Annual Report 2003

The Public Sector Pension Investment Board

PSP Investments

Corporate profile

The Public Sector Pension Investment Board (PSP Investments) is a Crown corporation established to invest in capital markets the net contributions received after April 1, 2000 from the pension plans of the Federal Public Service, Canadian Forces and Royal Canadian Mounted Police (Plans). PSP Investments operates at arm's length from the federal government. Its statutory objectives are to manage the funds entrusted to it in the best interests of the contributors and beneficiaries of the Plans and to maximize investment returns without undue risk of loss.

HIGHLIGHTS — FISCAL YEAR 2003

- *Consolidated net assets increase 43% to $8.1 billion.*
- *Total portfolio return is (13.5)% compared to the Policy Benchmark return of (12.9)%.*
- *Proportion of assets under active management climbs to 48.5%.*
- *The Board of Directors approves investments in new asset classes.*
- *Proxy Voting Guidelines implemented.*
- *Number of employees goes from 19 to 29.*
- *Key systems and procedures are put in place.*

CONTENTS

Annual Objectives

The legislation governing PSP Investments requires the annual report to include its objectives for the fiscal year under review, indicating to what extent they were met, and to state its objectives for the new fiscal year. This information is summarized below.

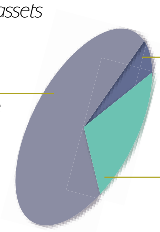
FISCAL YEAR 2003 OBJECTIVES	STATUS*
• Continue implementation of active investment management in order to generate value-added returns. (Assets actively managed increased from 31.4% to 48.5% of total portfolio.)	✔
• Upgrade performance measurement to a new system. (New performance system is fully operational.)	✔
• Implement an internal audit function. (A full year internal audit cycle was completed.)	✔
• Implement an automated order management system for equity trading. (Following a cost/benefit analysis, it was decided to postpone the initiative for the moment.)	Not required at this time

* ✔ indicates objective was substantially or completely achieved.

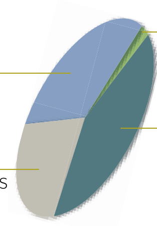
KEY OBJECTIVES FOR FISCAL YEAR 2004

- Ensure continuity during the transition to a new CEO.
- Develop strategies for investments in new asset classes.
- Establish a comprehensive risk management process to build on safeguards already in place.

Plan Accounts' Net Assets
(as of March 31st, 2003)
($,000)
% of total net assets



% Asset Classes
(as of March 31st, 2003)
($,000)



***Paul Cantor**, Chairperson*

Chairperson's Report

The Board of Directors of the Public Sector Pension Investment Board (PSP Investments) maintained its focus on building an organization that will be capable of generating returns at least sufficient to cover pension liabilities through a combination of superior investment performance and cost effectiveness. A challenging investment climate that hampered performance during fiscal year 2003 served to further validate the importance of building for the long term.

In November 2002, the Board approved changes to PSP Investments' strategy and long-term asset mix policy, authorizing a broadening of the portfolio to include new asset classes such as private equities and real estate. The move to increased diversification reflects the strong operational foundation in place, as well as changing market realities — most notably the need to be less concentrated in public equity markets. Development of investment strategies for private equities and real estate will commence in fiscal year 2004. Other alternative asset classes will also be considered going forward.

The changes to PSP Investments' asset mix are in keeping with our legislated mandate, which is 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 Plans and the ability of the Plans to meet their financial obligations.

Our challenge this year was to translate that overriding statutory objective into concrete investment objectives, in order to establish a linkage between funding liabilities and investment returns. To that end, the Board adopted the following objectives:

(1) Primary objective: Achieving a return (net of expenses) at least equal to the actuarial rate of return as determined by the Chief Actuary of Canada; and

(2) Secondary objective: Achieving a return exceeding PSP Investments' Policy Benchmark return by 0.50% (with a minimum value-added component equal to expenses).

It was also with a view to enhancing returns that the Board oversaw management's implementation of active investment management for a substantial proportion of assets over the course of the fiscal year under review. As of March 31, 2003, approximately $4.0 billion of assets were actively managed, compared with $1.8 billion a year earlier. Further details may be found in the *Report from Management*.

Proxy Voting Guidelines adopted during the final quarter of the previous fiscal year were put into force during fiscal year 2003. The guidelines are designed to ensure that shares beneficially owned by PSP Investments are voted in accordance with its investment policy and objectives. Moreover, the guidelines underscore the fact that, as one of Canada's major pension investment managers, we recognize our responsibility to take positions on vital corporate governance issues — and to vote our shares accordingly, in circumstances where we believe corporate practices fall short of current expectations. (The Proxy Voting Guidelines may be viewed on PSP Investments' Web site: **www.investpsp.ca** under Investments - Proxy Voting Guidelines.)

The Board of Directors also approved a new Communications Policy designed to ensure effective communications between PSP Investments and its various stakeholders, including the Advisory Committees of the three pension funds. Annual meetings with the Advisory Committees are part of the reporting requirements for PSP Investments. The latest such meeting was held October 24, 2002, at which time the Board Chairperson and the Chief Executive Officer reviewed the previous year's performance and provided an update on recent developments.

In March 2003, as our third year of operation was drawing to a close, it was decided, by mutual agreement between the Board of Directors and President and CEO Adel Sarwat, that we had reached a point where a leadership change would prove beneficial to the next phase of PSP Investments' development. Paul Haggis, a member of our Board and a former president of the Alberta Treasury Branches, was named chair of an ad-hoc management committee of the Board to oversee operations as the interim head of the organization until a permanent successor to Mr. Sarwat can be named. A search committee composed of Board members was formed to oversee the search process and make appropriate recommendations to the Board.

Finally, on behalf of the Board, I thank Mr. Sarwat for his hard work and dedication in putting together a strong organization that is well positioned for the successful fulfillment of PSP Investments' mandate. We also wish to express our confidence in the first-rate team of managers and employees that remains in place. Every effort will be made to ensure a smooth transition and the continuation of business as usual, as we strive to take the organization to the next level.

ACKNOWLEDGEMENTS

I should also like to take this opportunity to express my gratitude to fellow members of the PSP Investments' Board of Directors for their wise counsel and support over the course of the past year. Special thanks are owed two directors who left the Board at the end of fiscal year 2003. They are William R.C. (Bill) Blundell — who, as the organization's first Chairperson, has played such a pivotal role in its development — and Donna Soble Kaufman, who provided important leadership in her role as Chair of the Governance Committee. We very much regret the passing in July 2002 of Jean-Louis Bourbeau, who had been a valuable member of our Board since its inception. His perception and experience added wisdom and expertise that are greatly missed.

We welcome two new directors who were named to the Board, effective April 8, 2003. They are Jean E. Douville and Carol Hansell. Mr. Douville, of Montréal, is a chartered accountant and former President of Schroders Ventures Canada. Mrs. Hansell is a senior partner with Davies Ward Phillips & Vineberg LLP in Toronto, specializing in commercial and securities law.

On behalf of the entire Board, I would like to thank the staff of PSP Investments for their resourcefulness and dedication during a challenging and eventful year. They are the ones who convert strategy into meaningful action to further the interests of the plan sponsors, contributors and beneficiaries.

PRIORITIES GOING FORWARD:

Stakeholders may rest assured that the Board of Directors is committed to providing sound investment management within a framework of solid governance, enabling PSP Investments to carry out its responsibilities in an innovative yet disciplined manner that reflects changing market conditions while avoiding undue risk.

Our priorities for fiscal year 2004 include:

- Working with a new Chief Executive Officer to ensure a smooth transition and renewed momentum in terms of strategic direction;
- Overseeing the development of strategies for investments in new asset classes designed to enhance PSP Investments' ability to generate value-added returns and deliver on its performance objectives; and
- Establishing a comprehensive risk management system that will build on the safeguards already in place in order to better understand and optimize aggregate risk.

Paul Cantor
Chairperson

Report from Management

Fiscal year 2003 can best be characterized as a difficult period for Canadian pension funds, including the funds managed by the Public Sector Pension Investment Board (PSP Investments). Virtually all major equity markets worldwide ended sharply lower. PSP Investments recorded a loss of $933 million and a rate of return of (13.5)% for the 12 months ended March 31, 2003. Consolidated net assets as of the fiscal 2003 year-end were $8.1 billion at market value, compared with $5.6 billion a year earlier.

ACTIVE INVESTMENT MANAGEMENT ACCELERATED

Over the course of the year, we accelerated the implementation of active investment management with a view to maximizing returns. Active management began in fiscal year 2002, with $1.8 billion of assets — $600 million of equities in October 2001 and $1.2 billion of fixed income assets in February 2002. Over the course of fiscal year 2003, another $2.2 billion of Canadian, U.S. and foreign equities was brought under active management, bringing the total to approximately $4.0 billion as of March 31, 2003. That translates to 48.5% of all assets under management, compared with 31.4% a year earlier.

PSP Investments' assets are managed by eight external fund managers (including one passive fund manager) and four internal fund managers. Our internal asset management team was further strengthened with the recruitment of an additional equity manager during fiscal year 2003 and we completed our hiring of outside managers for equity investments. As well, for both internal and external managers, we began following Proxy Voting Guidelines that were adopted in the fourth quarter of fiscal year 2002.

ENHANCED CHECKS AND BALANCES

The organization also made good on its commitments to establish a full fledged Investment Risk Measurement function during fiscal year 2003, and to implement an Internal Audit function. As well, there was a continued focus on prudent management of expenses and strict adherence to budgets.

The Risk Measurement system — which employs advanced information technology and specialized software — represents a significant step in the on-going implementation and enhancement of PSP Investments' high-level risk management strategy. Having the capability to measure inherent risks within each portfolio, as well as those associated with the overall asset pool, will enable us to be more tactical in terms of controlling volatility and optimizing investment risks. The Risk Measurement system also forms an integral part of the platform required for the establishment of a full-fledged, comprehensive risk management system. This final step in the deployment of our risk management strategy is a top priority for the new fiscal year 2004.

OPERATIONAL SET-UP COMPLETED

Considerable progress was made during fiscal year 2003 in terms of establishing and implementing key systems and procedures that will enable PSP Investments to move forward in pursuit of its long-term performance goals. On the administrative side, staffing of the various operational areas was largely completed, a portfolio administration system and a performance measurement system were implemented and additions to the technology infrastructure — including a disaster-recovery plan and other security measures — were put in place. Appropriate procedures were developed for all areas of operations and new Human Resources tools were deployed.

The Board of Directors approved a number of policies (for example, a Compensation Policy, a Training and Development Policy and a Harassment Policy) that served as the basis for management to develop control procedures in various areas of operations, including Human Resources, Finance and Control, Performance Measurement and Portfolio Administration, to name a few.

KEY INITIATIVES FOR FISCAL YEAR 2004

A key initiative for fiscal year 2004 entails the development of the requisite strategy, systems and resources that will be required prior to the commencement of investments in private equities and real estate, in accordance with amendments to the asset mix policy approved by the Board of Directors. In terms of our approach to managing these new assets, the intent is to retain outside asset managers for real estate, complemented by an internal team to closely monitor performance. With regard to private equities, we will be setting up a small team that will be responsible for acquiring and managing appropriate funds in line with PSP Investments' goals and objectives. It is envisioned that, over time, each of the new asset classes will come to represent up to 5% of total assets.

Special emphasis will be placed on compliance in order to ensure that PSP Investments maintains rigorous controls as it introduces new asset classes and adds the additional staff required to manage and administer them.

The relocation of PSP Investments' principal business office to the 20th floor of our current address, 1250 René-Lévesque Boulevard West in Montréal, was successfully completed during the first quarter of fiscal year 2004.

POSITIONED TO ADD VALUE

With most of the requisite structure and systems now in place, the Board's approval of changes to the investment policy that reflect the current environment and our focus on risk management, PSP Investments has evolved to a point where it is set to add value as we move forward.

ACKNOWLEDGEMENTS

In conclusion, management wishes to express its appreciation to employees for their unstinting commitment and contributions throughout fiscal year 2003.

Fiscal Year 2003 Results

The Public Sector Pension Investment Board (PSP Investments) completed its third year of operation on March 31, 2003. During that period, it received $3.4 billion in net contributions from the Public Service, Canadian Forces and Royal Canadian Mounted Police pension funds. Cash inflows of varying amounts were received several times a month and invested as soon as possible in a policy neutral manner. On a consolidated basis at the fiscal 2003 year-end, 39.0% of assets were invested in Canadian Equities, 25.7% in Foreign Equities and 35.3% in Canadian Fixed Income securities. The market value of invested assets as of March 31, 2003 totalled $8.1 billion, compared with $5.6 billion a year earlier.

MARKET PERFORMANCE

Anticipated events, good or bad, usually are reflected quickly in stock and bond prices. However, prolonged and complex uncertainties present problems for the marketplace, leading to increased volatility: stocks are rewarded or punished disproportionately. Such was the case in the past year, during which the buildup to the war in Iraq intensified, corporate scandals on Wall Street continued and higher energy costs impacted consumer confidence and manufacturing costs. Buffeted by uncertainties, the markets experienced strong rallies punctuated by equally sharp corrections.

The U.S. economy — the primary driver of the world's economic wealth — languished and, in early October 2002, North American equity markets hit five-year lows. However, the overall Canadian economy outperformed that of most industrialized countries in 2002. As a result, Canadian equity markets were hit less hard than others. European equity markets suffered their biggest sell-off in 60 years. Corporate profits declined, reflecting both the economic slowdown and the appreciation of the euro against the U.S. dollar and the Japanese yen, which is eroding the competitiveness of European products and further pushing down profit expectations. Meanwhile, the Japanese stock market continued to decline, with indices reaching their lowest level in almost 20 years.

On the interest-rate front, U.S. monetary policy combined with a lack of inflation brought rates to a 40-year low: at fiscal-year's end, the Federal Reserve's discount rate stood at 1.25%. In Canada, the stronger economy was accompanied by an increase in inflation, prompting the Bank of Canada to increase its rate by 1.25% over the course of fiscal year 2003, to end at 3.25%.

The Canadian equity market ended the fiscal year with a (17.6)% return for the S&P/TSX Composite Index. However, foreign markets fared worse, generating returns (in Canadian dollars) for fiscal year 2003 of (30.6)% for the Standard and Poor's 500 Index and (29.2)% for MSCI EAFE Index. The Canadian fixed income market performed better, with the Scotia Capital Bond Universe Index generating a 9.2% return.

INVESTMENT RESULTS

In fiscal year 2003, the consolidated plan account produced a loss of $920.0 million before expenses. This compared with an income of $146.8 million in fiscal year 2002.

PERFORMANCE MEASUREMENT AND EVALUATION

Rigorous performance measurement is an essential tool for management to evaluate its internal and external managers. It is also the tool used by the Board of Directors and other stakeholders to evaluate the performance of PSP Investments.

BENCHMARKS

- Each asset class has a benchmark defined in PSP Investments' Statement of Investment Policies, Standards and Procedures (SIP&P);
- The rate of return for each asset class is compared against the relevant benchmark rate of return;
- A combined Policy Benchmark has been created from the asset class benchmarks and asset class weights established in the SIP&P. The Policy Benchmark is rebalanced at the end of each month;
- The total fund return is compared to the Policy Benchmark return.

RATES OF RETURN

The rate of return for the consolidated pension plan account in fiscal year 2003 was (13.5)%, reflecting the market conditions noted above and resulting from a (18.6)% rate of return for Canadian equities, a (30.5)% rate of return for foreign equities, a 9.4% rate of return for fixed income, and a 3.2% rate of return for cash equivalents.

This compares to a rate of return of (12.9)% for PSP Investments' Policy Benchmark and a 2.7% rate of return recorded by PSP Investments in fiscal year 2002.

Rates of Return on Consolidated Pension Plan Account *(for fiscal year 2003)*

	Portfolio returns	*Benchmark returns*	
Canadian Equities	(18.6)%	(17.6)%	S&P/TSX
Foreign Equities	(30.5)%	(29.9)%	S&P 500 & MSCI EAFE*
Fixed Income	9.4%	9.2%	SC Bond Universe
Cash Equivalents	3.2%	2.7%	SC 91-day T-bill
Consolidated accounts	(13.5)%	(12.9)%	Policy Benchmark**

These are time-weighted rates of return, before fees and expenses, for the consolidation of the three pension plan accounts. They are calculated in accordance with the mandatory requirements set forth by AIMR*** and audited as such.

* In Canadian dollars, weighted by market capitalization.
** Based on weights in the Investment Policy. See Page 10.
*** Association for Investment Management and Research

The equities' underperformance stems from the fact that fund managers generally anticipated a faster economic recovery in this period of declining interest rates. In addition, unlike previous cycles, the decline in interest rates did not lead to rising equity markets. Most of the external active fund managers started managing money for PSP Investments during the second half of calendar year 2002. Although they had good results for calendar year 2002, they were weaker in the second half of the fiscal year, after having started managing assets for PSP Investments.

Returns and benchmarks for each pension plan account are presented in the Notes of their respective financial statements.

CHANGES IN NET ASSETS

The consolidated pension plan accounts began fiscal year 2003 with net assets of $5.6 billion at market value. Consolidated net contributions during the fiscal year added $3.4 billion. After factoring in the net loss from operations, consolidated net assets as of the fiscal 2003 year-end were $8.1 billion at market value.

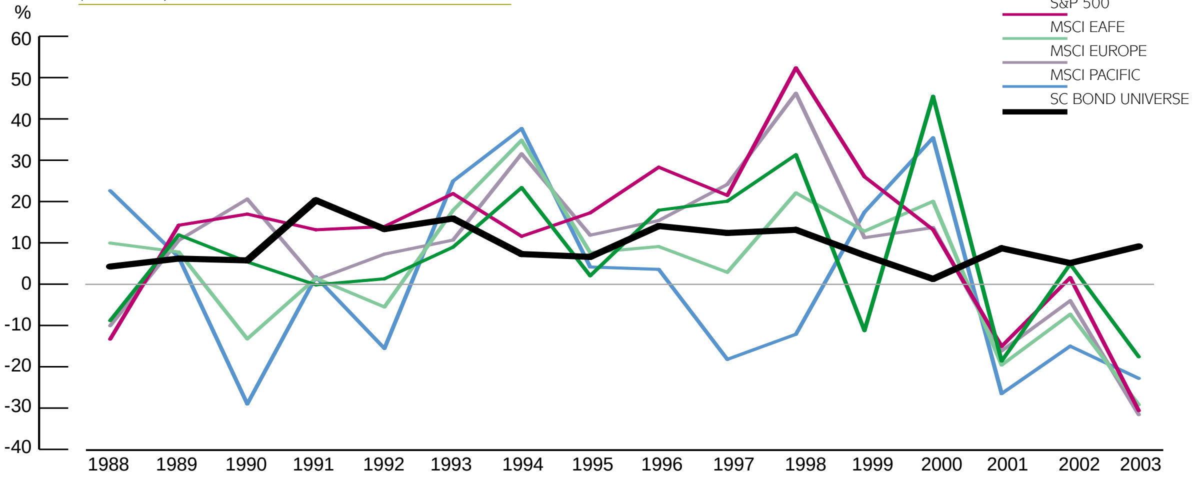
EXPENSES

The cost of operating PSP Investments during fiscal year 2003 totalled $13.0 million, compared to $7.3 million in fiscal year 2002. The higher costs can be attributed mainly to an increase in the number of employees and related office expenses, as well as external investment management fees.

Total expenses amounted to 0.21% of average assets — or 0.13% of average assets, when external investment management fees are excluded.Total expenses are expected to increase in fiscal year 2004. External investment management fees will see the largest increase, as a consequence of the expected growth in PSP Investments' assets and the higher portion of those assets that will be allocated to external active managers. Operating expenses will also be higher — and will increase slightly when expressed as a percentage of assets — reflecting the hiring of additional staff as well as ongoing maintenance costs and the amortization of the investment in new computer systems and fixed assets.

We remain vigilant about expenses and are committed to maintaining tight financial controls. PSP Investments' five-year plan targets a lower ratio of expenses to average assets, excluding external investment management fees. The magnitude of future fees and costs will depend on the nature of the new asset classes in which PSP Investments will invest.

Annual Index Returns
(In CAD $)



Investment Policy and Strategy

This section summarizes the statutory investment objectives of the Public Sector Pension Investment Board (PSP Investments) as well as the policy and strategy being utilized to achieve those objectives. Over the past year, there were several noteworthy changes to the strategy that reflected both new market realities and the Board of Director's continuing commitment to maximizing returns without undue risk of loss. A substantially increased proportion of assets was brought under active management and approval was given to commence investments in alternative asset classes. In addition, the Board adopted carefully defined new investment objectives.

STATUTORY INVESTMENT OBJECTIVES

The mission of PSP Investments, as set out in Section 4 of the *Act*, is straightforward:

- to manage funds in the best interests of contributors and beneficiaries of the Plans; and
- to maximize returns without undue risk of loss.

CONCRETE OBJECTIVES ADOPTED

To help ensure that investment strategy is properly aligned with the funding needs of the Plans, the Board of Directors, in March 2003, translated the overriding statutory objectives outlined above into concrete investment objectives, which were adopted as follows:

(1) Primary objective: Achieving a return (net of expenses) at least equal to the actuarial rate of return as determined by the Chief Actuary of Canada; and

(2) Secondary objective: Achieving a return exceeding the Policy Benchmark return by 0.50% (with a minimum value-added component equal to expenses).

Asset Mix Policy at Market Value *(for fiscal year 2003)*

	Target	*Range*	
Canadian Equities	35%	30%-40%	S&P/TSX
Foreign Equities	30%	25%-35%*	CUSTOMIZED**
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. Emerging markets will be included in the benchmark when investments are made in those markets. (EAFE is the MSCI Europe, Australasia and Far East Index).

ASSET MIX POLICY AMENDED

During fiscal year 2003, PSP Investments' assets continued to be managed in accordance with the long-term asset mix policy which, although reviewed annually, had essentially remained unchanged since February 2001. That policy provided for the assets to be invested as follows: 35% in Canadian equities; 30% in foreign equities (the maximum allowed pension funds under the *Income Tax Act*); 32% in Canadian fixed income vehicles; and 3% in cash equivalents.

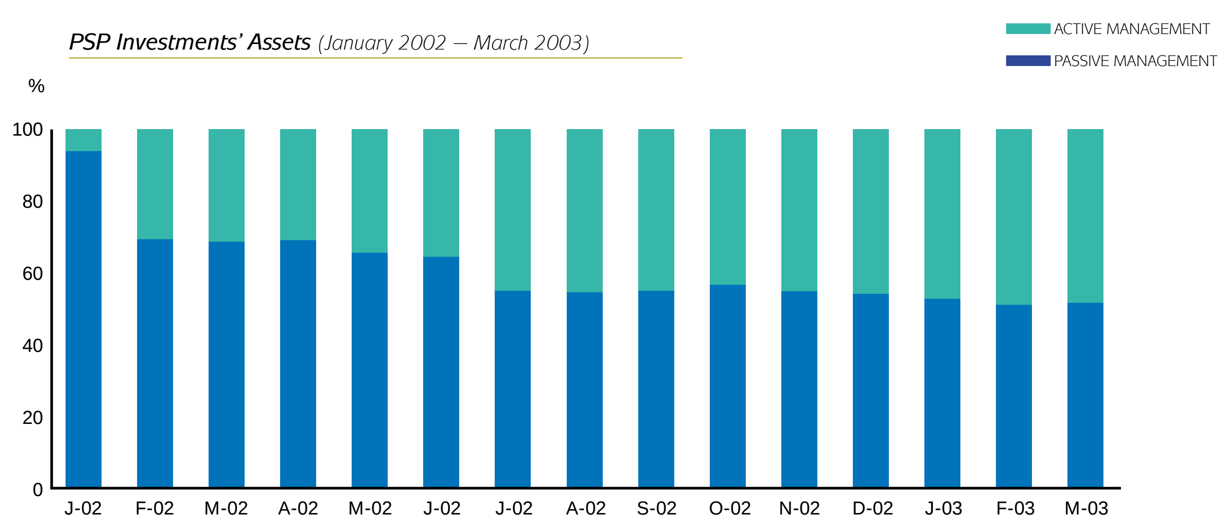
However, in the third quarter the Board approved changes to PSP Investments' strategy and long-term asset mix policy, authorizing a broadening of the total portfolio to include new asset classes. Development of strategies for investments in private equities and real estate will commence later in the new fiscal year. Other alternatives will also be considered going forward. Over time, each of the new asset classes will come to represent up to 5% of total assets. The move toward increased diversification reflects changing market realities — most notably the need to be less concentrated in public-equity markets — as well as the fact that PSP Investments has its internal structure largely in place and can meet the challenge represented by the new asset classes.

INCREASED USE OF ACTIVE INVESTMENT MANAGEMENT

During its first 18 months of operation, PSP Investments utilized so-called passive investment management. This entails replicating recognized market indices by purchasing shares and/or investing in Index funds that purchase shares — or other securities, as the case may be — in the same proportion in which they are represented in the relevant index. In October 2001, PSP Investments began implementing internally the active management of a portion of its assets as a means of maximizing returns. With active management, investment professionals can increase or reduce exposure to certain securities based on the perceived risk/return profile. The aim is to outperform the relevant market indices and thereby enhance PSP Investments' ability to maximize returns over time, without undue risk of loss.

A major step toward active management was taken in February 2002, with a mandate given to external fund managers involving $1.2 billion of fixed income assets. By the end of March 2002, $1.8 billion of fixed-income and equity assets were being actively managed. Over the course of fiscal year 2003, assets under active management increased to $4.0 billion — $1.5 billion in Canadian equities, $1.2 billion in foreign equities and $1.3 billion in fixed income assets. That equated to 48.5% of all assets under management as of March 31, 2003, up from 31.4% at the previous fiscal year-end.

PSP Investments' Assets *(January 2002 – March 2003)*



INVESTMENT RISK MANAGEMENT

With the advent of active investment management, PSP Investments also began implementing a multi-faceted system of checks and balances to limit the risks inherent in its investment activities.

The first step entailed strictly controlling both the overall percentage of assets allocated to active management and the amounts entrusted to individual managers. This was done in a manner that also reflects the degree of risk associated with the individual managers' styles. The second step, which was taken during fiscal year 2003, involved the establishment of a formal, in-house Investment Risk Measurement function, backed by the appropriate information systems and technological tools. This activity allows us to look at various measures of absolute and relative risks at the portfolio and total fund levels. During fiscal year 2004, armed with the data gleaned from the risk measurement system, the organization will take the final step in the deployment of its strategy by implementing a comprehensive risk management system.

Policies to manage other credit, market and financial risks have been in place since PSP Investments began operating. For instance, 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. Interest rate risks associated with fixed income investing are managed through diversification strategies, as is the currency risk implicit in foreign equities.

The Statement of Investment Policies, Standards and Procedures has recently been modified to permit the hedging of a portion of PSP Investments' foreign assets. Early in fiscal year 2004, PSP Investments began hedging 50% of the fair value of all US dollar denominated investments.

CASH FLOW AND REBALANCING

Over the course of fiscal year 2003, PSP Investments received $3.4 billion of new money to invest. This cash flow represented 60% of the total assets of $5.6 billion at the beginning of the fiscal year, April 1, 2002.

Cash flow is received several times a month in amounts ranging from relatively small sums to as much as $220 million. Consequently, clear policies and procedures for investing cash flows are an important consideration in the implementation of the overall investment policy.

On receipt of cash flow, it is immediately invested in all asset classes in such a manner that the resulting asset class weights are not disturbed by the cash flow.

Notwithstanding such procedures, there still will be a measurable (positive or negative) impact on performance stemming from the investment of new cash flows, given that PSP Investments is still in the early years of operation — with cash flow that is relatively large vis-à-vis assets. That is the main reason why the three pension plan accounts could generate slightly different returns.

The Board of Directors reviewed the cash flow allocation and rebalancing processes during the course of fiscal year 2003. In March 2003, it modified its investment policy in order to provide more flexibility to take advantage of market upturns. The portfolios are no longer rebalanced at fixed periods. Instead, they are allowed to fluctuate within set boundaries, with rebalancing essentially triggered by market movements.

Governance

Effective governance is essential in order to safeguard the capital entrusted to the Public Sector Pension Investment Board (PSP Investments) and to ensure that appropriate objectives are pursued and achieved in line with the fulfillment of its legislated mandate.

In this section of the annual report you will find pertinent information on the mandate itself, the role of the Board of Directors and key policies designed to guide the organization's activities and behaviour. New during the past fiscal year are specific Investment Objectives, a Policy on Communications and a Policy on Succession Planning for the Board of Directors.

INVESTMENT OBJECTIVES

Clearly defined investment objectives, designed to establish a linkage between the pension plans' funding liabilities and PSP Investments' returns, were adopted by the Board of Directors as follows:

(1) Primary objective: Achieving a return (net of expenses) at least equal to the actuarial rate of return as determined by the Chief Actuary of Canada; and

(2) Secondary objective: Achieving a return exceeding the Policy Benchmark return by 0.50% (with a minimum value-added component equal to expenses).

POLICY ON COMMUNICATIONS

PSP Investments has a responsibility to effectively manage all relevant communications between the organization and its stakeholders. The purpose of the Policy on Communications adopted by the Board of Directors during fiscal year 2003 is to ensure that:

- Effective communications are maintained between PSP Investments and its stakeholders;
- An appropriate communications plan is prepared annually by PSP Investments and approved by the Board of Directors;
- Issues facing PSP Investments are managed effectively from a communications perspective and key stakeholders are kept adequately informed regarding such issues;
- All communications are managed in a cost-effective, efficient and strategically appropriate manner;
- All communications are conducted in such a way as to foster openness and transparency between PSP Investments and its stakeholders; and
- All communications are conducted in the two official languages of Canada, utilizing clear and concise language.

SUCCESSION PLANNING

Sound principles of corporate governance require that organizations engage in succession planning with respect to directors and officers. The objective is to minimize any disruptions that may flow from the retirement of a key individual, allow for a smooth transition and ensure continuity of knowledge in the enterprise. PSP Investments has put in place plans for the succession of both directors and officers.

Planning for succession to the position of Chairperson of PSP Investments' Board of Directors will normally include identifying likely candidates currently on the Board or on other boards and appointing a deputy or vice chairperson. PSP Investments recognizes that, under the *Public Sector Pension Investment Board Act*, the prerogative of appointing a replacement for the Chairperson is that of the Governor in Council. The succession planning strategy adopted by the Board of Directors in November 2002 in no way derogates from that prerogative. Rather, its objective is to provide as much assistance as possible to the President of the Treasury Board by preparing for contingencies in a responsible manner.

In pursuance of sound succession planning, the Board of Directors created the position of Vice-Chairperson and appointed Paul Cantor to that position in November 2002. At the end of March 2003, upon the retirement of William R.C. Blundell from the Board of Directors, Mr. Cantor was appointed by the Governor in Council to succeed him as Chairperson.

LEGISLATED MANDATE

The legislated mandate of the Public Sector Pension Investment Board (PSP Investments) is:

- 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 Plans . . . and the ability of those Plans to meet their financial obligations."

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

RELATIONSHIP TO 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 (RCMP) 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.

The President and CEO and the Chairperson meet once a year with the Advisory Committees of the Plans.

ACCOUNTABILITY AND REPORTING

PSP Investments' 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 PSP Investments' legislation and is required to table its annual report in Parliament. PSP Investments is 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. Annual meetings with the advisory committees of the three pension plans are also part of the rigorous reporting requirements.

SELECTION OF DIRECTORS

A Board of Directors comprised of 12 members, including the Chairperson, governs PSP Investments. The Governor in Council appoints all members 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. PSP Investments' legislation disqualifies as Directors, members of the Senate, the House of Commons and provincial legislatures, federal government employees and those entitled to benefits from the Plans. There is one vacancy at the Board level which will be filled in the course of the year. (A list of current Directors may be found on Page 50.)

Further information relative to the Directors may also be viewed on PSP Investments' Web site: **www.investpsp.ca** under About Us – Board of Directors.

DUTIES OF DIRECTORS

In order to ensure that legislated and regulatory objectives are fully met, the Board of Directors has defined its role to include, among other responsibilities, the following:

- Appointment of the President and Chief Executive Officer (CEO);
- Approval of a written Statement of Investment Policies, Standards and Procedures;
- Approval of strategies for achieving investment performance objectives;
- Adoption of appropriate policies for the proper conduct and management of PSP Investments, including a Code of Conduct, Conflict of Interest Procedures and risk management policy;
- Approval of human resources and compensation policies;
- Establishment of appropriate performance evaluation processes for the Board of Directors, the President and CEO and other members of senior management;
- Preparation and approval of quarterly and annual financial statements for each underlying pension plan account and for PSP Investments as a whole.

BOARD COMMITTEES

The Board of Directors has established the following four standing committees to assist in the fulfillment of its obligations:

- Investment Committee;
- Audit and Conflicts Committee;
- Governance Committee; and
- Human Resources and Compensation Committee.

Recommendations of Board committees are subject to the approval of the full Board.

The Investment Committee consists of the full Board. It has established a subcommittee composed of Board members with extensive investment experience to help shape the Investment Committee agenda.

The composition of the committees is set out on page 50 of this report.

Two ad-hoc committees, a Management Committee and a Search Committee, were established in March 2003, following the departure of the President and Chief Executive Officer.

Further information relative to PSP Investments' committees may be viewed on PSP Investments' Web site: **www.investpsp.ca** under Governance – Duties & Responsibilities.

DIRECTORS' COMPENSATION

Compensation for members of PSP Investments' Board of Directors is determined based on the median compensation received by directors of companies included in the S&P/TSE 60 comparative group. It was reviewed in fiscal year 2003 and will be reviewed every two to three years thereafter. Each Director receives a $16,000 annual retainer. Chairs of committees are paid an additional $5,000 annual retainer. A $1,000 per-meeting fee is paid for each Board and Board committee meeting attended. However, only a single fee is paid when Board and Investment Committee meetings are held concurrently. (The Board met eight times during fiscal year 2003 and held 19 committee meetings.) An additional annual retainer of $24,000 is paid to the Chairperson of the Board, who is also entitled to receive a fee for each Board meeting attended but not for any Committee meeting attended. Furthermore, to recognize the added impact on Board members who are not from central Canada, an additional fee of $1,000 is paid to Directors who attend a meeting in person if their primary residence is outside Quebec and Ontario.

The compensation paid to Directors during fiscal year 2003 is summarized in Note 8(a) to the financial statements of PSP Investments.

CONFLICT OF INTEREST PROCEDURES

The Conflict of Interest Procedures for Directors are intended to provide a workable process for identifying, minimizing and resolving potential conflicts of interest. They help ensure that Directors have a full understanding and appreciation of PSP Investments' principles and values to assist them in determining appropriate business practices and behaviour.

The Conflict of Interest Procedures address such matters as the requirement for full disclosure; how and when a conflict may arise; deemed conflicts of interest; the duty to refrain from voting where a conflict exists; the use and disclosure of confidential information and the duty to report breaches. The Audit and Conflicts Committee of the Board of Directors is responsible for monitoring the application of these procedures.

The Conflict of Interest Procedures may be viewed in their entirety on PSP Investments' Web site: **www.investpsp.ca** under Governance – Conflict of Interest Policy.

ASSESSMENT OF BOARD PERFORMANCE

The Regulations adopted under PSP Investments' governing legislation require that the Board of Directors set out in the annual report the procedures in place for the assessment of its own performance. A formal performance evaluation policy, adopted in accordance with those requirements, focuses on procedures designed to encourage frank and confidential discussions between the Chairperson and individual Directors, as well as between the Chairperson and the President and CEO of PSP Investments. To facilitate the assessment process, guidelines for evaluating the Board of Directors' performance are distributed once a year to every Director as well as to the President and CEO. The guidelines take the form of a questionnaire. Directors submit their completed questionnaires to the Chairperson, who utilizes the feedback during subsequent one-on-one consultations with individual Directors and with the President and CEO. The discussions focus on concerns and opportunities for improvement, what is working properly or has improved since previous assessments. The outcome of these meetings is reviewed with the Governance Committee, following which a report summarizing the findings of the assessment process — complete with appropriate recommendations — is submitted to the full Board of Directors.

CODE OF CONDUCT

In accordance with its governing legislation, PSP Investments has a Code of Conduct for officers and employees. As well as ensuring stringent compliance with the relevant statutory requirements, the Code serves as a framework that provides officers and employees with a full understanding of the organization's 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 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. As well, PSP Investments maintains a restricted list of securities of which the organization has confidential knowledge. Officers and employees are prohibited from trading in securities on the restricted list.

The Audit and Conflicts Committee is responsible for monitoring the implementation and enforcement of the Code.

The Code of Conduct may be viewed on PSP Investments' Web site: **www.investpsp.ca** under Governance – Code of Conduct.

PROXY VOTING GUIDELINES

The Proxy Voting Guidelines are designed to ensure that shares beneficially owned by PSP Investments will be voted in accordance with its investment policy and objectives.

The Guidelines stipulate that PSP Investments will be mindful of best corporate governance principles when considering the merits of an issue and will exercise its voting rights with a view to maximizing the value of its shareholdings. The Guidelines focus on four areas considered crucial in terms of their potential impact on performance:

- the independence, size and effectiveness of a company's board of directors;
- management and directors' compensation, including stock options and incentive compensation plans;
- takeover protection; and
- shareholder rights.

The Guidelines apply equally to securities managed internally and those held in portfolios managed for PSP Investments by external managers.

The Proxy Voting Guidelines may be viewed on PSP Investments' Web site: **www.investpsp.ca** under Investments – Proxy Voting Guidelines.

POLICY ON SOCIAL AND ENVIRONMENTAL RESPONSIBILITY

The primary responsibility of PSP Investments is to provide for the financial benefit of contributors and beneficiaries of the three pension plans from which it receives funds and to support the fulfillment of the pension promise explicit in those plans. That responsibility notwithstanding, the Policy on Social and Environmental Responsibility states that "the environmental and social impact of the behaviour of corporations…may be one of a number of relevant factors that our investment professionals would wish to take into account in making investment decisions for the Plans".

The Policy on Social and Environmental Responsibility may be viewed on PSP Investments' Web site: **www.investpsp.ca** under Investments – Policy on Social & Environmental Responsibility.

Glossary

A

Active Investment Management
Selecting individual investments or groups of investments with the goal of earning higher returns than the general market. Active investment management can also reduce portfolio risk.

AIMR Performance Standards
The Association for Investment Management and Research (AIMR) is an international, nonprofit organization of more than 50,000 investment practitioners and educators in over 100 countries. The investment performance standards of AIMR are ethical principles and guidelines that promote uniformity in reporting investment performance.

Annual Report
A publication that includes the audited financial statements of an organization as well as management's discussion and analysis (MD&A) of its financial results and operations. PSP Investments' annual report must be issued within 90 days of its March 31 year-end and tabled by the President of the Treasury Board in the House of Commons.

Annualized Rate of Return
A rate of return expressed over one year, although the actual rates of return being annualized are for periods longer or shorter than one year.

Asset Mix
The proportion of assets invested in cash, fixed income securities, equities and other asset classes. Asset mix should reflect an investor's investment goals and risk tolerance. As a rule, investors with long-term needs can tolerate the higher risk of equities compared to fixed income securities in the expectation of higher returns. Consequently, their asset mix may be weighted more heavily to equities.

Asset Mix Policy
The asset mix needed to achieve an expected level of investment returns. Pension funds set their asset mix policy to ensure that investment returns plus plan member contributions are sufficient to pay all current and future pension benefits. In making our investment decisions, we take into consideration the financial obligations of the three public sector pension funds for which PSP Investments invest money.

B

Basis Point
One-hundredth of a percentage point. The difference between 5.25 per cent and 5.50 per cent is 25 basis points.

Benchmark
A standard against which rates of return can be measured, such as stock and bond market indexes developed by stock exchanges and investment dealers.

C

Cash Equivalents
Short-term, highly liquid securities (e.g. commercial paper, treasury bills, demand notes) with a term to maturity of less than one year from the date of issue. These investments are relatively easy to convert into cash.

Cost (or Book Value)
The purchase price, or original cost, of an investment.

Custodian
An independent organization entrusted with holding investments on behalf of the owner. The custodian maintains the financial records for the investments and may perform other services for the owner as well.

D

Derivatives
Financial contracts that derive their value from an underlying asset or index, such as an interest rate or foreign currency exchange rate. For example, a derivative contract based on the S&P 500 Index of large U.S. stocks fluctuates in value with the index, but involves buying one contract rather than each stock in the index. Derivatives can be less expensive and easier to acquire than the underlying assets. They can be used to manage risk, reduce cost and enhance returns. Some common derivatives are forwards, futures, swaps and options.

Diversification
A strategy to spread investment risk among different asset classes (stocks and bonds), different types of assets (public and private equities), among securities (different stocks), among economic sectors (financial services and natural resources) and among different countries.

E

Equities
Financial instruments that represent an ownership interest in a corporation, as well as a claim to proportionate shares of that corporation's assets and earnings. Also known as a "stock".

F

Fair Value (or Market Value)
The most recent price at which a security transaction took place.

Fiscal Year
A company's accounting or financial reporting year. Our fiscal year commences April 1 and ends March 31.

Fixed Income Securities
Securities that generate a predictable stream of interest, such as bonds, mortgages, debentures and preferred shares by paying a fixed rate of return until date, maturity or redemption.

Foreign Currency Risk
The risk that an investment's value will be affected by changes in exchange rates. International investments cause investors to face the risk of currency fluctuations.

I

Index
A broad-based measurement of a general market trend. Called an index because it is designed to reflect not only price changes, but value changes as well.

Index Fund
An investment fund that closely replicates the return of a market index.

Investment Management Fee
A fee that the manager of a fund charges for managing the portfolio and operating the fund. The fee is usually set as a fixed percentage of the fund's net asset value.

M

MSCI EAFE Index
A stock index created by Morgan Stanley Capital Inc. (MSCI) to measure the returns of investments in Europe, Australasia and the Far East. It contains stocks from 21 countries, including Japan, Australia, Hong Kong, New Zealand, Singapore, the U.K. and the Euro zone countries.

P

Passive Investment Management
A strategy designed to replicate a market index return by gaining exposure to individual securities in proportions that closely resemble their composition in an underlying index.

Pension Plan Account (or Plan Account)
Separate account established by PSP Investments for each of the pension plan funds to receive the pension fund's net contributions as well as the allocation of its investments and the results of its operations. There are three (3) pension plan accounts, one for each pension plan fund.

Pension Plan Fund
Created effective April 1, 2000 by the federal government to receive the employer and employee contributions in respect of the pension plans to provide for liabilities for service after April 1, 2000. There are three (3) pension plan funds, one for each of the Public Service Pension Plan; the Canadian Forces Pension Plan and the Royal Canadian Mounted Police (RCMP) Pension Plan.

Pension Plans
The pension plans of the Federal Public Service, the Canadian Forces and the Royal Canadian Mounted Police.

Portfolio
A group of investments, such as equities and bonds and possibly financial instruments such as derivatives regrouped for investment purposes.

Proxy Voting Rights
Written authorization by a shareholder for someone else to represent them and vote their shares at a shareholders' meeting, generally under stipulated guidelines or conditions.

R

Return (or Rate of Return)
The percentage change in assets in a particular period, consisting of income (such as interest, dividends or rent), plus realized and unrealized capital gains or capital losses.

Risk
The future chance or probability of loss in relative (that is, versus a benchmark) or absolute terms.

S

Scotia Capital Debt Market Indices
A series of indices created and maintained by Scotia Capital to measure the performance of Canadian bond and money markets. The **Universe Index** includes all marketable Canadian bonds with a term to maturity greater than one year, and is a broad measure of the performance of the Canadian bond market. The **91-Day T-Bill Index** is one of a number of money market indices maintained by Scotia Capital.

Social Investing
An investment process that uses screens to select or avoid investing in certain companies or industries to reflect religious, economic, political, social or personal priorities.

S&P/TSX Composite Index
The most diversified Canadian market index representing almost 90 per cent of the capitalization of Canadian-based companies listed on the TSX. A committee of the Toronto Stock Exchange and Standard and Poor's selects companies for inclusion in the S&P/TSX Composite Index.

Standard and Poor's 500 Composite Index (S&P 500 Index)
A U.S. index consisting of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The Standard & Poor's Company selects stocks for inclusion in the index.

Statement of Investment Policies, Standards and Procedures (or Investment Policy)
A written investment policy approved by the Board of Directors, and reviewed at least annually, relating to each pension plan fund. This is a requirement under paragraph 7(2) (a) of the Act. It addresses matter such as categories of investments; use of derivatives products; asset diversification and expected investment returns; management of credit, market and other financial risks; liquidity of investments; lending of cash and securities; evaluation of investments that are not regularly traded on a public exchange; and the exercise of any voting rights that PSP Investments has through its investments.

T

Time-Weighted Rate of Return
A return calculation methodology that eliminates the impact of cash flows into (or out of) a portfolio. This methodology recognizes the fact that managers have no control over the size and timing of cash flows.

CORPORATE DIRECTORY

Board of Directors and Investment Committee

(As at April 8, 2003)

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National Director, Social and Economic Policy
Canadian Labour Congress
Ottawa, Ontario

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Vice-President
Spartan Systems Limited
Saint John, New Brunswick

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Former President and CEO
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Montréal, Québec

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President and Chief Executive Officer
Princeton Developments Limited
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Vice President, Corporate Services and Chief Financial Officer
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Halifax, Nova Scotia

KEITH G. MARTELL, CA
Chairman of the Board
First Nations Bank of Canada
Saskatoon, Saskatchewan

CARL H. OTTO, CFA
President and CEO
IFPT Management Inc.
Montréal, Québec

SUSAN SHERK
Senior Human Environment Consultant
AMEC Plc
St.John's, Newfoundland and Labrador

CORPORATE DIRECTORY

Committees

(As at April 8, 2003)

The Audit and Conflicts Committee
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BARBARA BENDER
JEAN E. DOUVILLE
LYNN LOEWEN

The Governance Committee
LYNN LOEWEN, Chair
BOB BALDWIN
CAROL HANSELL
CARL H. OTTO

The Human Resources and Compensation Committee
BOB BALDWIN, Chair
RICHARD BRADSHAW
SUSAN SHERK

The Management Committee
PAUL G. HAGGIS, Chair

CORPORATE DIRECTORY

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