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January 9, 2013

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Directors

Canada Pension Plan Investment Board
One Queen Street East, Suite 2500
Toronto, Ontario M5C 2W5

Dear Members of the Board of Directors of the Canada Pension Plan Investment Board:

I write to you today regarding Canada Pension Plan Investment Board's ("CPPIB") disclosure policy. According to the CPPIB's 2012 Report on Responsible Investing:

> *"CPPIB adheres to the highest standards of transparency and accountability. Our Disclosure Policy states: 'Canadians have the right to know why, how, and where we invest their Canada Pension Plan money, who makes the investment decisions, what assets are owned on their behalf and how the investments are performing. Our comprehensive annual reports, together with the extensive information on the CPPIB website and release of quarterly investment results, help meet this commitment."*[1]

This is not an accurate statement, as I have come to learn over the past few weeks. I will outline the key shortfalls below:

CPPIB currently posts a listing of its "Private Equity Funds Commitments" on its website.[2] It discloses the fund name, fund currency, year of the commitment, commitment size, paid-in-capital, reported value, distributions received, and reported value plus distributions. The

[1] CPPIB 2012 Report on Responsible Investing, page 3
[2] http://www.cppib.ca/files/F2013/Q2F13_Financial_Documents/Website_Disclosure_Q2_F2013_FINALv2.pdf

information CPPIB provides on a quarterly basis also outlines the reported values in the fund's home currency, but none of this information allows Canadians to understand how our "investments are performing"[3].

First, CPPIB refuses to disclose, either publicly or upon specific media request[4], the internal rates of return (IRRs) for the various funds we've invested in. The "internal rate of return" is widely recognized as a traditional measure to judge how a private equity fund has performed over time, given the dramatic impact of the time-value-of-money.

Other public plans, such as the US$240 billion California Public Employees' Retirement System ("CalPERS"), the US$160 billion California State Teachers Retirement System ("CalSTRS"), the State of Oregon Public Employees Retirement System, the Washington State Investment Board and UTIMCO (via freedom of information requests in UTIMCO's case) all publicly disclose specific IRRs on a fund by fund basis (see representative documents enclosed or footnotes below linking to relevant fund website).

Here is an example of the impact of CPPIB's disclosure approach:

In 2005, CPPIB committed US$413.5 million to Blackstone V. That fund manager has drawn down US$402.8 million over the past eight years, and the value of our current fund holding and the distributions we've received is worth US$416.3 million, according to CPPIB disclosure.[5] As such, CPPIB reports that, based upon the carrying value, we've earned 3.2% on our investment to date.

According to CalSTRS, they've earned an IRR of 2% on the same fund over approximately the same period of time. A modest difference.

The gap is more stark on Carlyle Venture Partners II (2002), for example. CPPIB committed US$60 million there, and reports that the value of our investment, including distributions, is worth 10.6% more than what we originally invested. Not a great win, but at least a profit; ignoring the time-value-of-money issue.

According to CalPERS, their IRR was negative 2.1% on the same fund – clearly a bad outcome for investors. Canadians believe we made money on this fund, yet Californians are advised they experienced a negative financial return.

Small dollars perhaps, so let's look at KKR 2006, instead. CPPIB committed US$475 million to that fund, and reports on its website that the value and distributions in U.S. dollars are worth 27.8% more than the US$464.2 million that we ultimately invested.

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[3] See also, CPPIB's Disclosure Policy http://www.cppib.ca/files/F2013/Disclosure_Policy_1.pdf
[4] As requested of Linda Sims by a producer at the Business News Network, December 18, 2012
[5] http://www.cppib.ca/files/F2013/Q2F13_Financial_Documents/Website_Disclosure_Q2_F2013_FINALv2.pdf

According to CalSTRS, they made a 3.7% IRR on the same fund, below CPPIB's annual investment solvency target of 4% plus inflation.
Canadians are advised by CPPIB that we made 28% on our money on this fund investment, while investment professionals are aware that our rate of return (in U.S. dollars) was less than 4%, according to audited financial results published on the CalSTRS website.

CPPIB's disclosure of our US$200 million 2005 investment in Welsh, Carson, Anderson & Stowe X, for example, is also misleading: CPPIB reports the value and distributions (in USD) were worth 17.7% more than what we invested, while CalSTRS published their IRR to be a very substandard 3.3%.

Other examples of CPPIB's dramatically misleading approach to the release of financial information include our investments in Advent VI, Apax Europe VII, Apollo VI, Ares 2003, Blackstone IV, Bridgepoint Europe III, Diamond Castle IV, First Reserve XI, First Reserve XII, Hellman & Friedman V, KKR European Fund II, MatlinPatterson III, Permira IV....

Billions of dollars of commitments, all told; in each case our true investment return is overstated as a result of CPPIB's approach to return disclosure.

The second key area of misinformation arises as a result of CPPIB's decision to publish these cash flows in the home currency of the private equity fund in question, rather than Canadian dollars, which is the currency that we surely must use to fund the lion's share of our commitments to these largely U.S. and Euro-denominated private equity vehicles.

These same public plans – CalPERS[6], CalSTRS[7], Oregon[8], WSIB[9] and UTIMCO – all report the individual fund level return data on the basis of their own invested currency (being U.S. dollars), rather than the currency of the private equity vehicle in question (whether it be denominated in Canadian dollars, Euros or Renminbi, for example).

It makes sense. Reporting a profit on a fund investment is misleading if it turns out that you actually lost money when you converted the original investment back to the currency that you use for financial statement reporting purposes. Since CPPIB has a policy of not hedging foreign currency exposure[10], this issue cannot be foreign to the Board of Directors.

By publishing the information in the home currency of the fund, and not Canadian dollars (which is the currency of our audited financial statements, our original private equity fund investment and likely each subsequent capital call during the life of the individual fund), Canadians are unable to ascertain whether or not we made a profit or loss on each of these 135 investment vehicles – leaving aside the absence of an individual fund IRR calculation.

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[6] http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/equities/pe/private-equity-review/pe-perform-review/home.xml
[7] http://www.calstrs.com/investments/portfolio/privequityperformance.pdf
[8] http://www.oregon.gov/treasury/Divisions/Investment/Documents/OPERS/Monthly%20Returns/2012/FOIA%20Q2%202012.pdf
[9] http://www.sib.wa.gov/financial/pdfs/quarterly/ir063012.pdf
[10] CPPIB 2012 Annual Report, page 26

As such, Canadians cannot asses "how [our] investments are performing", since we have no idea about the impact of the changes in the relative values of the Canadian and U.S. dollars (or Euros) are having on our specific investment in this fund. Worse, CPPIB's current disclosure approach invariably misleads Canadians. Here's an example:

On June 30, 2005, to satisfy a capital call on our US$413.5 million commitment to Blackstone V, CPPIB needed to convert 1.2256 Canadian dollars to buy 1 U.S. dollar.[11] Over the course of the next few years, we would have paid rates such as 1.115 (June 30, 2006), 1.0634 (June 29, 2007), and so forth to satisfy follow-on capital calls for this U.S. dollar investment vehicle.

A year ago, for example, when distributions flowed back to CPPIB from this particular fund, CPPIB would have been converting U.S. dollars at a rate of 1.0192: about 20% below the value of the representative 2005 capital call. However, according to the CPPIB's website, we still made a positive return 3.3% on the investment due to the CPPIB's U.S. dollar fund performance reporting approach.

Given Blackstone V's modest nominal return of 3.3% on our capital, we likely lost money on our investment when the currency impact is taken into consideration...which is what is ultimately reflected in the audited financial statements of the CPPIB. Yet unavailable for specific fund level review by Canadians, unlike the people of Oregon, a state of 3.8 million people.

Because CalPERS, CalSTRS, Oregon, WSIB and UTIMCO all report their private equity cash flows in the hands of their beneficiaries, this confusion cannot arise. These managers are leading the way on the transparency and accountability front. At this time, CPPIB refuses to release this information about the very same fund investments[12], making a mockery of the claim that: *"CPPIB adheres to the highest standards of transparency and accountability."*

According to these excerpts from the August 9, 2012 terms of reference for the CPPIB Audit Committee, the decision to disclose these IRRs and home currency impact, as is done by CPPIB's peer group, ultimately rests with the CPPIB Board of Directors:

> *"review and recommend to the Board the release of quarterly financial statements"*
> *"review and recommend to the Board for approval financial content of the Annual Report"*
> *"review and assess appropriateness of accounting policies and financial reporting practices"*
> *"review and assess key estimates and judgments of Management that may be material to financial reporting"*
> *"the appropriateness of accounting policies and financial reporting practices used by CPP Investment Board"*
> *"receive a report from Management to ensure that adequate procedures are in place, and periodically review these procedures, for the review of public disclosure of financial statements and financial information extracted or derived from financial statements, other than public disclosure otherwise referred to in section 6.1"*

[11] Bank of Canada website

[12] As requested of Linda Sims by a producer at the Business News Network, December 18, 2012

The CPPIB's Policy on Responsible Investing[13] also provides helpful guidance on this matter:

> *"Disclosure is the key that allows investors to better understand, evaluate and assess potential risk and return, including potential impact of ESG factors on a company's performance."*

If the CPPIB is going to require the highest transparency from its own investee partners and the public companies that it invests in, as per the published excerpt above, I think Canadians equally deserve to have the same information about our investments in Apollo, Blackstone and KKR that is currently made available online to the citizens of many U.S. states. This is not about disclosing confidential details regarding the individual performance of the portfolio companies within these funds, as is cited on the CPPIB's website[14]. Although I note the double standard where CPPIB is quick to publicly discuss the profit we've made on Skype, ostensibly because it was a public company[15] (Skype filed an S-1 registration statement but never completed its IPO), CPPIB refuses to disclose what we've lost on the go-private / take-public of our direct investment in Freescale Semiconductor (now publicly-listed on the NYSE), for example.

This issue is simply about the release of information that the CPPIB has on hand regarding the performance of our external private equity fund program and the impact of currency swings on our investments. Data which is not subject to confidentiality agreements (as is evidenced by the ongoing publication of this same data by others). Should CPPIB continue to refuse to disclose what is regularly made public by its peers, it only serves to raise concerns – or perhaps confirm suspicions – that since inception, the net IRR of our $30 billion external private equity program is well below the CPPIB's solvency threshold.

Thank you, in advance, for considering this important matter. I look forward to hearing from you.

Respectfully,

Mark McQueen
President & CEO

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[13] Published August 10, 2010

[14] http://www.cppib.ca/Investments/Our_Investment_Partners/Funds_and_Secondaries_Partners/fund_commitments.html

[15] As requested of Linda Sims by a producer at the Business News Network, December 18, 2012: CPPIB official written response to BNN regarding the Skype vs. EMI, Freescale, TXU, etc. disclosure question: "The exceptions to this rule tend to be for publicly traded companies such as Skype, where our stake, the amount we paid for it, and the purchase price by Microsoft were all publicly available information."