

## **AUDITORS' REPORT**

To the President of the Treasury Board

We have audited the Balance Sheet of the Public Sector Pension Investment Board – Public Service Pension Plan Account (the “Public Service Pension Plan Account”) as at March 31, 2006 and the Statements of Net Income and Accumulated Net Income from Operations and of Changes in Net Assets for the year then ended. These financial statements are the responsibility of the Public Sector Pension Investment Board’s (“PSP Investments”) management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Public Service Pension Plan Account as at March 31, 2006 and the results of its operations and of changes in its net assets for the year then ended in accordance with Canadian generally accepted accounting principles. As required by the *Financial Administration Act*, we report that, in our opinion, these principles have been applied on a basis consistent with that of the preceding year.

Further, in our opinion, the transactions of the Public Service Pension Plan Account that have come to our notice during our audit of the financial statements have, in all significant respects, been in accordance with the applicable provisions of Part X of the *Financial Administration Act* and, as appropriate, the *Public Sector Pension Investment Board Act* (the “Act”) and regulations and the by-laws of PSP Investments.

*Deloitte & Touche LLP*

Chartered Accountants  
Toronto, Ontario  
April 28, 2006

**BALANCE SHEET**

As at March 31, 2006

(\$000's)	2006	2005
<b>ASSETS</b>		
Investments (Note 2)	\$20,268,133	\$13,977,850
Other assets (Note 3)	2,600	1,659
Due from the Canadian Forces Pension Plan Account (Note 6a)	3,124	2,071
Due from the Royal Canadian Mounted Police Pension Plan Account (Note 6a)	1,111	737
<b>TOTAL ASSETS</b>	<b>\$20,274,968</b>	<b>\$13,982,317</b>
<b>LIABILITIES</b>		
Investment-related liabilities (Note 2)	253,502	-
Accounts payable and accrued liabilities	24,977	7,047
	278,479	7,047
<b>NET ASSETS</b>	<b>\$19,996,489</b>	<b>\$13,975,270</b>
Accumulated net income from operations	\$ 4,892,175	\$ 1,958,743
Accumulated fund transfers	15,104,314	12,016,527
<b>NET ASSETS</b>	<b>\$19,996,489</b>	<b>\$13,975,270</b>

On behalf of the Board of Directors:



Lynn Loewen

Director and Chair of the Audit and Conflicts Committee

**STATEMENT OF NET INCOME AND ACCUMULATED NET INCOME FROM OPERATIONS**

For the year ended March 31, 2006

(\$000's)	2006	2005
<b>INVESTMENT INCOME</b>		
Interest and dividends	\$ 432,264	\$ 318,723
Net realized gains	1,734,154	302,983
Change in unrealized appreciation in value of investments	824,174	347,772
	2,990,592	969,478
<b>EXPENSES</b>		
Operating expenses (Note 6b)	28,346	14,905
External investment management fees	28,814	10,311
	57,160	25,216
<b>NET INCOME FROM OPERATIONS</b>	<b>2,933,432</b>	<b>944,262</b>
Accumulated net income from operations, beginning of year	1,958,743	1,014,481
Accumulated net income from operations, end of year	\$ 4,892,175	\$ 1,958,743

**STATEMENT OF CHANGES IN NET ASSETS**

For the year ended March 31, 2006

(\$000's)	2006	2005
<b>NET ASSETS, BEGINNING OF YEAR</b>	<b>\$13,975,270</b>	<b>\$10,205,922</b>
Fund transfers (Note 4)	3,087,787	2,825,086
Net income from operations	2,933,432	944,262
Increase in net assets for the year	6,021,219	3,769,348
<b>NET ASSETS, END OF YEAR</b>	<b>\$19,996,489</b>	<b>\$13,975,270</b>

**NOTES TO THE FINANCIAL STATEMENTS**

For the year ended March 31, 2006

**ORGANIZATION**

The Public Sector Pension Investment Board ("PSP Investments") was formed pursuant to the *Public Sector Pension Investment Board Act* (the "Act") with a mandate to invest the contributions of the Public Service, Canadian Forces and Royal Canadian Mounted Police pension plans in financial markets.

The Public Service pension fund was established by amendments to the *Public Service Superannuation Act*, to receive contributions and make benefit payments in respect of member service after April 1, 2000. The excess of contributions over benefits is transferred, by the Public Service pension fund, to PSP Investments – Public Service Pension Plan Account for investment. PSP Investments maintains records of the pension fund's net contributions, as well as the allocation of its investments and the results of its operations in each of the plan accounts.

PSP Investments is responsible for managing amounts that are transferred to it in the best interests of the beneficiaries and contributors under the *Public Service Superannuation Act*. The amounts are to be invested with a view of achieving a maximum rate of return, without undue risk of loss, with regards to the funding, policies and requirements of the pension plan established under the *Public Service Superannuation Act*.

**1 Summary of Significant Accounting Policies**

**Basis of Presentation**

These financial statements present the financial position and operations of PSP Investments and its wholly-owned subsidiaries as they pertain to the investment of the excess funds transferred to it from the Public Service fund. Accordingly, they do not reflect all of the assets, or the details of the pension contributions, payments and liabilities of the Public Service pension fund. The statements have been prepared in accordance with Canadian generally accepted accounting principles and the requirements of the *Act*.

The financial statement presentation has been changed from the prior year's presentation. References to the "PSP Funds" have been eliminated in the current year's presentation. Whereas prior years' financial statements presented a statement of investment portfolio holding unit interests in the "PSP Funds", this has been replaced by Note 2(a), an investment portfolio depicting the effective asset class holdings and maintaining the respective fair value and cost of the underlying investments held by PSP Investments.

Comparative figures have been re-classified to conform to the current year's presentation.

**Valuation of Investments**

Investments for each asset class are recorded as of the trade date and are stated at fair value. Fair value is an estimate of the amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act. Fair value of investments in pooled funds is based on unit values, which reflect the quoted market prices or other generally accepted pricing methodologies for the underlying securities.

**Income Recognition**

The investment income has been allocated proportionately based on the asset value held by the Public Service Pension Plan Account.

Investment income is recorded on the accrual basis and represents realized gains and losses on the disposal of investments, change in unrealized appreciation (depreciation) on investments held at the end of the year, interest income and dividends, and net operating income from private market real estate investments. These income items include the related distributions from pooled funds and limited partnerships.

## NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2006

### 1 Summary of Significant Accounting Policies (continued)

#### Translation of Foreign Currencies

Transactions in foreign currencies are recorded at the rates of exchange on the transaction date. Investments denominated in foreign currencies and held at the end of the year are translated at exchange rates in effect at the year-end date. The resulting realized and unrealized gains and losses on foreign exchange are included in investment income.

#### Fund Transfers

Amounts received from the Public Service pension fund are recorded on a cash basis.

#### Use of Estimates

In preparing these financial statements, management must make certain estimates and assumptions which can affect the reported values of assets and liabilities, related income and expenses and note disclosures. Actual results may differ from estimates.

### 2 Investments

#### (a) Investment Portfolio

The investment portfolio, as at March 31, is as follows:

ASSET CLASS	2006		2005	
	FAIR VALUE	COST	FAIR VALUE	COST
<b>Developed World Equity</b>				
Canadian Equity	\$6,767,034	\$5,832,659	\$5,598,409	\$4,637,602
US Large Cap Equity	1,895,296	1,754,068	1,670,120	1,654,927
EAFE Large Cap Equity	2,329,008	1,883,006	1,808,483	1,661,467
<b>Small Cap Developed World Equity</b>	1,452,710	1,315,588	75,906	67,918
<b>Emerging Markets Equity</b>	1,406,870	1,104,398	255,498	259,480
<b>Private Equity</b>	218,169	221,872	2,151	2,599
<b>Nominal Fixed Income</b>				
Cash Equivalents	284,402	284,402	316,115	316,115
Canadian Fixed Income	3,794,447	3,844,078	3,711,173	3,668,364
<b>Real Return Assets</b>				
World Inflation-linked Bonds	305,005	278,690	158,399	150,390
Real Estate	1,399,758	1,345,554	309,616	307,744
<b>Absolute Return</b>	415,434	401,894	71,980	73,494
<b>INVESTMENTS</b>	<b>\$20,268,133</b>	<b>\$18,266,209</b>	<b>\$13,977,850</b>	<b>\$12,800,100</b>
Investment-related liabilities (Note 7)	(253,502)	(253,502)	-	-
<b>NET INVESTMENTS</b>	<b>\$20,014,631</b>	<b>\$18,012,707</b>	<b>\$13,977,850</b>	<b>\$12,800,100</b>

World Government Bonds and Infrastructure were introduced as asset classes during the current fiscal year and no investments have been made as at March 31, 2006.

Direct investments, derivative contracts, and investment-related receivables and liabilities are classified by asset-mix category based on the intent of the investment strategies of PSP Investments. In addition to the different asset classes outlined in the asset mix policy, PSP Investments employs a number of absolute return strategies.

## NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2006

### 2 Investments (continued)

#### (b) Investment Asset Mix

PSP Investments has established a Statement of Investment Policies, Standards and Procedures (the "SIP&P"). The SIP&P sets out the manner in which the assets shall be invested for the three plan accounts. During the course of the year, PSP Investments modified its asset mix policy.

The investment asset mix, as set out in the SIP&P as at March 31, is as follows:

	2006		2005	
	ACTUAL ASSET MIX	POLICY PORTFOLIO	ACTUAL ASSET MIX	POLICY PORTFOLIO
<b>Equities</b>	70.2%	62.0%	67.3%	63.0%
<b>Fixed Income</b>	22.4	15.0	29.4	22.0
<b>Real Return Assets</b>	7.4	23.0	3.3	15.0
	100.0%	100.0%	100.0%	100.0%

Differences between the actual asset mix and the policy portfolio targets are due principally to target weights of certain asset classes which have yet to be attained. For instance, real return assets include real estate and infrastructure assets with policy portfolio target weights of 10% and 8%, respectively, and actual asset weights of only 7% and nil, respectively.

#### (c) Foreign Currency Risk

PSP Investments and its subsidiaries are exposed to currency risk through holdings of securities, units in pooled funds and units in limited partnerships of non-Canadian assets where investment values will fluctuate due to changes in foreign exchange rates. To mitigate this risk, PSP Investments may take, through derivative contracts, trading positions in foreign currencies.

The underlying net foreign currency exposures, as at March 31, were as follows:

CURRENCY (in Canadian \$)	2006		2005	
	FAIR VALUE (\$000'S)	% OF TOTAL	FAIR VALUE (\$000'S)	% OF TOTAL
US Dollar	\$4,201,445	57.0%	\$1,984,909	49.8%
Euro	1,140,725	15.4	691,634	17.3
Yen	669,089	9.1	358,723	9.0
British Pound	487,024	6.6	376,349	9.4
Other	878,768	11.9	576,948	14.5
	<b>\$7,377,051</b>	<b>100.0%</b>	<b>\$3,988,563</b>	<b>100.0%</b>

### 3 Other Assets

Other assets, as at March 31, consist of the following:

(\$000's)	2006	2005
Fixed assets	\$2,522	\$1,623
Other assets	78	36
	<b>\$2,600</b>	<b>\$1,659</b>

**NOTES TO THE FINANCIAL STATEMENTS**

For the year ended March 31, 2006

**4 Fund Transfers**

During the year, PSP Investments received fund transfers of \$3,088 million (2005 – \$2,825 million) from the Public Service pension fund. The transfers received are comprised of net current employer and employee contributions to the Public Service pension plan.

**5 Investment Performance**

Portfolio and benchmark returns, for the year ended March 31, are as follows:

	2006		2005	
	PORTFOLIO RETURNS	BENCHMARK RETURNS	PORTFOLIO RETURNS	BENCHMARK RETURNS
<b>Developed World Equity</b>				
Canadian Equity	28.8%	28.7%	15.6%	13.9%
US Large Cap Equity	9.5%	7.7%	(0.6)%	(1.8)%
EAFE Large Cap Equity	20.8%	20.0%	4.3%	5.9%
<b>Small Cap Developed World</b>	18.6%	19.3%	n.a.	n.a.
<b>Emerging Markets Equity</b>	39.6%	42.6%	n.a.	n.a.
<b>Private Equity</b>	0.6%	n.a.	(33.8)%	n.a.
<b>Nominal Fixed Income</b>				
Cash Equivalents	2.7%	2.8%	2.9%	2.2%
Canadian Fixed Income	4.7%	4.9%	5.0%	5.0%
<b>Real Return Assets</b>				
World Inflation-linked Bonds	10.9%	11.8%	8.8%	9.2%
Real Estate	21.6%	8.3%	7.9%	6.7%
<b>Total Return</b>	19.1%	18.0%	7.9%	7.2%

Returns have been calculated in accordance with the performance calculation methodology recommended by the CFA Institute. Returns are presented gross of expenses.

PSP Investments has identified relevant benchmarking for each asset class. The asset class benchmark returns are used in evaluating the relative performance of each asset class.

The total benchmark return aggregates the asset class benchmark returns according to the weights under the actual asset mix. The return of the private equity asset class is not being measured against any benchmark during the ramp-up period as disclosed in PSP Investments' SIP&P. However, for purposes of calculating the total 2006 and 2005 benchmark returns, the actual private equity portfolio returns of 0.6% and (33.8)%, respectively, are used.

The total portfolio returns includes the performance impact of absolute return strategies. Hedging investment returns have been netted against respective hedged assets.

**NOTES TO THE FINANCIAL STATEMENTS**

For the year ended March 31, 2006

**6 Expenses**

**(a) Allocation of Expenses**

The Act requires that the costs of operation of PSP Investments be charged to the three plans for which it provides investment services. Under section 4(3) of the Act, the president of the Treasury Board shall determine to which plan account these costs will be charged, in consultation with the Minister of National Defence and the Minister of Public Safety. An allocation policy has been developed which allocates the direct costs of investment activities, such as external investment management fees and custodial fees, to each plan account, and allocates, on a quarterly basis, operating expenses excluding custodial fees, based upon the asset value of each plan account.

Operating expenses, excluding custodial fees, have been allocated as follows:

	2006	2005
Public Service Pension Plan Account	72.2%	71.7%
Canadian Forces Pension Plan Account	20.5	20.9
Royal Canadian Mounted Police Pension Plan Account	7.3	7.4
	100.0%	100.0%

Expenses are financed by the Public Service Pension Plan Account, which is reimbursed by the other plan accounts on a quarterly basis.

**(b) Operating Expenses**

Operating expenses allocated to this plan account consist of the following:

(\$000's)	2006	2005
Salaries and benefits	\$16,328	\$7,579
General operating expenses	8,042	5,142
Professional and consulting fees	3,976	2,184
	\$28,346	\$14,905

Further details of operating expenses are shown in the PSP Investments' financial statements.

**7 PSP Capital Inc.**

As of March 31, 2006, PSP Capital Inc., a wholly-owned subsidiary of PSP Investments, has \$350 million of short-term promissory notes outstanding with maturity dates within 60 to 90 days of issuance of which \$253 million has been allocated to the Public Service Pension Plan Account. The capital raised was used primarily to finance real estate investments.

The operating expenses incurred by PSP Capital Inc. were allocated to each plan account as described in Note 6 (a).