consistent with our investment policy. As we become an active investor, the shares managed by our staff will be voted by PSP Investments.

RISK MANAGEMENT POLICIES

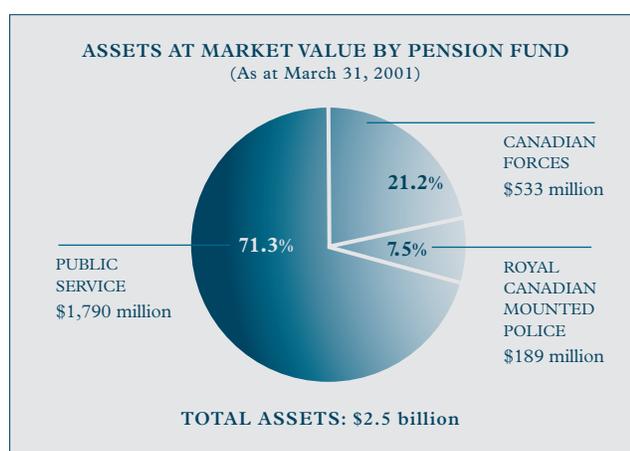
We have developed policies to manage credit, market and other financial risks as a result of our investment activities.

The credit risk of bonds and cash equivalent securities is managed by controlling the percentage held in lower rated securities as measured by an external credit rating agency. Equity and interest rate risks are inherent in equity and fixed-income investing and are managed through diversification strategies. Currency risk is implicit in foreign equities and is managed through asset diversification.

We are also developing policies to manage operational and other business risks.

FISCAL YEAR 2001 INVESTMENT PERFORMANCE

We completed our first year of operation on March 31, 2001. During that period, we received \$2.7 billion in net contributions from the Public Service, Canadian Forces and RCMP pension plans. Cash inflows were received several times each month and were invested as soon as possible.



On a consolidated basis by year end, approximately 34 percent of assets were invested in Canadian equities, 27 percent in foreign equities, and 39 percent in Canadian fixed-income securities.

The market value of invested assets at March 31, 2001 totalled \$2.5 billion.

MARKET PERFORMANCE

The decline in stock markets during our first fiscal

year presented buying opportunities for us as a new investor with positive cash flow.

The stock markets in which we invested generally declined at the start of our first quarter before rising steadily in the second quarter to peak at the beginning of September 2000.

In the second half of our fiscal year, equity values declined steadily. Our equity holdings purchased in the first half of the year lost value. The good news, however, is that we were able to expand our equity holdings at ever-reducing prices. (See graph on page 5). Our goal is to create a large equity portfolio representing 65 percent of total assets.

Declining interest rates during the latter part of our fiscal year increased the market value of our bond portfolio.

Recognizing that our performance will be measured over several years, we are confident of achieving our expected return over the long term.

INVESTMENT RESULTS

With respect to fiscal year 2001, the positive returns of \$43 million earned on fixed-income securities were insufficient to offset the negative returns of \$270 million from equities. As a result, the consolidated accounts had a net loss (including realized and unrealized gains and losses) of \$227 million at fiscal year end.

RATES OF RETURN ON CONSOLIDATED PENSION ACCOUNTS (For fiscal year 2001)

	PORTFOLIO RETURNS	BENCHMARK RETURNS	
Canadian Equities	(12.0)%	(12.2)%	TSE 300
Foreign Equities	(13.2)%	(13.0)%	S&P 500, EAFE*
Canadian Fixed Income	8.3%	8.3%	SC Bond Universe
Consolidated accounts	(4.1)%	(4.0)%	Policy Benchmark**

These are time-weighted rates of return, before fees and expenses, for the three consolidated pension accounts and cover the period from April 17, 2000 (the first day funds were invested) to March 31, 2001. They are calculated according to AIMR standards and audited as such.

*In Canadian dollars, weighted 50/50.

**Based on weights in the investment policy.

RATES OF RETURN

The rate of return for the consolidated pension accounts was -4.1% , reflecting the negative returns for the stock markets (-12.2% for Canadian equities and -13.0% for foreign equities) and the positive 8.3% return for the Canadian fixed-income market.

We measure the performance of each asset class against a market-based benchmark to determine whether we are achieving the level of results expected. Normally, an index-based portfolio should have the same result as the index itself, less the costs of making the transactions and related investment expenses. The difference between our fiscal year 2001 return on each asset class and the return for the corresponding benchmark is mainly due to the large cash inflows relative to the asset base during the year.

We then measure the total performance of the accounts against the policy benchmark defined as the average of the asset class benchmarks weighted by their mix in our investment policy. The rate of return for the consolidated pension accounts was -4.1% compared to the policy benchmark return of -4.0% , an acceptable tracking error for indexed funds.

The returns and benchmarks of each pension account are presented in Note 4 of the financial statements. The differences between the rates of return of the three pension accounts are due to their different start dates and their different cash-flow profiles.

CHANGES IN NET ASSETS

The significance of our first fiscal year results should be considered in the context of the financial position of the three plans.

The three new pension accounts began fiscal year 2001 with no net assets. Net contributions during the fiscal year added \$2.7 billion. After deducting the net loss from operations, net assets available at fiscal year end were \$2.5 billion.

ADMINISTRATIVE EXPENSES

The cost of operating PSP Investments in fiscal year 2001 totalled \$3.6 million for investment expenses, salaries and benefits, Directors' fees, professional and consulting fees, office rent and equipment, and other standard business expenses. Professional and consulting fees reflect the start-up nature of the organization and the fact that the Board of Directors sought advice in the absence of staff. Certain professionals were retained on contract to assist management in carrying out its responsibilities.

The allocation of administrative expenses among the three pension accounts is explained in Note 6 to the financial statements for each pension account.

We expect administrative expenses to increase over the next few years as we establish our administrative and financial operations, and hire operational and investment staff. Investment expenses for custodial fees and other expenses affected by the level of assets under management will continue to grow in absolute dollars. As our assets grow, administrative expenses as a percent of assets will trend down after peaking in the near future.

We are committed to managing a cost-efficient organization. Our goal is to measure administrative expenses against a suitable benchmark of expense ratios for institutional investors of similar size and purpose.

I N V E S T M E N T C E R T I F I C A T E

The *Public Sector Pension 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 Public Sector Pension Investment Board (“PSP Investments”) held during the year were in accordance with the Act and PSP Investments’ investment policies, standards and procedures. Accordingly, the Investment Certificate follows:

“The investments of PSP Investments held during the year ended March 31, 2001, were in accordance with the Act and PSP Investments’ Statement of Investment Policies, Standards and Procedures.”



WILLIAM R. C. BLUNDELL
Chairperson

CORPORATE DIRECTORY

BOARD OF DIRECTORS AND INVESTMENT COMMITTEE

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Montreal, Quebec

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Edmonton, Alberta

DONNA SOBLE KAUFMAN
Toronto, Ontario

LYNN LOEWEN
Halifax, Nova Scotia

KEITH G. MARTELL
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The Human Resources and Compensation Committee:

PAUL G. HAGGIS, Chair

BOB BALDWIN

RICHARD BRADSHAW

SUSAN SHERK

MANAGEMENT:

ADEL SARWAT, C.F.A.
President and Chief Executive Officer

CARL HALLER,
Executive Vice President

DANIELLE G. MORIN,¹
Chief Financial Officer

KEN MONDS,²
Director of Government / Plan Relations

¹ Started on April 9, 2001

² Started on January 3, 2001

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Ce rapport annuel est aussi disponible en français.

