RESERVE FORCE PENSION PLAN ACCOUNT

INDEPENDENT AUDITORS' REPORT

To the Minister of National Defence

REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying financial statements of the Public Sector Pension Investment Board – Reserve Force Pension Plan Account (the Reserve Force Pension Plan Account), which comprise the balance sheet as at March 31, 2011, and the statement of net income from operations and comprehensive income and the statement of changes in net assets for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

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 comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Reserve Force Pension Plan Account as at March 31, 2011, and the results of its operations and changes in its net assets for the year then ended in accordance with Canadian generally accepted accounting principles.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

As required by the *Financial Administration Act,* we report that, in our opinion, Canadian generally accepted accounting principles have been applied on a basis consistent with that of the preceding year.

Further, in our opinion, the transactions of the Reserve Force 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 regulations, the *Public Sector Pension Investment Board Act* and regulations and the by-laws of PSP Investments and its wholly-owned subsidiaries.

Deloitte & Touche LLP[1]

[1] Chartered accountant auditor permit No. 18527

May 12, 2011
Montreal, Canada

Sheila Fraser

Sheila Fraser, FCA
Auditor General of Canada

May 12, 2011
Ottawa, Canada

BALANCE SHEET

As at March 31

($ thousands)	2011	2010
ASSETS		
Investments (Note 3 (a))	**$339,327**	$240,642
Investment-related assets (Note 3 (a))	**8,223**	4,012
Other assets	**85**	63
TOTAL ASSETS	**$347,635**	$244,717
LIABILITIES		
Investment-related liabilities (Note 3 (a))	**$ 24,008**	$ 13,529
Accounts payable and other liabilities	**139**	61
Due to the Public Service Pension Plan Account	**241**	114
TOTAL LIABILITIES	**$ 24,388**	$ 13,704
NET ASSETS	**$323,247**	$231,013
Accumulated net income from operations and comprehensive income	**$ 43,730**	$ 5,541
Accumulated fund transfers	**279,517**	225,472
NET ASSETS	**$323,247**	$231,013

Commitments (Note 11)

The accompanying notes are an integral part of the financial statements.

On behalf of the Board of Directors:

Paul Cantor
Chair of the Board

William A. MacKinnon
Chair of the Audit Committee

STATEMENT OF NET INCOME FROM OPERATIONS AND COMPREHENSIVE INCOME

For the years ended March 31

($ thousands)	2011	2010
INVESTMENT INCOME (Note 6)	$ 38,759	$ 31,854
OPERATING EXPENSES (Note 7)	$ 570	$ 315
NET INCOME FROM OPERATIONS AND COMPREHENSIVE INCOME	$ 38,189	$ 31,539

The accompanying notes are an integral part of the financial statements.

STATEMENT OF CHANGES IN NET ASSETS

For the years ended March 31

($ thousands)	2011	2010
NET ASSETS, BEGINNING OF YEAR	$231,013	$115,238
Fund transfers (Note 5)	54,045	84,236
Net income from operations and comprehensive income	38,189	31,539
Increase in net assets for the year	92,234	115,775
NET ASSETS, END OF YEAR	$323,247	$231,013

The accompanying notes are an integral part of the financial statements.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

ORGANIZATION

The Public Sector Pension Investment Board (PSP Investments) is a Crown corporation created under the *Public Sector Pension Investment Board Act* ("the Act") to manage and invest amounts that are transferred to it, under the *Superannuation Acts*, by the funds (as defined in the Act) of the pension plans established under the *Public Service Superannuation Act*, the *Canadian Forces Superannuation Act* (CFSA), the *Royal Canadian Mounted Police Superannuation Act* (collectively "the *Superannuation Acts*"), and certain regulations under the CFSA ("the CFSA Regulations"). The pension plans established under the *Superannuation Acts* consist of the Public Service pension plan, the Canadian Forces pension plan, and the Royal Canadian Mounted Police pension plan, whereas the pension plan established under the CFSA Regulations is the Reserve Force pension plan. They are herein referred to individually as "the Plan" and collectively as "the Plans".

The fund from which amounts are currently transferred to PSP Investments ("the Fund") relates to pension obligations under the Reserve Force pension plan for service on or after March 1, 2007. The account managed by PSP Investments for the Fund is herein referred to as "the Plan Account". PSP Investments maintains records of the Fund's net contributions, as well as the allocation of its investments and the results of its operations in the Plan Account.

PSP Investments is responsible for managing amounts that are transferred to it from the Fund in the best interests of the beneficiaries and contributors under the *Canadian Forces Superannuation Act*. The amounts are to be invested with a view of achieving a maximum rate of return, without undue risk of loss, having regard to the funding, policies and requirements of the *Canadian Forces Superannuation Act* and the Reserve Force pension plan's ability to meet its financial obligations.

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 net contributions transferred to it from the Fund in respect of member service after March 1, 2007. Accordingly, they do not reflect all of the assets or the details of the pension contributions, payments and liabilities of the Fund. The financial statements are prepared in accordance with Canadian generally accepted accounting principles (GAAP). PSP Investments qualifies as an Investment Company and therefore reports its investments at fair value, in accordance with Accounting Guideline 18, "Investment Companies" (AcG-18). All changes in fair value are included in investment income (loss) as net unrealized gains (losses).

Comparative figures have been reclassified to conform to the current year's presentation.

VALUATION OF INVESTMENTS

Investments, investment-related assets and investment-related liabilities are recorded as of the trade date (the date upon which the substantial risks and rewards are transferred) and are carried at fair value. Fair value is an estimate of the amount of consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

At trade date, the best evidence of fair value is the transaction price. At each subsequent reporting period-end, market prices are used to determine fair value where an active market exists (such as a recognized securities exchange), as they reflect actual and regularly occurring market transactions on an arm's length basis. If quoted market prices are not available, then fair values are estimated using present value or other valuation techniques, using inputs existing at the end of the reporting year that are derived from observable market data.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

VALUATION OF INVESTMENTS (continued)

Valuation techniques are generally applied to investments in the Private Equity, Real Estate and Infrastructure asset classes (collectively "Private Market Investments"), over-the-counter (OTC) derivatives as well as asset-backed term notes (ABTNs). The values derived from applying these techniques are impacted by the choice of valuation model and the underlying assumptions made concerning factors such as the amounts and timing of future cash flows, discount rates, volatility and credit risk. In certain cases, such assumptions are not supported by market observable data.

The valuation methods of each asset class are described in Notes 3 (a) and (b).

VALUATION OF CAPITAL DEBT FINANCING

PSP Investments' short-term capital debt financing is recorded at cost plus accrued interest, which approximate fair value. The fair value of PSP Investments' long-term capital debt financing is based on prices that are obtained from third-party pricing sources. It is measured using an interest rate curve with a spread consistent with PSP Investments' credit quality.

TRANSACTION COSTS

Transaction costs are incremental costs directly attributable to the acquisition, due diligence, issue, or disposal of a financial asset or financial liability. Transaction costs are expensed as incurred and recorded as a component of investment income (loss).

INVESTMENT MANAGEMENT FEES

Investment management fees are costs directly attributable to the external management of assets on behalf of PSP Investments. Investment management fees incurred for Private Market Investments are paid by the investment directly, through capital contributions by PSP Investments or offset against distributions received from the investment. Investment management fees are also incurred for certain public equity investments, and these amounts are paid either directly by PSP Investments or offset against distributions received from pooled fund investments. In both cases, they are recorded against investment income (loss).

INCOME RECOGNITION

The investment income (loss) has been allocated proportionately based on the asset value held by the Plan Account.

Investment income (loss) is made up of interest income, dividends, realized gains (losses) on the disposal of investments and unrealized gains (losses) which reflect the change in unrealized appreciation (depreciation) of investments held at the end of the year. Interest income is recognized as earned. Dividends are recognized on the ex-dividend date and are reflected as dividend income. Dividends paid or payable on securities sold short are reflected as dividend expense. Other income includes securities lending income (net of fees on securities borrowed), and Private Market Investments' distributions from pooled funds, limited partnerships or from direct investments and co-investments.

TRANSLATION OF FOREIGN CURRENCIES

Investment transactions in foreign currencies are recorded at exchange rates prevailing 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 period-end date. The resulting realized and unrealized gains (losses) on foreign exchange are included in investment income (loss).

FUND TRANSFERS

Amounts received from the Fund are recorded in the Plan Account.

INCOME TAXES

PSP Investments and the majority of its subsidiaries are exempt from Part I tax under paragraph 149(1)*(d)* of the *Income Tax Act* (Canada).

USE OF ESTIMATES

In preparing these financial statements, management makes certain estimates and assumptions which can affect the reported values of assets and liabilities, principally the valuation of Private Market Investments, ABTNs, OTC derivatives, related income and expenses and note disclosures. Although estimates and assumptions reflect management's best judgement, actual results may differ from these estimates.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

2. FUTURE CHANGES IN ACCOUNTING POLICIES

In February 2008, the Accounting Standards Board of Canada (AcSB) confirmed that Canadian GAAP for publicly accountable enterprises would converge with International Financial Reporting Standards (IFRS) effective January 1, 2011.

In April 2010, the AcSB issued an exposure draft that proposed a scope expansion to Section 4600 "Pension Plans" to include entities, such as PSP Investments, that are separate from pension plans and whose sole purpose is to hold and invest assets received from one or more pension plans, but do not themselves have a pension obligation. Pursuant to the exposure draft, PSP Investments would be exempt from the IFRS requirement to consolidate its controlled investments and would continue to account for and report its investments at fair value.

Concurrent with the aforementioned standard-setting activities in Canada, the International Accounting Standards Board (IASB) had announced that it intended to propose that investment companies be exempt from consolidation and should account for their controlled investments at fair value.

In light of the announcement from the IASB, the AcSB announced in June 2010 that it had decided not to proceed with the scope expansion of Section 4600, but that it would reconsider this need once the IASB finalizes its standard.

In January 2011, the AcSB decided to defer the adoption of IFRS by investment companies, currently applying AcG-18 to annual periods starting on or after January 1, 2013. This deferral delays PSP Investments' transition to IFRS until the March 31, 2014 annual consolidated financial statements. PSP Investments will finalize its assessment of the impact of its transition to IFRS once the investment company standard is issued.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS

(A) INVESTMENT PORTFOLIO

The investment portfolio, before allocating the effect of derivative contracts and investment-related assets and liabilities to the asset classes to which they relate was as follows as at March 31:

($ thousands)	2011		2010	
Asset Class	**Fair Value**	**Cost**	Fair Value	Cost
World Equity				
Canadian Equity	**$ 78,794**	**$ 67,062**	$ 51,622	$ 47,166
Foreign Equity:				
US Large Cap Equity	**21,633**	**19,659**	10,657	10,125
EAFE Large Cap Equity	**17,210**	**16,604**	10,311	10,673
Small Cap Developed World Equity	**17,735**	**14,837**	9,755	8,878
Emerging Markets Equity	**15,759**	**12,841**	12,566	10,659
Private Equity	**30,542**	**25,312**	26,072	26,634
Nominal Fixed Income				
Cash, Cash Equivalents & Other [1]	**24,536**	**25,284**	23,051	23,716
World Government & Corporate Bonds	**15,918**	**16,302**	5,413	5,589
Canadian Fixed Income	**37,826**	**36,006**	35,127	34,028
Real Return Assets				
World Inflation-Linked Bonds	**16,616**	**16,881**	1,671	1,550
Real Estate	**36,986**	**39,539**	30,564	34,329
Infrastructure	**15,086**	**16,513**	11,777	12,263
Absolute Return	**10,686**	**3,080**	12,056	6,629
INVESTMENTS	**$339,327**	**$309,920**	$240,642	$232,239
Investment-Related Assets				
Amounts receivable from pending trades	**$ 3,886**	**$ 3,886**	$ 814	$ 814
Interest receivable	**780**	**780**	526	526
Dividends receivable	**279**	**279**	285	285
Derivative-related receivables	**3,278**	**156**	2,387	27
Total Investment-Related Assets	**$ 8,223**	**$ 5,101**	$ 4,012	$ 1,652
Investment-Related Liabilities				
Amounts payable from pending trades	**$ (6,043)**	**$ (6,043)**	$ (2,288)	$ (2,288)
Interest payable	**(117)**	**(117)**	(70)	(70)
Securities sold short	**(240)**	**(207)**	(564)	(656)
Securities sold under repurchase agreements	**(2,847)**	**(2,847)**	–	–
Derivative-related payables	**(1,101)**	**(133)**	(2,075)	(13)
Capital debt financing:				
Short-term	**(3,916)**	**(3,916)**	(3,243)	(3,243)
Long-term	**(9,744)**	**(9,542)**	(5,289)	(5,052)
Total Investment-Related Liabilities	**$ (24,008)**	**$ (22,805)**	$ (13,529)	$ (11,322)
NET INVESTMENTS	**$323,542**	**$292,216**	$231,125	$222,569

[1] Includes floating rate notes with maturities greater than one year with a fair value of $6,996 thousand for the Plan Account (2010 – $6,974 thousand).

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(i) Canadian Equity and Foreign Equity

Canadian Equity and Foreign Equity include direct and indirect investments in common shares, American depository receipts, global depository receipts, participation notes, preferred shares, income trust units, exchange traded funds, and securities convertible into common shares of publicly listed issuers.

Valuation Techniques

Direct investments in Canadian and Foreign Equities are measured at fair value using quoted market prices, namely, the bid price. In the case of investments in pooled funds, fair value is measured by using unit values obtained from each of the funds' administrators. Such unit values are derived from the fair value measurement of the underlying investments in each pooled fund.

(ii) Private Equity, Real Estate and Infrastructure

The Private Equity asset class is comprised of direct investments and co-investments in companies as well as fund investments. They include investments in various private entities as well as mezzanine debt and distressed debt.

The Real Estate asset class is comprised of direct investments in various private entities, properties and third-party debts, as well as fund investments in the real estate sector. Real Estate investments are classified into two portfolios (an equity portfolio and a debt portfolio). The equity portfolio is comprised of direct investments in properties, partnerships and companies operating in the office, retail, industrial, hospitality and residential sectors, as well as private funds invested in real estate assets. The debt portfolio is comprised of third-party loans such as junior and senior debts, construction loans, bridge loans, income-participating loans, mezzanine loans, other structured finance products as well as real estate debt funds (collectively "Real Estate Debt") where significant portions of the value are attributed to the underlying real estate assets. The Real Estate asset class is accounted for net of all third-party financings. As at March 31, 2011, the total amount of third-party financing included in the Real Estate asset class contracted by direct investments controlled by PSP Investments for the Plan Account was $11,778 thousand (2010 – $10,637 thousand).

The Infrastructure asset class is comprised of direct investments and co-investments in various private entities and fund investments. They include investments in companies engaged in the management, ownership or operation of assets in power, transportation and other regulated businesses. The Infrastructure asset class is accounted for net of all third-party financings. As at March 31, 2011, the total amount of third-party financing included in the Infrastructure asset class contracted by direct investments controlled by PSP Investments for the Plan Account was $285 thousand (2010 – $397 thousand).

Valuation Techniques

The fair value of Private Market Investments is determined at least annually, using acceptable industry valuation methods. During the year, the fair value is reviewed and adjusted, as appropriate, to reflect the impact of any significant market or investment-specific events or circumstances. For each investment, the relevant methodology is applied consistently over time as appropriate in the prevailing circumstances.

In cases where the services of third-party appraisers are used, management ensures their independence and that valuation methods used are consistent with professional appraisal standards. Such standards include the *International Private Equity and Venture Capital Valuation Guidelines*, the *Canadian Uniform Standards of Professional Appraisal Practice* and the *Uniform Standards of Professional Appraisal Practice* in the United States of America. In validating the work performed by appraisers, management ensures that the assumptions used correspond to financial information and forecasts of the underlying investment.

For direct investments in Private Equity and direct investments and co-investments in Infrastructure, valuation methods used include discounted cash flows, earnings multiples, prices of recent comparable transactions and publicly traded comparables. Assumptions used in such valuations include discount rates and projected cash flows, which are not fully supported by prices from market observable transactions.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(ii) Private Equity, Real Estate and Infrastructure (continued)

Valuation Techniques (continued)

For direct investments in Real Estate, valuation methods used include discounted cash flows, prices of recent comparable transactions and the direct capitalization approach. Assumptions used in such valuations include capitalization rates, projected cash flows and/or net operating income, which are not fully supported by prices from market observable transactions.

The fair value of Real Estate Debt is determined using either a yield-based or collateral-based valuation technique. The yield-based valuation technique involves discounting expected future cash flows that incorporate assumptions with respect to interest rates offered for similar loans to borrowers with similar credit ratings. The collateral-based valuation technique involves assessing the recoverable value of the collateral in question, net of disposal fees.

In the case of Private Equity, Real Estate, Infrastructure fund investments as well as Private Equity co-investments, the annual fair value is generally determined based on the audited fair values reported by the fund's general partner using acceptable industry valuation methods.

(iii) Nominal Fixed Income and World Inflation-Linked Bonds

Nominal Fixed Income includes Cash, Cash Equivalents & Other, World Government & Corporate Bonds and Canadian Fixed Income. Cash Equivalents include short-term instruments having a maximum term to maturity of one year. Floating rate notes are included in Cash, Cash Equivalents & Other, provided the final maturity date does not exceed three years and the coupons reset more than once per year. World Government & Corporate Bonds and Canadian Fixed Income include government bonds, provincial and territorial bonds, municipal bonds and corporate bonds. World Inflation-Linked Bonds reported as Real Return Assets are fixed income securities that earn inflation adjusted returns.

PSP Investments holds ABTNs reported as Canadian Fixed Income in the investment portfolio. The ABTNs were received in exchange for third-party or non-bank sponsored asset-backed commercial paper (ABCP) that suffered a liquidity disruption in mid-August 2007 and were subsequently restructured in January 2009. The ABTNs had an original face value of $1,962 million, of which $5,934 thousand has been allocated to the Plan Account.

PSP Capital Inc., a wholly-owned subsidiary of PSP Investments, provided funding facilities of a maximum amount of $969 million to support potential margin calls on the ABTNs, of which $4,840 thousand was allocated to the Plan Account. As at March 31, 2011, the margin funding facilities have not been drawn upon since inception. The agreement to exchange the non-bank ABCP for ABTNs included a moratorium preventing collateral calls for an 18-month period that ended on July 16, 2010.

Management's best estimate of the fair value of PSP Investments' ABTNs allocated to the Plan Account as at March 31, 2011 was equal to $6,926 thousand (2010 – $5,919 thousand). This amount was net of principal repayments and corresponding gains, together amounting to $1,007 thousand for the year ended March 31, 2011 (for the year ended March 31, 2010 – $2,774 thousand). PSP Investments recorded an increase of $1,102 thousand in the fair value of the ABTNs allocated to the Plan Account during the year ended March 31, 2011 (increase of $3,030 thousand during the year ended March 31, 2010). The fair value of the ABTNs allocated to the Plan Account was reduced by the impact of the funding facilities amounting to $319 thousand as at March 31, 2011 (2010 – $325 thousand).

Valuation Techniques

Cash Equivalents are recorded at cost plus accrued interest, which approximate fair value.

Fair values of bonds and floating rate notes are based on prices obtained from third-party pricing sources. They are determined using either an appropriate interest rate curve with a spread associated with the credit quality of the issuer or other generally accepted pricing methodologies.

ABTNs are measured at fair value using comparable notes with similar credit quality and terms as a proxy, while taking into consideration the impact of the funding facilities. The valuation model used includes certain assumptions that are not fully supported by market observable data. Such assumptions include interest rate spreads, assumed credit rating, expected returns, an average maturity of six years as well as liquidity estimates.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(iv) Absolute Return

In addition to the different asset classes outlined in the Statement of Investment Policies, Standards and Procedures (SIP&P), PSP Investments employs a number of absolute return strategies that consist of externally managed investments. Such investments take advantage of specific opportunities aimed to perform positively irrespective of market performance. Such opportunities include investments in equity, fixed income and derivative instruments.

Valuation Techniques

The fair value of these investments is obtained from the investment's external manager and reflects the fair value of the underlying equity, fixed income or derivative instruments.

(v) Amounts Receivable and Payable from Pending Trades

Amounts receivable from pending trades consist of proceeds on sales of investments, excluding derivative financial instruments, which have been traded but remain unsettled at the end of the reporting year.

Amounts payable from pending trades consist of the cost of purchases of investments, excluding derivative financial instruments, which have been traded but remain unsettled at the end of the reporting year.

Valuation Techniques

The fair value of amounts receivable and payable from pending trades reflects the value at which their underlying original sale or purchase transactions were undertaken.

(vi) Interest & Dividends Receivable

Interest and dividends are recorded at the amounts expected to be received as at the reporting date.

(vii) Interest Payable

Interest accrued is recorded at the amount expected to be paid as at the reporting date.

(viii) Securities Sold Short

Securities sold short reflect PSP Investments' commitment to purchasing securities pursuant to short selling transactions. In such transactions, PSP Investments sells securities it does not own with a commitment to purchasing similar securities on the market to cover its position.

Valuation Techniques

Using ask prices as inputs, the fair value of securities sold short is measured using the same method as the similar long positions presented under Nominal Fixed Income, World Inflation-Linked Bonds, Canadian Equity and Foreign Equity.

(ix) Securities Sold under Repurchase Agreements

PSP Investments is party to agreements which involve the sale of securities with a simultaneous agreement to repurchase such securities at a specified price and specified future date.

Securities sold under the repurchase agreements are not derecognized as PSP Investments retains all related risks and rewards of ownership. As such, all related income (loss) continues to be reported in Investment Income (Loss).

Obligations to repurchase the securities sold are accounted for as Investment-Related Liabilities. Interest expense related to such obligations is reported in Investment Income (Loss).

Valuation Techniques

Obligations to repurchase the securities sold under repurchase agreements are recorded at cost plus accrued interest, which approximate fair value.

(B) DERIVATIVE FINANCIAL INSTRUMENTS

Derivative financial instruments are financial contracts that are settled at a future date, the value of which is derived from changes in underlying assets, interest or exchange rates. Derivative financial instruments do not, typically, require an initial net investment. In certain cases, they require an initial net investment that is less than what would be required to hold the underlying position directly. PSP Investments uses derivative financial instruments to enhance returns or to replicate investments synthetically. Derivatives are also used to reduce the risk associated with existing investments.

PSP Investments uses the following types of derivative financial instruments:

(i) Swaps

Swaps are transactions whereby two counterparties exchange cash flow streams with each other based on predetermined conditions that include a notional amount and a term. Swaps are used to increase returns or to adjust exposures of certain assets without directly purchasing or selling the underlying assets.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(B) DERIVATIVE FINANCIAL INSTRUMENTS (continued)

(ii) Futures

Futures are standardized contracts to take or make delivery of an asset (buy or sell) at a specific time in the future for a specific price that is agreed upon today. Futures are used to adjust exposures to specified assets without directly purchasing or selling the underlying assets.

(iii) Forwards

Forwards are contracts involving the sale by one party and the purchase by another party of a predefined amount of an underlying instrument, at a predefined price and a predefined date in the future. Forwards are used for yield enhancement purposes or to manage exposures to currencies and interest rates.

(iv) Options

Options are the right, but not the obligation, to buy or sell a given amount of an underlying security, index, or commodity, at an agreed-upon price stipulated in advance, either at a determined date or at any time before the predefined maturity date.

(v) Warrants and Rights

Warrants are options to purchase an underlying asset which is in the form of a transferable security and which can be listed on an exchange.

Rights are securities giving shareholders entitlement to purchase new shares issued by a corporation at a predetermined price (normally less than the current market price) in proportion to the number of shares already owned. Rights are issued only for a short period of time, after which they expire.

(vi) Collateralized Debt Obligations

Collateralized debt obligations are a type of asset-backed security that is constructed from a portfolio of credit-related assets. Collateralized debt obligations are usually divided into several tranches with different credit risk levels and corresponding interest payments. Any losses are applied first to the more junior tranches (lowest risk rating) before moving up in seniority.

Valuation Techniques

All listed derivative financial instruments are recorded at fair value using quoted market prices with the bid price for long positions and the ask price for short positions. OTC derivatives are valued using appropriate valuation techniques, such as discounted cash flows using current market yields. The assumptions used include the statistical behaviour of the underlying instruments and the ability of the model to correlate with observed market transactions. Although pricing models used are widely accepted and used by other market participants, in the case of collaterized debt obligations, the nature of such instruments requires more significant assumptions about the behaviour of the default correlation. Such assumptions are not observable in the market.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(B) DERIVATIVE FINANCIAL INSTRUMENTS (continued)

Notional values of derivative financial instruments are not recorded as assets or liabilities as they represent the face amount of the contract. Except for credit derivatives [1], notional values do not represent the potential gain or loss associated with the market or credit risk of such transactions disclosed below. Rather, they serve as the basis upon which the cash flows and the fair value of the contracts are determined.

The following table summarizes the derivatives portfolio as at March 31:

($ thousands)

	2011				2010			
		Fair Value				Fair Value		
INVESTMENTS	Notional Value	Assets	Liabilities	Net	Notional Value	Assets	Liabilities	Net
Equity and Commodity Derivatives								
Futures	$ 2,398	$ –	$ –	$ –	$ 565	$ –	$ –	$ –
Total Return Swaps	30,891	1,064	(1)	1,063	17,602	578	(6)	572
Warrants and Rights	12	11	–	11	6	5	–	5
Options: Listed-purchased	2,466	69	–	69	–	–	–	–
Listed-written	2,204	–	(106)	(106)	26	–	–	–
Currency Derivatives								
Forwards	95,329	1,762	(675)	1,087	50,860	1,548	(139)	1,409
Swaps	9,323	135	(61)	74	–	–	–	–
Options: OTC-purchased	5,628	32	–	32	3,267	20	–	20
OTC-written	1,019	–	(10)	(10)	853	–	(4)	(4)
Interest Rate Derivatives								
Bond Forwards	5,536	29	(15)	14	1,027	–	(11)	(11)
Futures	9,867	–	–	–	2,605	–	–	–
Interest Rate Swaps	97,808	78	(92)	(14)	19,498	121	(192)	(71)
Total Return Swaps	3,599	–	(1)	(1)	14,041	93	(68)	25
Swaptions	19,635	35	(17)	18	–	–	–	–
Options: Listed-purchased	29,805	36	–	36	2,120	–	–	–
Listed-written	41,876	–	(39)	(39)	5,817	–	(2)	(2)
Credit Derivatives [1]:								
Purchased	2,331	17	(21)	(4)	142	6	–	6
Sold	2,278	10	(63)	(53)	3,714	16	(1,653)	(1,637)
Total	$362,005	$ 3,278	$(1,101)	$ 2,177	$122,143	$ 2,387	$(2,075)	$ 312

[1] Credit derivatives include credit default swaps and collateralized debt obligations. PSP Investments, through sold credit derivatives, indirectly guarantees the underlying reference obligations. The maximum potential exposure is the notional amount of the sold credit derivatives as shown in the table above.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(B) DERIVATIVE FINANCIAL INSTRUMENTS (continued)

The term to maturity based on notional value for the derivatives was as follows as at March 31, 2011:

($ thousands)

Less than 3 months	**$134,649**
3 to 12 months	**207,353**
Over 1 year	**20,003**
Total	**$362,005**

(C) FAIR VALUE MEASUREMENT

Investments, investment-related assets and investment-related liabilities are classified according to the following hierarchy based on the significant inputs used in measuring their fair value.

Level 1: Valuation is based on quoted prices in active markets for identical assets or liabilities.

Level 2: Valuation is based on quoted market prices for similar assets or liabilities in active markets or quoted prices for identical or similar assets or liabilities in markets that are not active. Level 2 also includes model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3: Valuation is based on model-based techniques for which significant assumptions are not observable in the market. They reflect management's assessment of the assumptions that market participants would use in pricing the assets or liabilities.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(C) FAIR VALUE MEASUREMENT (continued)

The following table shows the fair value of investments, investment-related assets and investment-related liabilities, based on the methods previously described, as at March 31, 2011:

($ thousands)	Level 1	Level 2	Level 3	No Level	Total Fair Value
World Equity					
Canadian Equity & Foreign Equity	$139,213	$ 11,918	$ –	$ –	$151,131
Private Equity	–	–	30,542	–	30,542
Nominal Fixed Income	3,250	67,222	7,808	–	78,280
Real Return Assets					
World Inflation-Linked Bonds	–	16,616	–	–	16,616
Real Estate	–	–	36,986	–	36,986
Infrastructure	–	–	15,086	–	15,086
Absolute Return	–	6,210	4,476	–	10,686
INVESTMENTS	$142,463	$101,966	$ 94,898	$ –	$339,327
Investment-Related Assets					
Amounts receivable from pending trades[1]	$ –	$ –	$ –	$ 3,886	$ 3,886
Interest receivable[1]	–	–	–	780	780
Dividends receivable[1]	–	–	–	279	279
Derivative-related receivables	108	3,155	15	–	3,278
Total Investment-Related Assets	$ 108	$ 3,155	$ 15	$ 4,945	$ 8,223
Investment-Related Liabilities					
Amounts payable from pending trades[1]	$ –	$ –	$ –	$ (6,043)	$ (6,043)
Interest payable[1]	–	–	–	(117)	(117)
Securities sold short	(240)	–	–	–	(240)
Securities sold under repurchase agreements	–	(2,847)	–	–	(2,847)
Derivative-related payables	(145)	(898)	(58)	–	(1,101)
Capital debt financing:					
Short-term	–	(3,916)	–	–	(3,916)
Long-term	–	(9,744)	–	–	(9,744)
Total Investment-Related Liabilities	$ (385)	$ (17,405)	$ (58)	$ (6,160)	$ (24,008)
NET INVESTMENTS	$142,186	$ 87,716	$ 94,855	$ (1,215)	$323,542

[1] No fair value hierarchy classification is required for these items.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(C) FAIR VALUE MEASUREMENT (continued)

The following table shows the fair value of investments, investment-related assets and investment-related liabilities, based on the methods previously described, as at March 31, 2010:

($ thousands)	Level 1	Level 2	Level 3	No Level	Total Fair Value
World Equity					
Canadian Equity & Foreign Equity	$ 87,882	$ 7,029	$ –	$ –	$ 94,911
Private Equity	–	–	26,072	–	26,072
Nominal Fixed Income	605	56,569	6,417	–	63,591
Real Return Assets					
World Inflation-Linked Bonds	–	1,671	–	–	1,671
Real Estate	–	–	30,564	–	30,564
Infrastructure	–	–	11,777	–	11,777
Absolute Return	–	6,187	5,869	–	12,056
INVESTMENTS	$ 88,487	$ 71,456	$ 80,699	$ –	$240,642
Investment-Related Assets					
Amounts receivable from pending trades[1]	$ –	$ –	$ –	$ 814	$ 814
Interest receivable[1]	–	–	–	526	526
Dividends receivable[1]	–	–	–	285	285
Derivative-related receivables	–	2,361	26	–	2,387
Total Investment-Related Assets	$ –	$ 2,361	$ 26	$ 1,625	$ 4,012
Investment-Related Liabilities					
Amounts payable from pending trades[1]	$ –	$ –	$ –	$ (2,288)	$ (2,288)
Interest payable[1]	–	–	–	(70)	(70)
Securities sold short	(564)	–	–	–	(564)
Derivative-related payables	(2)	(420)	(1,653)	–	(2,075)
Capital debt financing:					
Short-term	–	(3,243)	–	–	(3,243)
Long-term	–	(5,289)	–	–	(5,289)
Total Investment-Related Liabilities	$ (566)	$ (8,952)	$ (1,653)	$ (2,358)	$ (13,529)
NET INVESTMENTS	$ 87,921	$ 64,865	$ 79,072	$ (733)	$231,125

[1] No fair value hierarchy classification is required for these items.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(C) FAIR VALUE MEASUREMENT (continued)

The classification within the levels of the hierarchy is established at the time of the initial valuation of the asset or liability and reviewed on each subsequent reporting period-end.

There were no significant transfers between Level 1 and Level 2 during the year ended March 31, 2011 (no significant transfers during the year ended March 31, 2010).

Level 3 Reconciliation

The following table shows a reconciliation of all movements related to investments, investment-related assets and investment-related liabilities categorized within Level 3 for the year ended March 31, 2011:

($ thousands)	World Equity	Nominal Fixed Income	Real Return Assets	Absolute Return	Derivative–related receivables/payables (net)	Total
Opening Balance	$ 26,072	$ 6,417	$ 42,341	$ 5,869	$ (1,627)	$ 79,072
Purchases	13,558	908	26,094	511	2,400	43,471
Sales/Settlements	(19,329)	(260)	(15,153)	(5,110)	(70)	(39,922)
Total gains (losses)	10,549	743	(1,210)	3,206	(746)	12,542
Transfer out of Level 3	(308)	–	–	–	–	(308)
Closing Balance	$ 30,542	$ 7,808	$ 52,072	$ 4,476	$ (43)	$ 94,855

Total gains (losses), for the year ended March 31, 2011, included in investment income and categorized within Level 3, are presented as follows:

($ thousands)	World Equity	Nominal Fixed Income	Real Return Assets	Absolute Return	Derivative–related receivables/payables (net)	Total
Total realized gains (losses)	$ (1,220)	$ 7	$ 614	$ (225)	$ (1,270)	$ (2,094)
Total unrealized gains (losses)	$ 11,769	$ 736	$ (1,824)	$ 3,431	$ 524	$ 14,636
Total gains (losses)	$ 10,549	$ 743	$ (1,210)	$ 3,206	$ (746)	$ 12,542

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(C) FAIR VALUE MEASUREMENT (continued)

Level 3 Reconciliation (continued)

The following table shows a reconciliation of all movements related to investments, investment-related assets and investment-related liabilities categorized within Level 3 for the year ended March 31, 2010:

($ thousands)	World Equity	Nominal Fixed Income	Real Return Assets	Absolute Return	Derivative–related receivables/ payables (net)	Total
Opening Balance	$ 14,473	$ 3,846	$ 33,440	$ 2,329	$ (4,172)	$ 49,916
Purchases	15,901	–	13,294	5,479	8	34,682
Sales/Settlements	(7,557)	(1,411)	(16,442)	(102)	(3)	(25,515)
Total gains (losses)	3,255	3,982	12,049	(1,837)	2,540	19,989
Transfers into or out of Level 3	–	–	–	–	–	–
Closing Balance	$ 26,072	$ 6,417	$ 42,341	$ 5,869	$ (1,627)	$ 79,072

Total gains (losses), for the year ended March 31, 2010, included in investment income and categorized within Level 3, are presented as follows:

($ thousands)	World Equity	Nominal Fixed Income	Real Return Assets	Absolute Return	Derivative–related receivables/ payables (net)	Total
Total realized gains (losses)	$ 584	$ –	$ 218	$ (1)	$ 1	$ 802
Total unrealized gains (losses)	$ 2,671	$ 3,982	$ 11,831	$ (1,836)	$ 2,539	$ 19,187
Total gains (losses)	$ 3,255	$ 3,982	$ 12,049	$ (1,837)	$ 2,540	$ 19,989

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(C) FAIR VALUE MEASUREMENT (continued)

Level 3 Sensitivity Analysis

In the course of measuring fair value of financial instruments classified as Level 3, valuation techniques used incorporate assumptions that are based on non-observable data. Significant assumptions used for each asset class are described in Notes 3 (a) and (b). Although such assumptions reflect management's best judgment, the use of reasonably possible alternative assumptions could yield different fair value measures representing, at a minimum, a 2% increase/decrease (2010 – 3% increase/decrease) in the fair value of financial instruments categorized as Level 3. This excludes Private Market fund investments as well as Real Estate Debt, where a sensitivity analysis is not possible given the underlying assumptions used are not available to PSP Investments. In the case of Private Market fund investments, the fair value is determined based on the audited financial statements of the fund's general partner as indicated in Note 3 (a). With respect to Real Estate Debt, the fair value is obtained from third-party appraisers as described in Note 3 (a).

(D) INVESTMENT ASSET MIX

The SIP&P sets out the long-term target weights of the assets that will be invested for the Plan Account. Investments are classified by asset mix category as set out in the SIP&P based on the economic intent of the investment strategies of the underlying assets.

The net investments were as follows as at March 31:

	2011			2010		
($ thousands)	Fair Value		Policy Portfolio Long–Term Target	Fair Value		Policy Portfolio Long–Term Target
World Equity						
Canadian Equity	**$104,048**	**32.2%**	**30.0%**	$ 67,657	29.2%	30.0%
Foreign Equity:						
US Large Cap Equity	**21,344**	**6.6**	**5.0**	10,544	4.6	5.0
EAFE Large Cap Equity	**17,014**	**5.2**	**5.0**	10,205	4.4	5.0
Small Cap Developed World Equity	**17,959**	**5.5**	**5.0**	9,873	4.3	5.0
Emerging Markets Equity	**22,645**	**7.0**	**7.0**	14,920	6.5	7.0
Private Equity	**31,115**	**9.6**	**10.0**	27,096	11.7	10.0
Nominal Fixed Income						
Cash & Cash Equivalents [1]	**6,988**	**2.2**	**2.0**	9,451	4.1	2.0
World Government Bonds	**12,812**	**4.0**	**5.0**	10,626	4.6	5.0
Canadian Fixed Income	**30,029**	**9.3**	**8.0**	24,124	10.4	8.0
Real Return Assets						
World Inflation-Linked Bonds	**16,844**	**5.2**	**5.0**	10,714	4.6	5.0
Real Estate	**29,610**	**9.1**	**10.0**	25,562	11.1	10.0
Infrastructure	**13,134**	**4.1**	**8.0**	10,353	4.5	8.0
NET INVESTMENTS	**$323,542**	**100.0%**	**100.0%**	$231,125	100.0%	100.0%

[1] Includes amounts related to absolute return and real estate debt strategies.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

3. INVESTMENTS (continued)

(E) SECURITIES LENDING & BORROWING PROGRAMS

PSP Investments participates in securities lending and borrowing programs whereby it lends and borrows securities in order to enhance portfolio returns. Lending and borrowing transactions under such programs do not transfer the risks or rewards of ownership of the securities to the counterparty. Consequently, PSP Investments does not derecognize securities lent or recognize securities borrowed.

The securities lending and borrowing programs require collateral in cash, high-quality debt instruments or securities. Collateral transactions are conducted under terms that are usual and customary in standard securities lending and borrowing programs. PSP Investments and its counterparties are authorized to sell, repledge or otherwise use collateral held. The same securities or equivalent securities must be returned to the counterparty at the end of the contract, unless an event of default occurs. As at March 31, 2011, PSP Investments, on behalf of the Plan Account, has re-invested $8,348 thousand of collateral held (2010 – $8,840 thousand).

The following table illustrates the fair values of the Plan Account's allocated securities and collateral associated with the lending and borrowing programs as at March 31:

($ thousands)	2011	2010
Securities Lending		
Securities lent	$ 32,192	$ 20,003
Collateral contractually receivable[1]	33,676	20,873
Securities Borrowing		
Securities borrowed	240	564
Collateral contractually payable[2]	254	595

[1] The minimum fair value of collateral required is equal to 102% of the fair value of the securities lent.

[2] The minimum fair value of collateral required is equal to 100% of the fair value of the securities borrowed.

(F) SECURITIES SOLD & COLLATERAL PLEDGED UNDER REPURCHASE AGREEMENTS

Securities sold under repurchase agreements are described in Note 3 (a) (ix) and involve pledging collateral consisting of cash or securities deemed acceptable by the counterparties. Collateral transactions are conducted under terms that are usual and customary in standard repurchase arrangements. Such terms require the respective counterparty to pledge additional collateral based on the changes in the fair value of the existing collateral pledged. The counterparties are authorized to sell, repledge or otherwise use collateral held. The securities pledged as collateral must be returned to the respective counterparty at the end of the contract, unless an event of default occurs. PSP Investments does not sell, repledge or otherwise use collateral held.

On behalf of the Plan Account, PSP Investments pledged collateral under the repurchase agreements with a fair value of $2,847 thousand at March 31, 2011 (2010 – nil).

4. INVESTMENT RISK MANAGEMENT

Risk Management is a central part of PSP Investments' operations. Included in the overall risk management framework is a continuous process whereby PSP Investments systematically addresses the investment risks related to its various investment activities with the goal of achieving a maximum rate of return without undue risk of loss.

A risk governance framework that includes required reporting on risk to all levels of the organization ensures that appropriate investment objectives are pursued and achieved in line with the fulfillment of PSP Investments' legislated mandate. The Board of Directors and its committees oversee all risk matters and receive assurances from senior management, including the Chief Risk Officer, as well as PSP Investments' independent internal auditor reporting directly to the Audit Committee.

PSP Investments has adopted an Investment Risk Management Policy which is an integral part of its risk control system and supplements the SIP&P. The objective of this policy is to provide a framework to manage the risks that PSP Investments is exposed to, namely market, credit and liquidity risks.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

4. INVESTMENT RISK MANAGEMENT (continued)

(A) MARKET RISK

Market risk is the risk that the value of an investment will fluctuate as a result of changes in market prices, whether those changes are caused by factors specific to the individual investment, volatility in share and commodity prices, interest rate, foreign exchange or other factors affecting similar securities traded in the market.

Market risk management focuses on the following two key components:

– Policy Portfolio

The Policy Portfolio (long-term asset mix), as defined in the SIP&P, determines a diversification strategy to mitigate risk whereby PSP Investments invests in a diversified portfolio expected to achieve a return at least equal to the Actuarial Rate of Return (ARR); defined as the rate of return assumption used by the Chief Actuary of Canada in the latest actuarial valuation reports of the Plans. In the absence of other factors affecting the funding of the Plans or changes to pension benefits under the Plans, the ARR is the rate of return required to maintain funding requirements and pension benefits at their current levels.

– Active Management

Active management is defined as the sum of investment strategies that deviate from the approved Policy Portfolio. It is designed to supplement the returns of the Policy Portfolio within an active risk budget.

The risks associated with these components are the Policy Portfolio market risk and the active risk. The Policy Portfolio market risk represents the investment risk arising from the exposure to approved asset classes in the approved weightings. In establishing its Policy Portfolio, PSP Investments also takes into consideration the impact of the Policy Portfolio market risk on the funding risk. The funding risk is the risk that the assets under management will be insufficient to meet the relevant pension liabilities of the Plans. The Policy Portfolio is reviewed at least annually as part of the review of the SIP&P, and this review includes changes, if any, to PSP Investments' long-term expectations of market conditions and other factors that may affect the funding levels of the Plans.

Active risk refers to all market risk arising from active management activities. It is managed in accordance with the Investment Risk Management Policy.

Measurement of Market Risk

The Value-at-Risk (VaR) is one of the methods used to measure market risk and is reported on a quarterly basis. It is not the maximum potential loss, but rather the maximum loss not exceeded with a given confidence level, over a given period of time. PSP Investments uses a Historical VaR model incorporating ten years' worth of market returns scaled to a twelve-month holding period at a 95% confidence level. In measuring Policy Portfolio risk, VaR represents the absolute loss expected from the Policy Portfolio (Policy Portfolio VaR). Whereas in terms of measuring the active risk, VaR reflects the loss relative to the Policy Portfolio benchmark (Active VaR).

VaR is statistically valid under normal market conditions and does not specifically consider losses from severe market events. It also assumes that the future will behave in a pattern similar to the past. Consequently, if future market conditions differ significantly from those of the past, potential losses may differ from those originally estimated.

The following table shows the Total VaR consisting of the Policy Portfolio VaR, the Active VaR and the diversification effect, calculated as a percentage of net investments, as at March 31. The diversification effect captures the impact of holding different types of assets which may react differently in various types of situations and thus reduces the Total VaR.

	2011	2010
Policy Portfolio VaR	**22.4%**	21.2%
Active VaR	**2.2**	1.8
Total VaR (Undiversified)	**24.6**	23.0
Diversification Effect	**(2.9)**	(2.0)
Total VaR	**21.7%**	21.0%

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

4. INVESTMENT RISK MANAGEMENT (continued)

(A) MARKET RISK (continued)

Stress Testing

Although VaR is a widely accepted risk measure, it is complemented by other risk measurement methodologies that provide greater insight on market risk. PSP Investments uses stress testing and scenario analysis to examine the impact on financial results of abnormally large movements in risk factors. Stress testing and scenario analysis are used to test a portfolio's sensitivity to various risk factors and key model assumptions. These methods also use historically stressed periods to evaluate how a current portfolio reacts under such circumstances. Stress testing and scenario analysis are also deployed to assess new product performance.

(i) Interest Rate Risk

Interest rate risk refers to the risk that fluctuations in interest rates will directly affect the fair value of the Plan Account's net asset values. The most significant exposure to interest rate risk is related to the investment in bonds, ABTNs and Real Estate Debt.

The terms to maturity of the investments, before allocating the effect of derivative contracts and investment-related assets and liabilities were as follows as at March 31, 2011:

	Terms to Maturity				
($ thousands)	Less than 1 Year	1 to 5 Years	5 to 10 Years	Over 10 Years	Total
Government of Canada bonds	$ 140	$ 6,403	$ 322	$ 2,632	$ 9,497
Provincial and Territorial bonds	648	2,524	3,952	2,306	9,430
Municipal bonds	59	229	236	33	557
Corporate bonds	732	5,054	3,683	1,947	11,416
ABTNs	–	269	6,657	–	6,926
Total Canadian Fixed Income	$ 1,579	$ 14,479	$ 14,850	$ 6,918	$ 37,826
Total World Government & Corporate Bonds	$ 4,434	$ 5,773	$ 2,607	$ 3,104	$ 15,918
Total World Inflation-Linked Bonds	$ –	$ 4,444	$ 4,633	$ 7,539	$ 16,616
Real Estate Debt [1]	$ 1,237	$ 403	$ –	$ –	$ 1,640
Grand Total	$ 7,250	$ 25,099	$ 22,090	$ 17,561	$ 72,000

[1] Real Estate Debt is a component of the Real Estate asset class disclosed in Note 3 (a).

The terms to maturity of PSP Investments' capital debt financing are disclosed in Note 8.

Absolute return strategies, as described in Note 3, and derivative contracts are also subject to interest rate risk exposures. These exposures are reflected in the VaR calculation described in Note 4 (a).

Additionally, the exposure to interest rate risk for short-term instruments is not significant due to their short-term nature.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

4. INVESTMENT RISK MANAGEMENT (continued)

(A) MARKET RISK (continued)

(ii) 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. Fluctuations in the relative value of the Canadian dollar against these foreign currencies can result in a positive or a negative effect on the fair value of the investments. To mitigate this risk, PSP Investments may take, through foreign forward contracts or cross currency swaps, positions in foreign currencies. PSP Investments' policy is to hedge a target of 50% of its foreign currency investments. Additional factors are considered when implementing the hedging target for investments in emerging countries, namely, total relative exposure and cost effectiveness.

The underlying net foreign currency exposures for the Plan Account, after allocating the effect of derivative contracts and investment-related assets and liabilities for both monetary and non-monetary items were as follows as at March 31:

	2011		2010	
Currency (in thousands of Canadian $)	**Fair Value**	**% of Total**	Fair Value	% of Total
US Dollar	**$ 52,917**	**54.0%**	$ 31,343	51.2%
Euro	**13,297**	**13.6**	9,066	14.8
British Pound	**7,422**	**7.6**	3,883	6.4
Brazilian Real	**4,909**	**5.0**	3,342	5.5
Japanese Yen	**3,948**	**4.0**	2,143	3.5
Hong Kong Dollar	**3,702**	**3.8**	2,527	4.1
Korean Won	**2,618**	**2.7**	1,753	2.9
Australian Dollar	**1,704**	**1.7**	756	1.2
New Taiwan Dollar	**1,569**	**1.6**	997	1.6
South African Rand	**937**	**1.0**	786	1.3
Others	**4,872**	**5.0**	4,579	7.5
Total	**$ 97,895**	**100.0%**	$ 61,175	100.0%

PSP Investments and its subsidiaries also had commitments, denominated in foreign currencies of $22,203 thousand ($19,698 thousand US, €2,062 thousand and R1,356 thousand South African Rands) for the Plan Account which were not included in the foreign currency exposure table.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

4. INVESTMENT RISK MANAGEMENT (continued)

(B) CREDIT RISK

PSP Investments is exposed to credit risk, that is, the risk that the issuer of a debt security or that the counterparty to a derivative contract, to a securities lending and borrowing transaction or to securities sold under repurchase agreements, is unable to meet its financial obligations.

Credit risk encompasses the risk of a deterioration of creditworthiness and the respective concentration risk. Credit risk monitoring entails an evaluation of the credit quality of each issuer and counterparty that transacts with PSP Investments. To perform this evaluation, PSP Investments relies on four recognized credit rating agencies. A minimum of two credit ratings are used to classify each security. Except for ABTNs, securities rated by only one agency are classified as "not rated". If the agencies disagree as to a security's credit quality, PSP Investments uses the lowest of the available ratings.

To monitor the evolution of credit risk, PSP Investments periodically produces a concentration report by credit rating of all credit-sensitive financial securities with the exception of securities held in pooled funds or for Private Market Investments.

PSP Investments' concentration of credit risk by credit rating for the Plan Account was as follows as at March 31:

	2011	2010
Investment grade (AAA to BBB–)	**98.0%**	98.1%
Below investment grade (BB+ and below)	**0.4**	0.2
Not rated:		
Rated by a single credit rating agency	**–**	0.2
Not rated by credit rating agencies	**1.6**	1.5
Total	**100.0%**	100.0%

The breakdown of credit concentration risk for the Plan Account did not include investments in distressed debt included in pooled funds in the amount of approximately $11 million as at March 31, 2011 (2010 – approximately $10 million). Such investments typically include debt securities of issuers close to default, and the investment in such securities are quasi-equity in nature.

As at March 31, 2011, the Plan Account also had a net notional exposure of $1,453 thousand (2010 – $3,067 thousand) to various tranches of collateralized debt obligations, of which approximately 44% (2010 – approximately 64%) of the underlying dollar exposure was rated "Investment grade", as well as funding facilities of a maximum amount of $4,840 thousand (2010 – $4,840 thousand) to support potential margin calls on the ABTNs (Note 3 (a) (iii)).

As at March 31, 2011, the Plan Account's maximum exposure to credit risk, excluding collateral held and the investments in distressed debt and collateralized debt obligations described above, amounted to approximately $89 million (2010 – approximately $65 million). This amount also excludes the impact of guarantees and indemnities disclosed in Note 10.

(i) Counterparty Risk

Counterparty risk represents the credit risk from current and potential exposure related to transactions involving derivative contracts, securities lending and borrowing as well as securities sold under repurchase agreements. In order to minimize counterparty risk, PSP Investments deals only with counterparties with a minimum credit rating of "A–" as at the trade date, as provided by a recognized credit rating agency. PSP Investments monitors the credit ratings of counterparties on a daily basis. With respect to derivative contracts, PSP Investments has the ability to terminate all trades with most counterparties who have their credit rating downgraded below "A–" subsequent to the trade date.

PSP Investments' policy also requires the use of the International Swaps and Derivative Association (ISDA) Master Agreement with all counterparties to derivative contracts. The ISDA Master Agreement provides the contractual framework within which dealing activities across a full range of OTC products are conducted.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

4. INVESTMENT RISK MANAGEMENT (continued)

(B) CREDIT RISK (continued)

(i) Counterparty Risk (continued)

As a credit mitigation technique, the ISDA Master agreement contractually binds both parties to use master-netting arrangements and, in the case of default of the counterparty, close-out netting. Additionally, the Credit Support Annex (CSA) to the ISDA Master Agreement enables PSP Investments to realize any collateral placed with it in the case of default of the counterparty. The CSA also requires PSP Investments to contribute further collateral when requested. All collateral transactions are in high-quality debt instruments or securities. The CSA also regulates the exchange of collateral when the credit exposure to a counterparty exceeds a predetermined threshold. In certain cases, counterparties are authorized to sell, repledge or otherwise use collateral held. On behalf of the Plan Account, PSP Investments did not deposit nor did it pledge any securities as collateral with respect to derivative contracts at March 31, 2011 (2010 – $1,038 thousand). All collateral deposited or pledged was held, in the prior fiscal year, with counterparties having a minimum credit rating of “A–”. Securities with a fair value of $762 thousand were received from counterparties as collateral at March 31, 2011 (2010 – $883 thousand). PSP Investments does not sell, repledge or otherwise use any collateral held with respect to derivative contracts.

With respect to transactions involving securities lending and borrowing as well as securities sold under repurchase agreements, collateral requirements are in place to mitigate counterparty risk. Notes 3 (e) and 3 (f) describe collateral requirements in securities lending and borrowing programs as well as securities sold under repurchase agreements, respectively.

In the case of the securities lending program, PSP Investments' exposure to counterparty risk is further mitigated as the custodian of the securities lent assumes the risk that a counterparty will be unable to meet its obligations associated with the collateral requirements.

Risk Management is responsible for counterparty risk monitoring and mitigation as well as maintaining a comprehensive, disciplined, and enterprise-wide process for tracking and managing counterparty risk. As such, Risk Management measures counterparty risk on an ongoing basis, evaluates and tracks the creditworthiness of current counterparties and mitigates counterparty risk through collateral management.

(C) LIQUIDITY RISK

Liquidity risk corresponds to PSP Investments' ability to meet its financial obligations when they come due with sufficient and readily available cash resources. PSP Investments' cash position is monitored on a daily basis. In general, investments in cash, cash equivalents, floating rate notes, debt and public equities are expected to be highly liquid as they will be invested in securities that are actively traded. Risk Management and Treasury utilize appropriate measures and controls to monitor liquidity risk in order to ensure that there is sufficient liquidity to meet financial obligations as they come due. A liquidity report taking into consideration future forecasted cash flows is prepared and presented to senior management on a weekly basis. This ensures that sufficient cash reserves are available to meet forecasted cash outflows. Additionally, sufficient sources of liquidity are maintained for deployment in case of market disruption.

PSP Investments has the ability to raise additional capital through the use of its capital debt program. This program allows PSP Investments to issue short-term promissory notes and medium-term notes. Note 8 provides additional information on the usage of the capital debt program.

The terms to maturity of the notional amount of derivatives are disclosed in Note 3 (b).

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

4. INVESTMENT RISK MANAGEMENT (continued)

(C) LIQUIDITY RISK (continued)

Financial Liabilities

The following tables present the fair value of non-derivative-related financial liabilities as well as derivative-related financial assets and liabilities, aggregated according to their maturities as at March 31, 2011:

($ thousands)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Non-derivative-related financial liabilities[1]				
Amounts payable from pending trades	$ (6,043)	$ –	$ –	$ (6,043)
Interest payable	–	(117)	–	(117)
Securities sold short	(240)	–	–	(240)
Securities sold under repurchase agreements	(2,847)	–	–	(2,847)
Capital debt financing	(3,195)	(721)	(9,744)	(13,660)
Accounts payable and other liabilities	(101)	(13)	(25)	(139)
Total	$ (12,426)	$ (851)	$ (9,769)	$ (23,046)

($ thousands)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Derivative-related financial assets and liabilities				
Derivative-related assets	$ 1,333	$ 1,890	$ 55	$ 3,278
Derivative-related liabilities[1]	(717)	(264)	(120)	(1,101)
Total	$ 616	$ 1,626	$ (65)	$ 2,177

[1] Liabilities are presented in the earliest period in which the counterparty can request payment.

5. FUND TRANSFERS

On behalf of the Plan Account, PSP Investments received fund transfers of $54,045 thousand for the year ended March 31, 2011 (2010 – $84,236 thousand) from the Fund.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

6. INVESTMENT INCOME

(A) INVESTMENT INCOME

Investment income, for the years ended March 31, was as follows:

($ thousands)	2011	2010
Interest income	$ 2,770	$ 1,781
Dividend income	3,239	1,789
Other income	968	931
Dividend expense	(106)	(112)
Interest expense (Note 8)	(335)	(237)
Transaction costs	(295)	(89)
External investment management fees [1]	(210)	(141)
	6,031	3,922
Net realized gains [2]	9,959	6,395
Net unrealized gains	22,769	21,537
Investment Income	**$ 38,759**	$ 31,854

[1] Includes amounts incurred for public market investments that are paid directly by PSP Investments (Note 1). This excludes certain public market pooled fund investment fees, primarily related to performance, in the amount of $470 thousand for the year ended March 31, 2011 (2010 – $56 thousand) as well as Private Market Investments' management fees that are not paid directly by PSP Investments.

Private Market Investments' management fees, which generally vary between 0.1% and 2.0% of the total invested and/or committed amount, amounted to $781 thousand for the year ended March 31, 2011 (2010 – $759 thousand).

[2] Includes foreign currency gains of $577 thousand for the year ended March 31, 2011 (2010 – $2,468 thousand).

(B) INVESTMENT INCOME BY ASSET MIX

Investment income by asset mix based on the economic intent of the investment strategies of the underlying assets as outlined in the SIP&P, for the years ended March 31, after allocating net realized and unrealized gains (losses) on investments to the asset classes to which they relate, was as follows:

($ thousands)	2011	2010
World Equity		
Canadian Equity	$ 16,826	$ 15,035
Foreign Equity:		
US Large Cap Equity	1,703	1,088
EAFE Large Cap Equity	1,015	964
Small Cap Developed World Equity	2,715	1,246
Emerging Markets Equity	2,495	4,002
Private Equity	5,634	5,865
Nominal Fixed Income		
Cash & Cash Equivalents	116	170
World Government Bonds	190	(1,471)
Canadian Fixed Income	1,265	813
Real Return Assets		
World Inflation-Linked Bonds	444	(1,104)
Real Estate	3,516	213
Infrastructure	(269)	743
Absolute Return [1]	3,109	4,290
Investment Income	**$ 38,759**	$ 31,854

[1] Includes amounts related to real estate debt strategies.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

7. EXPENSES

(A) ALLOCATION OF EXPENSES

The Act requires that the costs of operation of PSP Investments be charged to the Plan Accounts 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 was developed which allocates the direct costs of investment activities, such as external investment management fees and custodial fees, to each Plan Account, based upon the asset value of each Plan Account at the time the expense was incurred.

All other operating expenses, excluding the direct cost of investment activities listed above, for the years ended March 31, were allocated in proportion to the annual amount of net assets in each Plan Account as follows:

	2011	2010
Public Service Pension Plan Account	**72.7%**	72.5%
Canadian Forces Pension Plan Account	**19.7**	20.0
Royal Canadian Mounted Police Pension Plan Account	**7.1**	7.2
Reserve Force Pension Plan Account	**0.5**	0.3
Total	**100.0%**	100.0%

Expenses are paid by PSP Investments by way of advances from the Public Service Pension Plan Account, which are reimbursed by the other Plan Accounts on a quarterly basis.

(B) OPERATING EXPENSES

Operating expenses allocated to this Plan Account, for the years ended March 31, consisted of the following:

($ thousands)	**2011**	2010
Salaries and benefits	**$ 351**	$ 182
Professional and consulting fees	**40**	32
Office supplies and equipment	**63**	38
Other operating expenses	**25**	14
Depreciation of fixed assets	**50**	24
Occupancy costs	**24**	15
Custodial fees	**12**	5
Remuneration earned by Directors	**3**	3
Travel and related expenses for Directors	**1**	1
Communication expenses	**1**	1
Total	**$ 570**	$ 315

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

8. CAPITAL DEBT FINANCING

PSP Investments' Capital Debt Financing program consists of the private placement of short-term promissory notes as well as medium-term notes issued by PSP Capital Inc., a wholly-owned subsidiary of PSP Investments. The capital raised is primarily used to finance investments in the Real Estate and Infrastructure asset classes. It is unconditionally and irrevocably guaranteed by PSP Investments in accordance with its corporate leverage policy.

During the year ended March 31, 2011, the Board of Directors amended the maximum amount authorized for the Capital Debt Financing program. Pursuant to such amendment, as at March 31, 2011, the maximum amount authorized was 7.5% of the net investments plus all recourse debt outstanding of PSP Investments. Within such amount, the short-term promissory note component cannot exceed $3 billion. As at March 31, 2010, the maximum amount authorized by the Board of Directors for the short-term promissory notes and medium-term notes was $2 billion and $2 billion, respectively.

The following outlines the terms as well as the fair value of the notes issued under the Capital Debt Financing program allocated to the Plan Account as at March 31:

($ thousands)	**2011**	2010
Short-term promissory notes, bearing interest between 1% and 1.39% and maturing within 29 and 363 days of issuance (March 31, 2010 – 14 and 120 days)	**$ 3,916**	$ 3,243
Medium-term notes Series 1, bearing interest of 4.57% per annum and maturing on December 9, 2013	**$ 5,885**	$ 5,289
Medium-term notes Series 2, bearing interest of 2.94% per annum and maturing on December 3, 2015	**$ 3,859**	$ –
Total	**$ 13,660**	$ 8,532

The capital amounts allocated to the Plan Account to be paid at maturity are $3,924 thousand for the short-term promissory notes, and $5,575 thousand and $3,902 thousand for the Series 1 and Series 2 medium-term notes, respectively.

The operating expenses incurred by PSP Capital Inc. were allocated to each Plan Account as described in Note 7 (a).

Interest expense, for the years ended March 31, was as follows:

($ thousands)	**2011**	2010
Short-term promissory notes	**$ 49**	$ 31
Medium-term notes	**286**	206
Total	**$ 335**	$ 237

9. CAPITAL MANAGEMENT

As an investment company, PSP Investments' objectives in managing its capital are:

- To invest fund transfers, outlined in Note 5, in the best interests of the beneficiaries and contributors under the *Superannuation Acts*. The funds received are invested with a view of achieving a maximum rate of return, without undue risk of loss, having regard to the funding, policies and requirements of the pension plans established under the *Superannuation Acts* and the ability of the Plans to meet their financial obligations. The funds are also invested in accordance with the Investment Risk Management policies which are outlined in Note 4.
- To maintain an appropriate credit rating to achieve access to the capital markets at the lowest cost of capital. Through PSP Capital Inc., and its leverage policies, PSP Investments has the ability to raise capital by issuing short-term promissory notes and medium-term notes. Note 8 provides information on the capital debt financing and Note 4 (c) provides information on PSP Investments' liquidity.

The capital structure of PSP Investments consists of fund transfers and capital debt financing. PSP Investments has no externally imposed restrictions on capital.

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2011

10. GUARANTEES AND INDEMNITIES

PSP Investments provides indemnification to its Directors, its Officers, its vice-presidents and to certain PSP Investments representatives who are asked to serve on boards of directors (or like bodies) or investment advisory boards (or like bodies) of entities in which PSP Investments or its wholly-owned subsidiaries have made an investment or have a financial interest. As a result, but subject to the Act, PSP Investments may be required to indemnify these representatives for costs incurred, such as claims, actions or litigations in connection with the exercise of their duties, unless the liability of such a representative relates to a failure to act honestly and in good faith. To date, PSP Investments has not received any claims or made any payment for such indemnity.

In certain cases, PSP Investments also provides indemnification to third parties in the normal course of business. As a result, PSP Investments may be required to indemnify such third parties in connection with the performance of their contractual obligations. To date, PSP Investments has not received any claims nor made any payments for such indemnities.

As at March 31, 2011, PSP Investments agreed to guarantee, as part of an investment transaction, a non-revolving term loan. In the event of a default, the Plan Account could assume the obligation up to $1,375 thousand (2010 – $1,375 thousand) plus interest and other related costs.

As part of an investment transaction entered into during the year ended March 31, 2011, a wholly-owned subsidiary of PSP Investments has agreed to provide indemnification with respect to the contractual obligations and commitments of a third-party. In the event of a default by such third-party, the subsidiary may be required to assume an obligation of up to $195 million, of which $1,088 thousand may be allocated to the Plan Account, as estimated at the time of the completion of the investment transaction. The subsidiary would also have direct recourse against the defaulting third party in all circumstances. The guarantee expires in April 2012.

PSP Investments also unconditionally and irrevocably guarantees all credit facilities, short-term promissory notes and medium-term notes issued by PSP Capital Inc.

11. COMMITMENTS

PSP Investments and its subsidiaries have committed to enter into investment transactions, which will be funded over the next several years in accordance with agreed terms and conditions. The portion of PSP Investments' commitments that would be assumed by the Plan Account was as follows as at March 31, 2011:

($ thousands)

Private Equity	$ 14,160
Real Estate	5,230
Infrastructure	4,353
Public markets	1,437
Total	**$ 25,180**