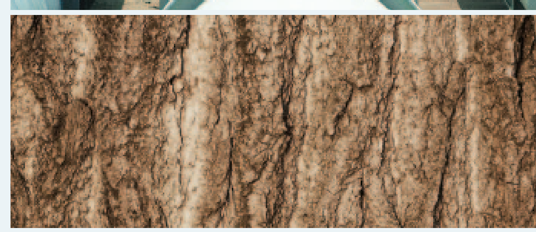
PUBLIC SECTOR PENSION INVESTMENT BOARD

2012 ANNUAL REPORT







2012

PSP INVESTMENTS

WHO WE ARE AND WHAT WE DO

CORPORATE PROFILE

The Public Sector Pension Investment Board ("PSP Investments" or the "Corporation") is a Canadian Crown corporation established to invest the amounts transferred by the Government of Canada equal to the proceeds of the net contributions since April 1, 2000, for the pension plans of the Public Service of Canada, the Canadian Forces and the Royal Canadian Mounted Police, and since March 1, 2007, for the Reserve Force Pension Plan (collectively the "Plans"). The amounts so transferred to the Corporation are to fund the liabilities under the Plans for service after the foregoing dates (the "Post-2000 Liabilities").

Its statutory objects are to manage the funds transferred to it in the best interests of the contributors and beneficiaries under the Plans and to maximize investment returns without undue risk of loss, having regard to the funding, policies and requirements of the Plans and their ability to meet their financial obligations.

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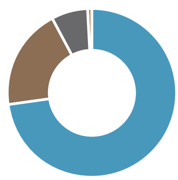
AT A GLANCE

ASSET MIX
As at March 31, 2012

28.6%	Foreign Equity
23.2%	Real Return Assets
22.4%	Canadian Equity
15.8%	Nominal Fixed Income
10.0%	Private Equity



NET ASSETS PER PENSION PLAN ACCOUNT
As at March 31, 2012 ($ billions)

73.1%	Public Service	47.1
19.3%	Canadian Forces	12.4
7.1%	RCMP	4.6
0.5%	Reserve Force	0.4

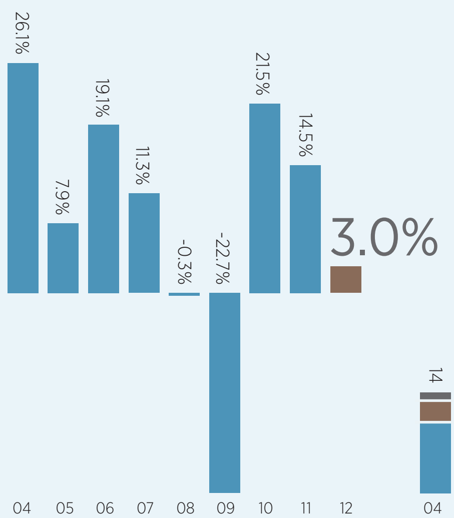
Net assets: $64.5 billion

2012

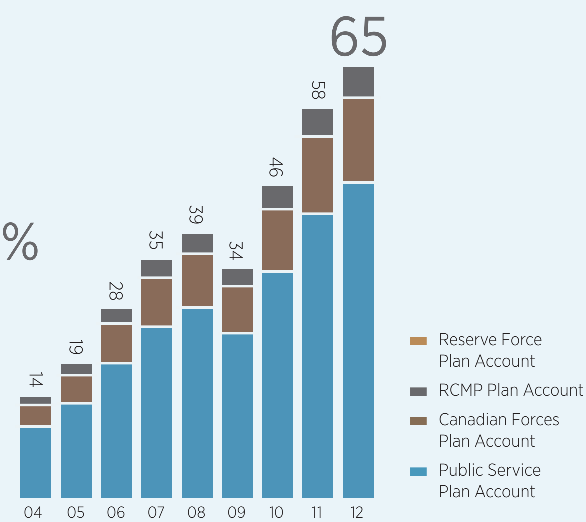
HIGHLIGHTS
FISCAL YEAR 2012

- Consolidated net assets increased 11% to $64.5 billion.
- Investment income of $1.7 billion after expenses. Total portfolio return of 3.0% compared to the benchmark return of 1.6%.
- Three-year annualized return of 12.7%, investment income of $16.5 billion and value-added above benchmark of $2.4 billion.
- A majority of portfolios outperformed their benchmarks.
- Implementation of changes to Policy Portfolio, including addition of Renewable Resources asset class.
- Assets managed internally reached approximately $48 billion, or 74% of total net assets. Assets actively managed internally totalled more than $23 billion, up from almost $18 billion in fiscal year 2011.

ANNUAL PERFORMANCE
As at March 31



CHANGES IN NET ASSETS (CONSOLIDATED)
As at March 31 ($ billions)



CORPORATE OBJECTIVES FISCAL YEAR 2012

INTERNAL AND ACTIVE MANAGEMENT

Increase investment activities and level of assets managed internally and actively with the aim of improving overall investment cost structure (expressed as a percentage of assets under management) and increasing the probability of meeting or exceeding the desired long-term actuarial rate of return.

ACHIEVEMENTS

- Assets managed internally totalled approximately $48 billion or 74% of assets. Of the almost $37 billion in assets actively managed, more than $23 billion or 63% are managed internally.
- Operating and asset management expenses as a percentage of assets decreased by almost 10%.
- Recruited 17 investment professionals to support growth in internal active management.

TALENT MANAGEMENT

Advance corporate-wide engagement initiatives that strengthen corporate culture. Implement the recruitment and development initiatives required to support the increased internal and active management initiatives in order to maximize our return without undue risk. Produce the programs that develop management capabilities to support the Succession Plan. Ensure that all employees have corporately aligned development plans in place. Implement the human resources systems that provide comprehensive accurate key performance indicators. Provide for Board of Directors transition.

ACHIEVEMENTS

- Achieved a high engagement level in the independent employee engagement survey.
- Completed the implementation of company-wide Integrated Talent Management Solution providing comprehensive information related to performance, compensation and recruitment.
- Reduced employee turnover ratio.
- Enhanced reporting of key human resources indicators to the Board of Directors.

ENTERPRISE RISK MANAGEMENT

Implement the enterprise risk management and reporting measures required for increased internal and active management in order to maximize our return without undue risk. Implement the recommendations from the Special Examination and the Risk Control Self Assessment completed in fiscal year 2011.

ACHIEVEMENTS

- Reviewed and refined, as required, all policies and procedures governing enterprise, operational and investment risk management in light of the Special Examination recommendations and Risk and Control Self Assessment findings.
- Evolved risk measurement and monitoring practices through ongoing development of risk metrics.
- Improved governance structure surrounding the management of operational risks.

STRATEGIC PLAN

Close the 2012 three-year Strategic Plan. Develop and approve the Vision 2015 three-year Strategic Plan recognizing the increasingly complex and challenging investment environment.

ACHIEVEMENTS

- Substantially completed Vision 2012 Strategic Plan.
- Adopted three-year Vision 2015 Strategic Plan in June 2012.

2012

KEY CORPORATE OBJECTIVES FISCAL YEAR 2013

Investments

Continue to execute the Private Markets' business plans towards the 42% target allocation and greater internal and active management in Public Markets. Increase network of international investment partners. Maintain a competitive total investment cost structure.

Enterprise Risk Management

Continue to refine risk management activities and reporting measures required for increased internal and active management. Ensure policies and procedures framework is aligned with changing economic and regulatory environment. Continue implementation of Responsible Investment Policy.

Strategic Plan

Implement first year of Vision 2015 three-year Strategic Plan. Ensure individual objectives are aligned with Strategic Plan. Communicate Vision 2015 to the organization.

Talent

Ensure proper teams are in place through internal appointments and recruitment of high performing employees to support the deployment of the investment strategies. Evolve leadership and development plans to extend succession planning at deeper levels in the organization. Develop and implement engagement initiatives to build upon the results of the fiscal 2012 employee survey.

2013

INTERIM CHAIR'S **REPORT**

PSP Investments achieved positive results and generated value added relative to its performance benchmark in fiscal year 2012, despite a volatile investment climate roiled by events ranging from debt concerns in the European Union and the United States to the Japanese earthquake and tsunami.

From a strategic perspective, fiscal year 2012 was a transitional year as investment teams began implementing changes to the Policy Portfolio, which had been approved by the Board of Directors following a comprehensive review and became effective April 1, 2011.

In essence, we reduced the allocation to World Equity and increased from 28% to 42% the overall target allocation to Private Markets — including Real Return assets such as Real Estate, Infrastructure and a new asset class, Renewable Resources, which are a good match for the inflation-sensitive nature of the Plans' long-term liabilities. The changes reflect our current expectations of long-term market conditions and were designed to further refine the alignment of the Policy Portfolio with the Plans' Post-2000 Liabilities, in addition to taking advantage of our exceptional liquidity.

Each year, PSP Investments receives an inflow of new funds in the magnitude of $4 billion, with net contributions projected to remain positive for at least the next 15 years. Consequently, we are in a rather favourable position with a degree of liquidity and flexibility that enables us to focus on a long-term investment horizon. During fiscal year 2012, the overall weighting of private-market investments increased from 22.8% to 27.0%, representing a net increase of $4.2 billion in Private Market asset classes.

Our Policy Portfolio is constructed to achieve a return at least equal to the "actuarial rate" over the long term — that is the rate of return required to maintain funding requirements and pension benefits at current levels. In his latest actuarial valuation of the Canadian Forces Pension Plan, the Chief Actuary of Canada reduced the actuarial rate of return from 4.3% after inflation to 4.2% after inflation.

Over the nine-year span since we began the move to diversification, PSP Investments has in fact exceeded the targeted actuarial rate despite the impact of the global financial crisis. One hundred dollars invested in PSP Investments nine years ago would have been worth $194 at the end of fiscal year 2012, whereas that same $100 earning the actuarial rate of return would have been worth $171.

ENHANCED RISK MANAGEMENT REPORTING

One of the Board's crucial on-going roles is to ensure that effective enterprise, investment and operations risk policies are in place. Mindful of the Corporation's mandate to maximize returns without undue risk, we worked closely with management this past year to implement changes designed to further enhance risk management and oversight and ensure that the risk framework is properly aligned with our revised strategy. That interaction not only yielded enhanced reporting procedures but also afforded an opportunity for Board members to continue developing a more dynamic vision of risk.

COST EFFECTIVENESS

Given the Corporation's continued rapid growth, the Board is committed to making certain that PSP Investments' resources are managed in an efficient, cost-effective manner that enables it to benefit from scalability. Cost efficiency is among the main benefits to be derived from PSP Investments' increased focus on internal management of the portfolio. Considering that the amount of assets internally managed has grown from approximately $21 billion to almost $48 billion since the end of fiscal year 2009, the scope of the inherent savings is considerable.

The effectiveness of both the Board's and management's efforts is reflected in the fact that, while assets have increased by some 91% over that same period, operating and asset-management expenses rose by only 11%.

ACKNOWLEDGEMENTS

On behalf of Board members past and present, I would like to pay tribute to former Chair Paul Cantor, who stepped down when his term expired just prior to the fiscal year-end after nine years as Chair. Determined to provide PSP Investments with nothing less than an exemplary level of governance, Paul set the tone at the top and led by example. Tough and decisive when called for, he encouraged frank discussion around the boardroom table and understood well the complementary roles of oversight and insight in fulfilling the Board's mandate. The solid core values and unrelenting commitment to excellence that have been embraced throughout PSP Investments are a legacy of Mr. Cantor's leadership.

Special thanks are due as well to Bob Baldwin, who has retired from the Board. His contribution to the Board and to PSP Investments has been extremely valuable. Like Paul, Mr. Baldwin had been a member of our Board from the very outset, serving with distinction for almost a dozen years as a director and committee chair.

I also wish to take this opportunity to formally welcome Micheline Bouchard and Garnet Garven, who joined the Board during fiscal year 2012. Ms. Bouchard and Mr. Garven both bring valuable knowledge and experience that are in keeping with PSP Investments' on-going commitment to strong governance. I welcome, as well, the reappointment of Léon Courville for an additional four-year term. At this writing, we are awaiting additional appointments that will bring the Board up to full strength as well as the naming of a new Chair.

In conclusion, I would like to express the appreciation of the entire Board to President and CEO Gordon J. Fyfe and his senior team, as well as to all employees, for delivering good results under challenging circumstances in fiscal year 2012, while keeping PSP Investments on a steady growth trajectory.

Cheryl Barker.

Cheryl Barker
Interim Chair

PRESIDENT'S **REPORT**

PSP Investments recorded a solid performance during fiscal year 2012 in a global marketplace characterized by continuing volatility and the debt crisis in Europe. We generated a total portfolio return of 3.0% versus 1.6% for the Policy Portfolio Benchmark.

For the three-year period since the financial meltdown of 2008-2009, PSP Investments had an annualized return of 12.7% generating $16.5 billion in investment income, and $2.4 billion of value added, over and above benchmark returns. It was the third consecutive year that we have outperformed our key benchmark. A majority of our portfolios outperformed their respective benchmarks during fiscal year 2012, highlighted by particularly strong relative performances from Real Estate, Public Markets equities and fixed income portfolios.

PSP Investments' overall performance for fiscal year 2012 was impacted by the negative performance of global equities, most notably in the Canadian, European and Emerging Markets. Fixed Income markets, on the other hand, posted one of their best performances of recent years.

During the year, we reduced our exposure to public equities and increased our exposure to Private Market and Real Return asset classes. Our Real Estate, Private Equity, Infrastructure and Renewable Resources asset classes all posted positive returns ranging from 2.7% to 13.4%.

While markets can be challenging in the short-term, we continued to diversify the portfolio and take advantage of PSP Investments' exceptional liquidity as markets offer attractive opportunities for patient investors with deep pockets to acquire some outstanding assets at very favourable valuations.

Taking into account investment income of $1.7 billion after expenses as well as $4.7 billion of funds transferred by the Plans, PSP Investments' consolidated net assets increased by 11% to a new peak of $64.5 billion as at March 31, 2012. Over the three years since the global financial crisis, the value of our total net assets has increased by 91% from their fiscal 2009 year-end level.

Another noteworthy event during the year was our capital market medium-term notes issuance in which we benefited from the lowest fixed coupon rate ever attained by a Canadian pension fund investment manager in the Canadian market. This is a further testament to the triple "A" credit rating that the organization continues to maintain.

INVESTING IN FUTURE GROWTH

Fiscal 2012 was noteworthy for the high level of investment activity and volume of transactions, as our teams continued pursuing opportunities to capitalize on our competitive advantages by investing in future growth.

Early in fiscal year 2012, we made our first investment in a new asset class — Renewable Resources — with the acquisition of a 50% interest in TimberWest Forest Corporation, the largest owner of private timberlands in Western Canada. TimberWest owns approximately 808,000 acres (*327,000 hectares*) of private land on Vancouver Island and additional crown rights to harvest on government timberlands. The Renewable Resources asset class will initially include farmland as well as timber.

Over the course of the fiscal year, our Real Estate team made more than 30 direct investments. Included were additional properties in Brazil and Colombia, reflecting PSP Investments' intensified focus on high-growth emerging markets where burgeoning middle-class populations are driving demand.

The acquisition of a strategically located lower-Manhattan office building — which ranks among the largest buildings in all of New York City — was one of a number of additions to our increasingly diversified portfolio of properties in the US which now also includes warehouse and industrial properties.

Other noteworthy real-estate transactions included office properties in key cities in Europe and North America in collaboration with local partners, further enhancing a portfolio that generated the second best returns of any asset class during the latest fiscal year.

Infrastructure is an asset class that tends to require both persistence and patience, given that attractive investment opportunities are limited in number and generally of a complex nature. Several years of hard work seeking out suitable opportunities and partners led to accelerated growth in fiscal year 2012, when our Infrastructure team made investments totalling some $1.5 billion. This brought the value of the portfolio to approximately $3.6 billion at year's end.

Included among the Infrastructure acquisitions was PSP Investments' second major investment in the ports sector — a participation in Forth Ports Limited, one of the United Kingdom's largest maritime operators with seven ports in London and Scotland. As well, we acquired an ownership interest in Gassled, one of the largest offshore pipeline systems in the world. Gassled transports the majority of the natural gas sourced from the Norwegian Continental Shelf to markets in the U.K. and Western Europe.

Private Equity is another area where we have increased our asset allocation. In November 2011, PSP Investments along with two partners acquired Kinetic Concepts, Inc. (KCI) in a transaction valued at approximately US$ 6.3 billion. Texas-based KCI, with some 7,000 employees and a market presence in more than 20 countries, has the leading global market share in negative pressure wound therapy. This is a very attractive asset that provides exceptional opportunities for growth and value creation.

The value of assets managed internally increased from approximately $21 billion to almost $48 billion over the last three years

FOCUSING ON INTERNAL ACTIVE MANAGEMENT

An on-going strategic thrust entails further increasing the level of PSP Investments' assets under internal active management.

During fiscal year 2012, the proportion of total assets being managed internally amounted to 74% — up sharply from 62% just three years ago at the end of fiscal year 2009. Over that same period, the value of assets managed internally increased from approximately $21 billion to almost $48 billion.

From another perspective, it is noteworthy that approximately 63% of all our actively managed assets now are being managed internally. When compared to external management, internal management brings two major benefits: lower costs and a closer alignment of investment managers' goals with PSP Investments' mandate.

With respect to Public Markets, where PSP Investments still has a majority of its assets invested, the volume of assets managed internally *and* actively increased from approximately $600 million in 2009 to almost $11 billion at the end of fiscal year 2012.

The strong performance of our Fixed Income team during fiscal year 2012 provides an excellent example of the advantages of internal active management. The team did an exceptional job managing the European debt crisis, not only avoiding the worst of the fallout but enabling PSP Investments to generate some solid returns, both in absolute terms and relative to the benchmark.

Lingering volatility made fiscal year 2012 a challenging one overall for our Public Markets teams. For instance, at the mid-point of the year, most major stock market indices were significantly lower — Standard & Poor's negative 7.6%, Emerging Markets negative 18.0%, and the TSX negative 16.5% — although they subsequently rebounded somewhat. The majority of our Public Markets teams managed to equal or better their respective benchmarks over the course of the fiscal year.

NEW STRATEGIC PLAN

Having a clearly defined strategic direction or vision is paramount to the success of our organization. Accordingly, another of our key corporate objectives this past year entailed the development of a new strategic plan that would build upon Vision 2012, our previous three-year road map which has now been fully implemented.

Vision 2015, approved by the Board of Directors in June 2012, reflects a continuation of the underlying strategies developed in fiscal year 2004 when we began to diversify the portfolio, which have been refined over the years to reflect the changing impact of the external environment.

The new three-year plan sets out four main strategic goals. They include: further refining our investment strategy and policies, including the Policy Portfolio, its structure and alignment with the sponsor and the beneficiaries; continuing to implement the active management philosophy; developing scalable and efficient operations that form an integral part of the investment process; and supporting the Corporation in its next development stage through talent management, leadership and total-reward strategies.

ENTERPRISE RISK MANAGEMENT (ERM)

An additional priority involved enhancing our enterprise risk management and reporting measures. To that end, working with the Board, we have improved the quality of our ERM reporting to further strengthen the Board's capabilities with respect to its oversight and governance roles.

ACKNOWLEDGEMENTS

I wish to take this opportunity to recognize outstanding efforts and thank employees throughout PSP Investments for their hard work and commitment during fiscal year 2012. I would also like to express my appreciation to the Board of Directors for their counsel and support over the course of a challenging year.

I also want to acknowledge Bob Baldwin who was among the first Directors appointed to our Board in March 2000 and who retired from the Board this year. Bob has made an enormous contribution to the organization, particularly in better understanding the liabilities of the Plans.

And finally, I wish to pay tribute to a truly remarkable individual, our long-time Chair Paul Cantor, who retired from PSP Investments' Board effective March 5, 2012, having served as a member from its inception in 2000 and as Chair since 2003. Mr. Cantor played an enormous role in nurturing PSP Investments from a fledgling organization into a robust, diversified fund that ranks among the largest pension investment managers in Canada and is highly regarded internationally. An indefatigable worker, he strove to be the best Chair of any public fund in the world and, in the process, made us all better. Thank you Paul.

WELL POSITIONED GOING FORWARD

Having adhered to our strategy and stayed the course through the financial crisis and subsequent period of uncertainty, we look forward with confidence to the point in the cycle where we will be able to realize substantial gains on the high-quality assets and investment opportunities we have availed ourselves of over the past several years.

Meanwhile, we are continuing to build and develop our world-class team of investment and leadership professionals and forge new partnerships around the globe, with a view to achieving the high-calibre performance and sustainable returns required to fulfill our mandate.

Gordon J. Fyfe
President and Chief Executive Officer

MANAGEMENT'S DISCUSSION OF FUND PERFORMANCE AND RESULTS

INVESTMENT APPROACH, OBJECTIVES, THE POLICY PORTFOLIO AND ACTIVE MANAGEMENT

INVESTMENT APPROACH AND OBJECTIVES

PSP Investments' mandate is described in Section 4 of the *Public Sector Pension Investment Board Act* (the "Act"):

- To manage the amounts transferred to it in the best interests of contributors and beneficiaries under the Plans; and to maximize returns without undue risk of loss, having regard to the funding, policies and requirements of the Plans and the ability of those Plans to meet their financial obligations.

Based on these statutory objects, PSP Investments' Board of Directors implemented an investment approach around two key pillars:

1. A Policy Portfolio (defining the asset mix — how assets will be allocated among various asset classes), which is expected to achieve a return at least equal to the long-term actuarial rate of return used by the Chief Actuary of Canada in his latest actuarial valuations of the Plans (i.e. a real return of 4.2%[1], after inflation). In the absence of other factors affecting the funding of the Plans as it relates to the Post-2000 Liabilities, it is the rate of return required to maintain funding requirements and pension benefits at current levels.
2. Active management activities, which are designed to generate returns over and above the Policy Portfolio and assist in attaining the actuarial rate of return within an active risk budget.

The following investment objectives were established to assess the performance of this investment approach:

- Absolute Return: achieve a long-term return (net of expenses) at least equal to the actuarial rate of return;
- Relative Performance: achieve a target return exceeding the Policy Portfolio return.

POLICY PORTFOLIO

A key pillar of PSP Investments' approach is the Policy Portfolio. The Policy Portfolio is reviewed at least annually within an asset-liability framework, affording a thorough understanding of the linkage between the Policy Portfolio and the Plans' Post-2000 Liabilities. Understanding this linkage helps ensure that PSP Investments' approach and results not only meet the actuarial rate of return, but also achieve this rate of return with an acceptable level of risk related to the funding of the Plans. This framework also ensures proper alignment of interests between PSP Investments and the Plans' stakeholders.

[1] In the actuarial reports on the Plans for the Canadian Forces as at March 31, 2010, tabled in Parliament in October 2011, the actuarial real rate of return was reduced from 4.3% to 4.2%.

– PSP Investments' Policy Portfolio is expected to achieve a return at least equal to the actuarial rate of return over the long term (i.e. a real return of 4.2%), with a level of funding risk that is deemed acceptable.

A risk-free real rate of return could be achieved with Canada Real Return Bonds (RRBs). However, the yield on RRBs is currently approximately 0%. This is well short of the 4.2% required to maintain funding requirements at their current level. Taking on market risk is therefore required to achieve this 4.2% real rate of return.

This market risk entails funding risk (whereby the value of the assets could fall below the value of the Post-2000 Liabilities). The level of risk deemed acceptable is the funding risk associated with a portfolio composed of public, liquid asset classes (debt and equity securities) which, based on PSP Investments' expectations of long-term market conditions, would be required to achieve this real rate of return over time.

– PSP Investments' Policy Portfolio recognizes the unique characteristics of the Plans' Post-2000 Liabilities and the net inflows expected to fund these liabilities.

A portfolio composed of public, liquid asset classes would miss out on opportunities afforded by the unique characteristics of the Plans' Post-2000 Liabilities and their funding. PSP Investments is expected to receive positive net inflows over at least the next 15 years, an exceptional situation that constitutes a significant competitive advantage. The high level of liquidity allows for further diversification into less-liquid asset classes such as Private Markets, including Private Equity, Infrastructure, Real Estate and Renewable Resources. The latter three provide for a diversified exposure to Real Return assets, recognizing the inflation-sensitive nature of the Post-2000 Liabilities.

Asset-liability studies conducted on behalf of the Board of Directors indicate that the increased diversification and the liability-matching characteristics of the Policy Portfolio should provide for a higher likelihood of meeting the actuarial target rate of return, with the same or an even lower level of funding risk over time.

POLICY PORTFOLIO
As at March 31, 2012

World Equity 54%	Public Market Equity	40%
	Private Equity	14%
Real Return Assets 33%	Real Estate	13%
	Infrastructure	13%
	World Inflation-Linked Bonds	5%
	Renewable Resources	2%
Nominal Fixed Income 13%	Fixed Income	11%
	Cash & Cash Equivalents	2%

– Renewable Resources added to the Policy Portfolio

Following a thorough review of the Policy Portfolio that began during fiscal year 2010, changes were made in April 2011, including a reduced allocation to World Equity and an increased allocation to Real Return assets and private asset classes. Those changes were followed by the addition of a new asset class during the fiscal year: Renewable Resources. This asset class, which initially includes timber and farmland, is expected to enhance the alignment of PSP's Policy Portfolio with the Post-2000 Liabilities of the Plans. It offers three significant advantages:

1. It is expected to provide diversification with regard to the sources and patterns of return versus current asset classes (e.g. returns are driven in part by biological growth – a unique attribute).
2. It is expected to offer an illiquidity premium, which PSP Investments is well positioned to capture given the positive net inflows expected over at least the next 15 years.
3. It is expected to provide long-term inflation-hedging characteristics particularly well-matched with the nature of the Plans' Post-2000 Liabilities.

ACTIVE MANAGEMENT

Active management activities form the second pillar of PSP Investments' approach. They are designed to generate returns over and above the Policy Portfolio and assist in attaining the actuarial rate of return within an active risk budget. These activities typically involve the creation of investment strategies that are different from the Policy Portfolio benchmarks. In equities, this is usually accomplished by overweighting or underweighting specific sectors or securities relative to the Policy Portfolio equity benchmarks.

PSP Investments believes that its size makes the deployment of active management strategies particularly advantageous. Notably, this approach offers economies of scale and allows for an increased scope of activities in selected asset classes. Accordingly, PSP Investments has been increasing the proportion of its assets under internal active management and expanding relationships with selected partners. Bringing more investment management in house provides for better control in terms of risk, investment cost savings and increased influence over major decisions.

Bringing more investment management in house provides for better control in terms of risk, investment cost savings and increased influence over major decisions.

CHANGE IN NET ASSETS AND FUND PERFORMANCE

PERFORMANCE MEASUREMENT AND EVALUATION

Based on the Statement of Investment Policies, Standards and Procedures (SIP&P), PSP Investments evaluates its investment strategies, as well as individual investment mandates, through performance measurement. The performance for each investment strategy and mandate is compared to an appropriate benchmark.

BENCHMARKS

A combined Policy Portfolio benchmark ("Policy Benchmark") is constructed using the asset class benchmarks weighted by the actual portfolio asset class weightings. The return for each asset class is compared to the relevant benchmark return, while PSP Investments' overall return is compared to the Policy Benchmark return.

The following benchmarks were used to measure relative performance for each asset class and for the Policy Benchmark return for fiscal year 2012.

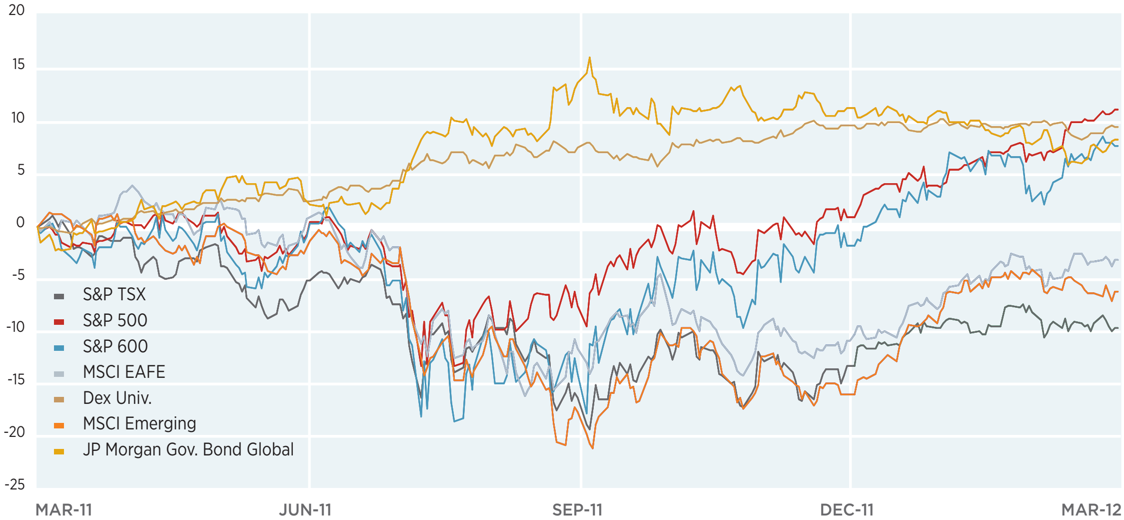
Asset Class	Benchmark
World Equity	
Canadian Equity	S&P/TSX Composite Index
Foreign Equity US Large Cap Equity EAFE Large Cap Equity Small Cap Developed World Equity Emerging Markets Equity	 S&P 500 Index MSCI EAFE Index S&P 600 Index and MSCI EAFE Small Cap Index MSCI EMF Index
Private Equity	Private Equity Fund Universe and Private Equity Cost of Capital[1]
Nominal Fixed Income	
Cash & Cash Equivalents	DEX 91 Day T-Bill Index
Fixed Income	JP Morgan Government Bond Index Global and DEX Universe Bond Index
Real Return Assets	
World Inflation-Linked Bonds	Four Country ILB Index[1]
Real Estate	Real Estate Cost of Capital[1]
Infrastructure	Inflation Adjusted Infrastructure Risk Premium and Infrastructure Cost of Capital[1]
Renewable Resources	Renewable Resources Cost of Capital[1]

[1] Customized benchmark

MARKET OVERVIEW

PERFORMANCE OF MAJOR WORLD INDICES

Fiscal year 2012 ($ CAD, percent)



The resilience of the global economy and markets' appetite for risk were severely tested over the past year with the landscape dominated by a succession of economic shocks, geopolitical events and adverse policy events. The Japanese earthquake and tsunami disrupted global supply chains, the lagging impact of rising oil prices weighed on consumer purchasing power, the US debt-ceiling negotiations thrust politics onto centre stage and the European debt crisis continued to escalate. As a result, global economic growth slowed noticeably, from an estimated 5.2% in calendar 2010 to 3.8% in 2011. The US economy came close to stalling in the early part of the year, raising fears of a double-dip recession, Europe fell into recession outright and many emerging economies – most notably China – downshifted as well. As a result, global equities fell sharply during the summer months and bond yields plunged to new cyclical lows, spurred in part by another round of purchases by the US Federal Reserve (Fed) and a commitment from the Fed to hold its policy rate unchanged through to the end of 2014. At the same time, however, a rash of ratings downgrades and mounting default risks sent peripheral European yields soaring to new highs.

Market performance varied widely by region. The U.S. rebounded forcefully as fears of a another double-dip recession dissipated, while European policymakers managed to inject massive amounts of liquidity into the banking system and cobble together a deal on Greek debt. But European stock markets had more ground to catch up and ended the year lower as a result. Emerging markets were also severely hit, with the MSCI Emerging Market Index losing 6.3% on the year, despite a strong recovery from the precipitous drop of the summer months. The MSCI World Index managed to erase the better part of its losses, finishing up 3.3%.

With bond yields falling to new lows, it was another good year for fixed income markets, with the notable exception of those countries at the heart of the European debt crisis. Correspondingly, the JP Morgan Government bond index returned a solid 8.6% over the course of the year.

CANADA

The Canadian economy was not immune to the shocks that plagued the global economy as the year got underway. Real Gross Domestic Product (GDP) actually contracted in the opening quarter of the fiscal year, reflecting in large part the supply disruptions following the Japanese earthquake and tsunami, but bounced back forcefully in the following quarter. More significant, however, is the fact that the domestic side of the economy, and consumer spending in particular, appeared to gradually lose steam as the year drew on. After a strong run following the end of the recession, consumers started to waver as job growth stalled, concerns about debt levels continued to mount and prospects for the housing market began to soften. Weaker commodity prices also weighed on Canada's performance. As a result, Canadian equities noticeably underperformed their US counterparts, with the S&P/TSX Composite Index losing 9.8% over the course of the year. Canadian bonds fared well, however, with the DEX Universe Index gaining 9.7% as the Bank of Canada kept its policy rate unchanged at 1% and credit spreads continued to shrink.

UNITED STATES

The US economy came dangerously close to "stall speed" in the early part of the year, as the lingering impact of the increase in oil prices and supply disruptions from the Japanese earthquake and tsunami lowered economic growth. Confidence was also severely eroded by ongoing budget issues, from a battle over the increase in the debt ceiling to the extension of the payroll tax credit and extended unemployment benefits. Nonetheless, the economy managed to pull itself back on its feet and job growth finally resumed towards the end of the calendar year. However, the legacy of the financial crisis remains – the US housing market has yet to fully turn the corner and the amount of slack built up in the economy and labour markets remains huge. With the economy still on a fragile footing, the Fed introduced another asset–purchase program dubbed "operation twist" and pledged to keep the Fed funds rate unchanged until the end of 2014. Equity markets responded favourably to the additional stimulus measures and, as a result, the S&P 500 recorded a gain of 11.5%.

EUROPE

The sovereign debt crisis was once again right, left and centre in Europe. Markets were severely buffeted – especially during the summer months – as fears of defaults and contagion to the financial sector sent peripheral bonds yields soaring and equity markets tumbling. In response, the European Central Bank flooded the banking system with liquidity through two long-term refinancing operations, which managed to stabilize markets. After keeping the markets at the edge of their seats, European authorities, private investors and the International Monetary Fund (IMF) finally agreed on a Greek debt swap and bail-out package as the year drew to a close. While this helped European markets regain some of the lost ground, they still ended the year in the red, accounting for a significant part of the 3.2% drop in the EAFE index.

JAPAN

The Japanese economy had a very rough ride over the past year. The earthquake and tsunami took a significant bite out of GDP growth, as the economy contracted sharply in the first half of the calendar year. Although GDP rebounded in the third quarter, a sharp drop in exports due mainly to the impact of floods in Thailand sent Japanese economic performance back into negative territory. With the global outlook souring and the economy still suffering from the side-effects of the shocks, the Bank of Japan continued to inject liquidity into the economy. As a result, bond yields have remained anchored at extremely low levels while equity markets have gained ground with the Nikkei up 8.8% on the fiscal year, although it remains below its pre-tsunami level.

EMERGING MARKETS

Although they rebounded during the final quarter of the fiscal year, emerging market equities lost ground, weighed down by concerns about the spillover effects of the European debt crisis and, just as importantly, by fears of a "hard landing" in China. While the Chinese economy has slowed, the pace of deceleration appears modest, providing some reassurance to the markets. Nonetheless, Chinese authorities have downgraded their expectations for growth and the central bank lowered its reserve requirements for banks by 50 basis points as inflation pressures began to subside. With growth prospects waning, many emerging Asian economies also put their policy settings on hold or started to ease up on credit. The same was true in Latin America, with Brazil's economy decelerating sharply and the central bank engineering a total of 275 basis points in rate cuts – telegraphing that further easing is in the pipeline.

PRIVATE MARKETS

Private Equity

On the private equity front, fundraising has been challenging. In the U.S., private equity firms have been more selective given the lack of funds. In Europe, the continuing uncertainty has brought opportunity but also significant risks. Credit markets are only flowing freely for best-of-breed companies and leverage for buy-outs is more difficult. Consequently, more equity has been required in capital structures.

Real Estate

Real estate markets in most developed economies continued to struggle. In the United States, residential markets have yet to show signs of life and on the commercial side, the revival in momentum in the first half of the year evaporated as economic uncertainty continued to build. While commercial vacancy rates have declined, they remain high, keeping a lid on rents. In Europe, property markets remained sluggish, reflecting the economic uncertainty and tight credit conditions. Overall, the economic uncertainty led institutional and retail investors to largely target lower risk "core" properties that have secure, predictable long-term cash flow streams. As a result, initial yields (cap rates) declined for the highest quality assets and prices increased accordingly. This was the case not only in the advanced economies but also many emerging markets as well.

Infrastructure

This last year has seen some slowdown in infrastructure investment activity in reaction to growing uncertainty in Europe and slightly reduced overall lending. Investors continued to rethink their regional allocation focusing on a reduced number of countries in Europe, mainly in the north, and increasing their focus on Australia and South America. Some governments have been moving faster towards asset privatizations or public-private partnerships to involve investors in their plan for financial recovery. The energy sector remained the most popular for infrastructure investment. Strategic corporate investors were noticeably active in M&A activity, repositioning themselves to finance future growth through asset sales, spinoffs or joint-ventures.

PSP INVESTMENTS as at March 31, 2012

One year rate of return
3.0%

Net income from operations
$1.7 billion

Contributions
$4.7 billion

Net assets
$64.5 billion

CHANGE IN NET ASSETS

The net assets of PSP Investments increased by $6.5 billion during fiscal year 2012, a gain of 11% that was attributable to fund contributions and investment performance. Net assets at the end of fiscal year 2012 were $64.5 billion, up from $58.0 billion at the end of the previous fiscal year.

PSP Investments generated net income from operations of $1.7 billion during the latest fiscal year, compared to $6.9 billion of income generated in fiscal year 2011. These results for fiscal year 2012 represent a consolidated rate of return of 3.0%, compared to 14.5% in fiscal year 2011. PSP Investments received $4.7 billion in contributions during fiscal year 2012.

CONSOLIDATED RETURNS

The 3.0% rate of return recorded by PSP Investments in fiscal year 2012 exceeded the Policy Benchmark rate of return by 1.4% and added $850 million in value over and above the Policy Benchmark return. Over the past five fiscal years, PSP Investments has recorded a compound annualized rate of return of 2.0%, compared to the Policy Benchmark rate of return of 2.7% for that same period.

The overall performance of 3.0% for fiscal year 2012 was driven primarily by strong results from the Real Estate, Private Equity and Fixed Income portfolios. Public Markets Equities benefited from favorable results from US Large Cap Equity and Small Cap Developed World Equity portfolios, each producing returns of 11.4% and 7.6%, respectively. This was partially offset by negative returns in the remaining Public Market Equity portfolios as a result of the negative performance of global stock markets, as outlined in the Market Overview. Canadian Equity was the worst performing asset class in fiscal year 2012 with an investment return of negative 9.8%. However, its impact on PSP Investments' overall return was mitigated as the exposure to this asset class was in the process of being reduced during the year, going from 32.2% of total assets under management at the end of fiscal year 2011 to 22.4% at fiscal year-end 2012.

The excess return of 1.4% (relative to the Policy Benchmark) achieved during fiscal year 2012 was generated primarily by absolute return mandates as well as the Real Estate, Emerging Market Equity and Fixed Income portfolios. For the fiscal year ended March 31, 2012, investments in asset-backed term notes, included in absolute-return mandates, generated investment income of $342 million. The improved credit profile of the asset-backed term notes portfolio, tightening credit spreads and continuing favorable market conditions were the primary reasons for the increase in value of these investments.

PORTFOLIO AND BENCHMARK RETURNS

As at March 31, 2012

Asset Class	Fiscal Year 2012				5-year	
	Fair Value ($ millions)[1]	Fair Value %	Portfolio Returns %	Benchmark Returns %	Portfolio Returns %	Benchmark Returns %
World Equity						
Canadian Equity	14,464	22.4	(9.8)	(9.8)	1.0	1.1
Foreign Equity						
US Large Cap Equity	5,294	8.2	11.4	11.5	(3.3)	(0.9)
EAFE Large Cap Equity	4,760	7.4	(2.7)	(3.2)	(5.7)	(6.2)
Small Cap Developed World Equity	3,641	5.6	7.6	7.1	(2.1)	0.0
Emerging Markets Equity	4,787	7.4	(4.3)	(6.3)	2.4	1.7
Private Equity	6,444	10.0	7.7	7.7	5.5	1.7
Nominal Fixed Income						
Cash & Cash Equivalents[2]	1,597	2.5	1.2	0.9	2.0	1.8
Fixed Income	8,569	13.3	10.1	9.4	5.9	5.7
Real Return Assets						
World Inflation-Linked Bonds	3,982	6.2	15.3	15.3	4.1	4.1
Real Estate	7,055	10.9	13.4	6.7	5.8	6.9
Infrastructure	3,607	5.6	2.7	9.6	3.5	5.6
Renewable Resources (0.75 year)[3]	325	0.5	5.1	3.8	–	–
Total	**64,525**	**100.0**	**3.0**	**1.6**	**2.0**	**2.7**

Except otherwise indicated, returns are time-weighted rate of return and have been calculated in accordance with the performance calculation methodology recommended by the CFA Institute.

The internal rate of return methodology is used to calculate the returns for the Real Estate, Private Equity, Infrastructure and Renewable Resources asset classes.

The total portfolio return includes the performance impact of asset allocation and absolute return strategies and is calculated gross of direct expenses. Hedging investment returns are netted against the return of the respective hedged assets for the Private Market asset classes, or included in Total Return, for the Public Markets.

1 The 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.

2 Fair value includes amounts related to absolute return and real estate debt strategies.

3 The Renewable Resources asset class has existed for less than one year. The portfolio and benchmark returns presented are since inception.

PUBLIC MARKETS as at March 31, 2012

One year rate of return
1.4%

Investment income*
$640 million

Net assets
$45.5 billion

70.5% of total net assets

* Excluding external investment management fees

PUBLIC MARKETS

Public Markets is composed of Canadian Equity, Foreign Equity, Fixed Income and World Inflation-Linked Bonds. Net assets in Public Markets totalled $45.5 billion at the end of fiscal year 2012, an increase of $2.0 billion from $43.5 billion at the end of fiscal year 2011. Overall, Public Markets recorded investment income of $640 million, excluding external investment management fees, for a return of 1.4% compared to a benchmark return of 0.1%. Six of the seven Public Market portfolios equalled or outperformed their respective benchmarks.

External equity managers added $93 million of relative value during fiscal year 2012, mainly as a result of the outperformance by emerging markets managers. External global macro, fixed income and foreign currency absolute return strategies added $77 million of relative value, mainly as a result of the effect of positions in gold and US and German bonds. Internal active management added $71 million of relative value, generated mainly from equity and fixed income strategies. Asset-backed term notes contributed $330 million of relative value as PSP Investments fully benefited from a reduction of risk on the underlying assets as they approach maturity and were also positively impacted by the contraction of credit spreads.

Public Markets investments are overseen by both internal and external managers using a combination of active and index-replication strategies. Net assets managed in active strategies totalled $17.9 billion at the end of fiscal year 2012, an increase of $0.7 billion from $17.2 billion at the end of fiscal year 2011. The proportion of active strategies managed internally increased to 60%, from 53% at the end of the previous fiscal year.

EQUITIES

Net assets in Public Markets equities totalled $32.9 billion at the end of fiscal year 2012, an increase of $0.1 billion from the $32.8 billion total at the end of fiscal year 2011.

Public Markets equities recorded an investment loss of $1.2 billion for a negative return of 3.4% in fiscal year 2012, versus the benchmark return of negative 3.8%. The outperformance of the Public Markets equities portfolio vis-à-vis the benchmark was mainly due to a strong relative performance from emerging markets portfolios.

As noted in the Market Overview, economic concerns stemming primarily from monetary issues in Europe as well as weakening emerging market economies led many stock markets lower, although there were notable exceptions to this trend. As a result, the Canadian Equity portfolio was down 9.8% during fiscal year 2012, while the US Large Cap Equity portfolio gained 11.4%. Elsewhere, the EAFE Large Cap Equity portfolio was down 2.7%, while the Small Cap Developed World Equity and Emerging Markets Equity asset classes posted investment returns of 7.6% and negative 4.3%, respectively.

FIXED INCOME

Net assets in Fixed Income and World Inflation-Linked Bonds totalled $12.6 billion at the end of fiscal year 2012, up from $10.7 billion at the end of fiscal year 2011. Overall, these fixed income portfolios earned $1.3 billion in investment income for a return of 11.6% in fiscal year 2012, versus a benchmark return of 11.1%. The outperformance was mainly due to an overweight position in corporate credit, as well as directional and relative value strategies on interest rates and sovereign credit.

PRIVATE EQUITY

Net assets of the Private Equity portfolio totalled $6.4 billion at the end of fiscal year 2012, an increase of $0.8 billion from $5.6 billion at the end of fiscal year 2011.

Private Equity generated $453 million in investment income, excluding transaction costs, for a rate of return of 7.7% for fiscal year 2012, in line with the benchmark return of 7.7%. This income is further split between funds for $261 million and direct and co-investments for $192 million.

Gains in the fund segment were driven by exposures to the US market, while European funds lagged behind, confronted by a difficult credit and macroeconomic environment, and very slow mergers and acquisitions activity. The strong performance of the direct and co-investment strategy is mainly attributable to Telesat and China Network Systems among others, which recorded continued growth in revenue and EBITDA, creating added value in the portfolio. From a total portfolio perspective, exposures to both the US and Canadian markets performed particularly well, while our Asian and European exposures lagged behind. On a five-year basis, Private Equity investments generated a 5.5% annualized return, compared to the benchmark return of 1.7% for the same period.

The Private Equity portfolio has a long-term focus with investments held for an average of five to ten years. The portfolio is invested globally in collaboration with strategic partners with whom PSP Investments has established relationships. PSP Investments continues to diversify its Private Equity portfolio, with direct and co-investments playing an increasingly important role.

During the past fiscal year, the Private Equity Group committed strategically to fund opportunities, selectively making new commitments to managers with unique and specialized investment strategies underpinned by a strong alignment of interests and preferred terms and economics.

As at March 31, 2012, direct and co-investments accounted for 34% of assets of the Private Equity portfolio, up from 32% at the end of the previous fiscal year. Direct and co-investments amounted to $2.2 billion at the end of fiscal year 2012. Among the year's noteworthy transactions was the acquisition of Kinetic Concepts Inc. (US Health Care – Equipment & Services) which was partnered alongside Apax Partners and the CPP Investment Board.

Overall, the Private Equity portfolio is well diversified both from a geographic and sector perspective. As a result of the acquisition of Kinetic Concept Inc. and strong relative performance of the US market, there has been an increase in US exposure at the expense of other geographical markets.

PRIVATE EQUITY as at March 31, 2012

One year rate of return

7.7%

Investment income*

$453 million

Net assets

$6.4 billion

10.0% of total net assets

* Excluding transaction costs

PRIVATE EQUITY
DIVERSIFICATION BY GEOGRAPHY
As at March 31, 2012

United States	45.1%
Canada	23.4%
Europe	16.4%
Asia	15.1%

The majority of the Private Equity portfolio exposure is in North America.

PRIVATE EQUITY
DIVERSIFICATION BY SECTOR
As at March 31, 2012

Consumer Discretionary	28.6%
Telecom	26.4%
Health Care	11.1%
Information Technology	9.2%
Financial	7.4%
Materials and Industrial	6.8%
Energy	5.5%
Other	5.0%

REAL ESTATE as at March 31, 2012

One year rate of return

13.4%

Investment income*

$770 million

Net assets

$7.1 billion

10.9% of total net assets

* Excluding transaction costs

REAL ESTATE

Net assets of the Real Estate portfolio totalled $7.1 billion at the end of fiscal year 2012, an increase of $1.8 billion from the $5.3 billion at the end of fiscal year 2011.

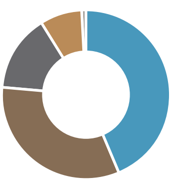
Real Estate generated $770 million in investment income, excluding transaction costs, for a return of 13.4% in fiscal year 2012, compared to a benchmark of 6.7%.

The robust returns are attributable in part to consistent cash flows generated by a diversified portfolio, which includes very stable multi-family and seniors residential properties as well as office, retail and hotel assets in Canada, the U.S., Europe and Brazil. Also reflected in the results are increased valuations and realized gains stemming mainly from Canadian hotel, seniors and office assets, US multi-family assets and Brazilian office and retail assets, plus gains generated by strategic investments in high-yield real estate debt instruments.

On a five-year basis, Real Estate investments generated a 5.8% annualized return, compared to a benchmark return of 6.9% for the same period. Since the inception of the Real Estate portfolio in fiscal 2004, Real Estate investments have generated an annualized return of 9.2%, compared to a benchmark of 6.9%.

The year-over-year increase in net assets reflects both new investments and positive valuations of existing assets. New investments made during fiscal year 2012 included office properties in New York, London, Edmonton, California's Silicon Valley, Frankfurt, Madrid and Washington; retail properties in Sweden, France, the U.S. and Colombia; industrial properties in the U.S.; and multi-family properties in Canada. As well, the Real Estate Group increased its investments in high-yield and distressed debt strategies and in Canadian hotel properties.

As at March 31, 2012, direct ownership and co-investments accounted for 79% of the assets in Real Estate, up from 75% at the end of the previous fiscal year.



REAL ESTATE
DIVERSIFICATION BY GEOGRAPHY
As at March 31, 2012

Canada	43.7%
United States	32.9%
Europe	14.7%
Emerging countries	8.1%
Asia	0.6%

The majority of the Real Estate portfolio exposure is in North America, mainly in Canada.

REAL ESTATE
DIVERSIFICATION BY SECTOR
As at March 31, 2012

Retirement/Residential	31.4%
Office	24.0%
High-Yield Debt	9.7%
Retail	7.6%
Health Care	7.4%
Hotel	7.2%
Industrial	3.7%
Other	9.0%

INFRASTRUCTURE

The net assets of the Infrastructure portfolio totalled $3.6 billion at the end of fiscal year 2012, an increase of $1.2 billion from the $2.4 billion at the end of fiscal year 2011.

Infrastructure generated $81 million in investment income, excluding transaction costs, for a return of 2.7% in fiscal year 2012, compared to the benchmark return of 9.6%. The benchmark return was influenced by government intervention to keep interest rates low and a flight to quality in government bonds. The portfolio return was driven mainly by distributions from direct and co-investments. The performance of a majority of the investments in the utilities and transportation portfolio was above the benchmark. These investments are located outside North America. In the energy sector, the changing pattern in supply and demand of natural gas in North America continued to negatively affect the portfolio. Since inception, Infrastructure investments have generated a 3.7% annualized return, compared to a Policy Benchmark return of 5.0% for the same period.

The year-over-year increase in net assets in Infrastructure came from six new direct investments totalling $1.5 billion, the highest annual amount invested since the creation of the asset class. Opportunities came from sellers which were deleveraging or redeploying capital as well as new strategic partnerships. Over the course of the fiscal year, the Infrastructure Group acquired an interest in a joint venture that operates a major natural gas pipeline, a significant participation in hydroelectric facilities and a participation in a UK-based landlord ports operator, as well as various other investments related to the energy sector. These investments were mainly in Europe, Canada and the United States. Their diverse nature as well as the variety of sectors and regions involved contributed to enhanced portfolio diversification.

As at March 31, 2012, direct and co-investments accounted for 83% of the assets of the Infrastructure Portfolio, up from 76% at the end of the previous fiscal year.

INFRASTRUCTURE as at March 31, 2012

One year rate of return
2.7%

Investment income*
$81 million

Net assets
$3.6 billion

5.6% of total net assets

* Excluding transaction costs

INFRASTRUCTURE
DIVERSIFICATION BY GEOGRAPHY
As at March 31, 2012

United Kingdom	24.4%
Europe	22.3%
United States	17.7%
Canada	13.5%
Australia	12.0%
South America	10.1%

The Infrastructure portfolio is diversified mostly across the Americas and Europe.

INFRASTRUCTURE
DIVERSIFICATION BY SECTOR
As at March 31, 2012

Transportation	29.4%
Oil & Gas Storage and Transport	27.1%
Electric Generation & Transmission	20.8%
Water Utilities	12.1%
Oil & Gas Exploration and Production	9.9%
Other	0.7%

OPERATING AND ASSET MANAGEMENT EXPENSES

In fiscal year 2012, PSP Investments' cost ratio (i.e. operating expenses plus asset management expenses as a percentage of average net investment assets) decreased to 60.6 basis points, or 60.6 cents per $100 of average net investment assets, from 67.0 basis points, or 67 cents per $100 of average net investment assets in fiscal 2011, as a result of increased efficiencies and economies of scale driven by the increase in the internal active management of assets and higher net investment assets. Asset management expenses include management fees paid to external asset managers and transaction costs. Transaction costs can vary significantly year over year depending on the complexity and size of our Private Markets investment activities.

PSP Investments' cost ratio decreased for the fourth consecutive year, mainly as a result of the internal active management investment strategy adopted by PSP Investments in fiscal year 2004. Assets managed internally increased to approximately $48 billion at the end of fiscal year 2012 compared to $43 billion at the end of the previous year. Since the end of fiscal year 2009, assets managed internally have increased by almost $27 billion, or 128%. Although the shift does impact operating expenses, on balance, based on market data, the costs related to internal active management are approximately three to seven times less expensive than the costs related to management fees paid to external active managers, depending on the type of asset and implementation style involved.

PSP Investments' cost ratio includes operating expenses of $148 million for fiscal year 2012 compared to $114 million for fiscal year 2011. As a percentage of net investment assets, operating expenses amounted to 24.8 basis points, or 24.8 cents per $100 of average net investment assets, compared to 22.3 basis points, or 22.3 cents per $100 of average net investment assets in fiscal year 2011. The increase in operating expenses for the current fiscal year can be attributed to the increase in headcount and related expenses required to support the execution of the internal active investment strategy mentioned previously. The increase in operating expenses in basis points has been more than offset by the decrease in basis points in external asset management expenses.

STRATEGIC AND OPERATING REVIEW

During the fiscal year ended March 31, 2012, the Government of Canada launched its Strategic and Operating Review ("SOR") initiative. The SOR is primarily aimed at federally-appropriated Crown corporations and at government departments and programs. The goal of the SOR is to generate savings from operating expenditures and to improve productivity while also examining the efficiency and effectiveness of programs. Even though PSP Investments is a federally non-appropriated Crown Corporation, it undertook a review to adhere to the spirit and intent of the SOR initiative.

Net investment performance is the main contributor to reducing the cost to the Plans' sponsor (the Government of Canada). To this end, PSP Investments has increased investment activities and level of assets managed internally and actively with the aim of improving its overall investment cost structure (expressed as a percentage of average net investment assets) and has increased the probability of meeting the desired long-term actuarial rate of return. In this respect, PSP Investments' net performance over the past nine years has been 7.6%, surpassing the expected long-term rate of return requirements of the Plans.

From a cost perspective, PSP Investments has been carefully managing growth in investment activities by ensuring rigorous oversight as asset levels increased over the last several years. PSP Investments' strategy of increasing its proportion of assets managed internally has resulted in increased efficiencies and economies of scale. PSP Investments' cost ratio has declined in each of the past four fiscal years, going from 86.9 basis points, or 86.9 cents per $100 of average net investment assets, in fiscal year 2009 to 60.6 basis points, or 60.6 cents per $100 of average net investment assets, in the current fiscal year, a decrease of 30%. During this period, internally managed assets have increased by approximately $27 billion, while operating expenses grew by only $62 million. We estimate that for fiscal year 2012 alone, based on market data on investment implementation style, the increase in internally managed assets of $27 billion has resulted in savings ranging from $120 million to $180 million compared with what costs would have been had PSP Investments deployed these assets with external investment managers.

PSP Investments remains committed to maintaining an effective overall cost structure and has adhered to the spirit and intent of the SOR initiative by investing in scalable and cost-effective operations, managing its assets as efficiently as possible and by improving its cost ratio each year for the past four years.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

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

In 2011, the AcSB decided to defer the adoption of IFRS by investment companies, currently applying Accounting Guideline 18 "Investment Companies" (AcG-18) to annual periods starting on or after January 1, 2014. This deferral delays PSP Investments' transition to IFRS until the March 31, 2015 annual consolidated financial statements.

The AcSB's decision was in response to an announcement by the International Accounting Standards Board (IASB) in 2010, regarding an Exposure Draft (ED) being developed. The IASB proposed to define an investment entity and exempt it from consolidation by requiring it to measure all controlled investments at fair value, with changes recognized in profit or loss. The ED, Investment Entities, was published in August 2011 and is expected to be finalized in the second half of 2012. PSP Investments will complete the assessment of the impact of its transition to IFRS once the ED is finalized and a standard is issued.

The AcSB also announced in 2011 that it will evaluate whether entities like PSP Investments, which are separate from a pension plan and without a pension obligation, and whose sole purpose is to hold and invest assets received from one or more pension plans, would qualify as investment entities under the IASB's ED. Based on the result of this evaluation, the AcSB will then decide whether these entities would need to be included within the scope of Section 4600 "Pension Plans", where investments are accounted for at fair value.

RISK MANAGEMENT

ENTERPRISE RISK MANAGEMENT

As the manager of public pension assets, PSP Investments is responsible for acting in the best interest of the contributors and beneficiaries of the Plans and maximizing returns without undue risk of loss. PSP Investments acknowledges that it must take risks to achieve its legislated mandate and that the management of the full spectrum of risks must be integrated on an enterprise-wide basis.

PSP Investments faces risk in all aspects of its activities and places emphasis on continuous improvement of its risk management capabilities. As a result, PSP Investments has established an enterprise risk management framework to provide a structure for identifying, evaluating and managing its various investment and non-investment risks. The framework is a core component of PSP Investments' Enterprise Risk Management Policy. The policy also defines PSP Investments' responsibilities relating to its enterprise risks from the perspective of the Board and its committees, the management committees and the investment groups and support groups within the Corporation. In addition to the Enterprise Risk Management Policy, an Investment Risk Management Policy and an Operational Risk Management Policy deal with the specific characteristics of these risks.

PSP Investments' enterprise risk management framework is guided by the following principles:

- Promote a risk-aware culture;
- Establish and implement a risk management framework that enables PSP Investments to identify, evaluate, manage, monitor and report on enterprise risks;
- Integrate enterprise risk management into strategic and financial objectives;
- Operationalize sound risk management processes.

PSP Investments periodically reviews its risk management policies ensuring governance for all of the Corporation's risks. In fiscal year 2012, based on the results of the prior year's Risk and Control Self Assessment findings and Special Examination recommendations, the Risk Management Group identified opportunities to enhance its risk management policies.

Enterprise risks are categorized to facilitate a universal understanding of all the risks faced by PSP Investments. The Corporation's enterprise risk categories are defined as:

- Investment risk: the risk of loss inherent in achieving investment objectives, including market, liquidity, credit and counterparty, leverage and concentration risks.
- Governance risk: the risk of a lack of consistent corporate management, cohesive policies and organizational structure alignment.
- Strategic risk: the risk of not achieving strategic goals or business objectives.
- Operational risk: the risk of a direct or indirect loss resulting from inadequate or failed internal processes, people or systems, or from external events.
- Stakeholder risk: the risk of not maintaining efficient relations with PSP Investments' plan sponsors and key business partners.
- Legal and regulatory risk: the risk of non compliance with applicable regulations, or a change in legislation, regulations or other mandatory industry practices.
- Reputational risk: the risk that an activity undertaken by PSP Investments or its representatives impairs its image in the community or lowers public opinion and stakeholder confidence in it.

ENTERPRISE RISK MANAGEMENT FRAMEWORK

PSP Investments' Enterprise Risk Categories

INVESTMENT RISK					
Market Risk	Liquidity Risk	Credit and Counterparty Risk	Leverage Risk	Concentration Risk	
NON INVESTMENT RISK					
Governance Risk	Strategic Risk	Operational Risk	Stakeholder Risk	Legal and Regulatory Risk	Reputational Risk

In fiscal year 2012, PSP Investments continued the ongoing application of its enterprise risk management framework, aligned with its three-year strategic plan.

Key accomplishments for the fiscal year include the following:

- Further refined risk limits and attributed active risk across asset classes through a structured risk budget process and resulting information ratio for increased measurement of active returns;
- Enhanced and detailed monitoring and reporting of investment risk drivers by portfolio via new risk metrics; and
- Operationalized the process for the management and reporting of risks identified in the prior year's Risk and Control Self Assessment including enhanced risk measurement and reporting practices surrounding operational risks.

RISK MANAGEMENT GOVERNANCE MODEL

PSP Investments promotes a risk-aware culture involving all employees. Senior management and employees are not only active participants in risk identification, but also in risk evaluation, management, monitoring and reporting.

The Board of Directors contributes to risk oversight by:

– Establishing the investment objectives, Investment Policy and Policy Portfolio;

– Participating in the definition of PSP Investments' risk philosophy;

– Being aware of the extent to which PSP Investments' management has established effective enterprise risk management within the organization;

– Reviewing the corporate risk profile provided by management; and

– Being apprised of material risks and how PSP Investments' management is responding to them.

In order to oversee and manage risks related to its investments and operations, senior management has created various committees, including the Management Investment Committee, Management Operations Committee, Risk Steering Committee, Valuation Committee, New Business Activity Committee and Information Technology Governance Committee.

In fiscal year 2012, enhanced risk reporting was implemented at the various committees and sub-committees where warranted, for increased internal and active management. Additionally, the governance structure surrounding the introduction and monitoring of new business activities was enhanced.

INVESTMENT RISK MANAGEMENT

The Investment Risk Management Policy is an integral component of PSP Investments' risk management program to support the management of risks incurred through the fund's investment processes. The policy establishes an investment risk management framework, with a goal of ensuring that investment activities respect the risk philosophy of PSP Investments.

PSP Investments faces five principle investment risk types: (i) market risk; (ii) liquidity; (iii) credit and counterparty; (iv) leverage risk; and (v) concentration risk.

The framework covers the key elements required to establish a comprehensive investment risk management process.

The Investment Risk Management Policy also supplements the Statement of Investment Policies & Procedures ["SIP&P"]. As such, the Investment Risk Management Policy has been developed to effectively manage investment risks related to the policy portfolio and active management activities:

– Policy Portfolio
The Policy Portfolio, as defined in the SIP&P and described on page 10 sets out a strategy to mitigate risk through a diversified investment portfolio;

– 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 risk and the active risk. The Policy Portfolio risk represents the investment risk arising from the exposure to approved asset classes in the approved weightings. Active risk refers to all market risk arising from active management activities, and is managed in accordance with the Investment Risk Management Policy.

OPERATIONAL RISK MANAGEMENT

Operational risk is one of the key enterprise risks that PSP Investments is exposed to. The Operational Risk Management Policy currently in place within PSP Investments defines the guiding principles and frames boundaries to prudently and proactively manage the risks to which PSP Investments is exposed.

Operational risk management at PSP Investments is structured around six types of risk: (i) people management; (ii) process and information management; (iii) systems and data management; (iv) theft and fraud; (v) business disruption; and (vi) model and valuation.

INTERNAL AUDIT AND COMPLIANCE

INTERNAL AUDIT

Internal Audit is an independent, objective assurance and consulting activity designed to add value and improve PSP Investments' operations. It helps to achieve PSP Investments' objectives by using a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

INTERNAL CONTROLS

The internal-controls environment is derived from the Committee of Sponsoring Organizations of the Treadway Commission (COSO) model. COSO defines internal control as a process, affected by an entity's Board of Directors, management and personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

– Strategic – High-level goals, aligned with and supporting its mission;

– Operational – Effectiveness and efficiency of operations;

– Reporting – Reliability of financial reporting;

– Compliance – Compliance with applicable laws and regulations.

PSP Investments annually reviews its control environment as well as key controls in all departments, as required under Section 28 of the Act.

The control functions are carried out at various levels and in various departments. Each control is designed to ensure that PSP Investments' policies and procedures are respected and applied consistently. All policies are approved by the Board of Directors and are supported by procedures that provide a framework for their implementation.

COMPLIANCE

PSP Investments must act with integrity and maintain high ethical standards at all times. The objective of the Compliance Department, in conjunction with the Legal Affairs Department, is to ensure stringent compliance by PSP Investments and its employees with its policies and procedures, including the Code of Conduct for Officers, Employees and Others (the "Employee Code"), as well as relevant laws and statutory requirements.

Compliance with internal investment policies and procedures is achieved primarily through daily monitoring of transactions and quarterly reporting to the Audit Committee, which is responsible for monitoring the compliance function. Processes are also in place to monitor compliance with the Employee Code. The Employee Code describes PSP Investments' corporate principles and values, with the aim of assisting employees and those subject to its provisions in determining appropriate business practices and behavior.

Among other things, the Employee Code includes sections on: personal and professional conduct, which requires unwavering commitment to honesty and integrity; conflicts of interest; gifts, hospitality and other benefits; bribery; protecting PSP Investments' assets and; personal trading, which requires the pre-authorization and reporting of personal investment transactions.

PSP Investments takes the Employee Code seriously. Violations will be subject to appropriate discipline, including termination of employment or engagement. As such, the Employee Code also includes a whistle-blowing provision designed to encourage employees and those subject to its provisions to step forward and report any financial fraud or other fraudulent and inappropriate activities.

The Compliance Officer is responsible for the Employee Code's procedures and reports quarterly to the Governance Committee who is responsible for monitoring application of the Employee Code. The Employee Code may be viewed on PSP Investments' website **www.investpsp.ca**.

GOVERNANCE

Effective governance is essential to safeguard the capital entrusted to PSP Investments and to ensure that appropriate objectives are pursued and achieved, consistent with the fulfillment of the Corporation's legislated mandate. This section describes PSP Investments' governance framework, including its mandate, the roles of the Board of Directors and Board committees and key policies that guide the organization's activities and behaviour.

MANDATE

PSP Investments is a Crown corporation created in 1999 by Act of Parliament (the *Public Sector Pension Investment Board Act,* or the "Act"). PSP Investments' mandate is twofold: managing the funds transferred to it by the Government of Canada for the Canadian Forces, the Reserve Force, the Public Service and the Royal Canadian Mounted Police ("RCMP") pension plans (the "Plans") in the best interests of the contributors and beneficiaries; and investing its assets with a view to achieving a maximum rate of return without undue risk of loss, having regard to the funding, policies and requirements of the Plans and their ability to meet their financial obligations.

Effective April 1, 2000, the Government of Canada created three new pension fund accounts (the "Pension Funds"), one for each of the Public Service, the Canadian Forces and the RCMP Plans. On March 1, 2007, the Government established the Reserve Force Pension Plan and created a Pension Fund for it as well. Employer and employee contributions in respect of service after the date of creation of a particular Pension Fund ("post-funding service") are deposited to the relevant Pension Fund. Amounts equal to the net balances in these Pension Funds (that is contributions minus benefits payments for post-funding service, as well as plan administration expenses) are then transferred to separate accounts maintained at PSP Investments (the "Pension Plan Accounts") for each of the Pension Funds, to be invested in accordance with the approved investment policy and strategy.

The Government of Canada manages and administers the Plans. The President of the Treasury Board is responsible for the Public Service Pension Plan, the Minister of National Defence for the Canadian Forces Pension Plan and the Reserve Force Pension Plan, and the Minister of Public Safety for the RCMP Pension Plan. PSP Investments is the exclusive investment manager of the amounts transferred to the Pension Plan Accounts.

BOARD OF DIRECTORS

PSP Investments' operations and activities are overseen by a Board of Directors composed of 11 members, including the Chair of the Board. Directors are appointed by the Governor in Council on the recommendation of the President of the Treasury Board to hold office during good behaviour for a term not exceeding four years. Candidates for directorships are selected from a list of qualified individuals proposed by a nominating committee established by the President of the Treasury Board (the "Nominating Committee") pursuant to the Act. The Nominating Committee operates separately from the Board of Directors, the President of the Treasury Board and the Treasury Board Secretariat. Members of the Senate, the House of Commons and provincial legislatures, as well as employees of PSP Investments or the Government of Canada and those entitled to benefits from the Plans, are disqualified from serving as Directors. The Chair of the Board is designated from among the Directors by the Governor in Council on the recommendation of the President of the Treasury Board, after consultation with the Board of Directors, the Minister of National Defence and the Minister of Public Safety. On the expiry of the term of an incumbent Director, the incumbent may be reappointed and, in any event, continues in office until a successor is appointed.

The Board of Directors plays an active role in guiding PSP Investments. Therefore, a substantial time commitment is expected of Directors, particularly the Chair of the Board and the Chairs of Board committees, for meetings, travel and preparation for meetings.

In fiscal year 2012, two Directors were appointed and two Directors left PSP Investments' Board. On September 29, 2011, the Governor in Council appointed Ms. Micheline Bouchard and Mr. Garnet Garven as Directors for terms of four years, and the term of Mr. Bob Baldwin expired. On March 5, 2012, the date of the expiration of his term, Mr. Paul Cantor resigned both as a Director and Chair of the Board of PSP Investments. On March 27, 2012, the President of the Treasury Board designated Ms. Cheryl Barker as Interim Chair to exercise the powers and perform the duties and functions of the Chair until further notice or until such time as the Governor in Council designates a new Chair of the Board. On March 31, 2012, the Board was composed of the following nine Directors, with two vacant positions in the process of being filled:

- Cheryl Barker, Interim Chair
- Micheline Bouchard
- Anthony R. Gage
- Lynn Haight
- Michael P. Mueller
- Diane Bean
- Léon Courville
- Garnet Garven
- William A. MacKinnon

Canadian securities regulators have defined the concept of "independent director" applicable to publicly-listed issuers as an individual who has no direct or indirect material relationship with the issuer. A "material relationship" has been defined as a relationship which could, in the view of the issuer's board of directors, be reasonably expected to interfere with the exercise of an individual's independent judgment. Those regulations do not apply to PSP Investments, given that it is not a publicly-listed issuer. However, based on the same definitions, all Directors of PSP Investments would be considered independent directors.

All Directors of PSP Investments must have an excellent understanding of the role of a director and possess a general knowledge of pensions and a broad knowledge of investment management and its related risks.

In addition to investment management knowledge, the Directors of PSP Investments possess a wide range of professional experience in a variety of fields, including accounting, finance, economics and human resources. Biographies of each Director, as of March 31, 2012, can be found beginning on page 54.

ROLES AND RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND BOARD COMMITTEES

BOARD OF DIRECTORS

In order to ensure that PSP Investments' statutory mandate is met, the Board of Directors, in addition to the requirements of the Act, has defined its role to include, among other responsibilities, the following:

- Appointment and termination of the President and CEO;
- Annual review and approval of proposed amendments to the written Statement of Investment Policies, Standards and Procedures ("SIP&P") for each Pension Plan Account;
- Approval of strategies for achieving investment performance objectives and benchmarks against which to measure performance;
- Adoption of appropriate policies for the proper conduct and management of PSP Investments, including a Code of Conduct for Officers, Employees and Others ("Employee Code"), and a Code of Conduct for Directors ("Director Code");
- Ensuring that effective enterprise, investment and operations risk policies are in place;
- Approval of human resources and compensation policies;
- Establishment of appropriate performance-evaluation processes for the Board of Directors, the President and CEO and other members of senior management; and
- Approval of quarterly and annual financial statements for each Pension Plan Account and for PSP Investments as a whole.

The Terms of Reference describing the roles and responsibilities of the Board of Directors and its committees and the Chair of the Board may be viewed in their entirety on PSP Investments' website **www.investpsp.ca**.

BOARD COMMITTEES

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

- Investment Committee
- Governance Committee
- Audit Committee
- Human Resources and Compensation Committee

A special Chairperson Nominating Committee chaired by Ms. Cheryl Barker was created on September 30, 2011 to recommend to the President of Treasury Board a Director to serve as Chair of the Board in replacement of Mr. Paul Cantor whose term was expiring on March 5, 2012. The Special Chairperson Nominating Committee having fulfilled its mandate, was wound up on November 8, 2011.

INVESTMENT COMMITTEE

The Investment Committee is responsible for overseeing the investment management function of PSP Investments. The Investment Committee's duties assigned to it by the Board or provided for in the Act include the following:

- Approving all investment proposals and related borrowings above thresholds delegated by the Board to management for approval;
- Making annual and other recommendations to the Board of Directors on the SIP&P for each Pension Plan Account;
- Overseeing PSP Investments' investment risks and ensuring that an appropriate control environment is in place to govern the management of investment risks; and
- Approving the engagement of external investment managers having discretionary authority to invest PSP Investments' assets under management.

The Investment Committee is composed of all members of the Board of Directors[1] and is chaired by Mr. Anthony R. Gage.

[1] Ms. Micheline Bouchard and Mr. Garnet Garven were appointed to the Investment Committee on September 29, 2011, date of their appointment as Directors.

AUDIT COMMITTEE

The Audit Committee's role is generally to review financial statements and the adequacy and effectiveness of PSP Investments' systems of internal controls. This includes internal controls over the accounting and financial-reporting systems within PSP Investments, as well as internal information system controls and security. Many of the duties of the Audit Committee are set out in the Act. These duties include:

- Reviewing quarterly and annual financial statements for each Pension Plan Account and for PSP Investments as a whole, recommending them to the Board for approval and discussing any letters to management regarding any significant concerns on the part of the joint external auditors;
- Meeting separately with PSP Investments' joint external auditors and internal auditors, without management present, to discuss and review specific issues related to the Audit Committee;
- Overseeing PSP Investments' operational risks and ensuring that an appropriate control environment is in place to govern the management of operational risks inherent to PSP Investments' activities;
- Ensuring that internal audits are conducted in respect of PSP Investments and its subsidiaries; and
- Adopting and maintaining an appropriate whistle-blowing mechanism for reporting fraudulent, illegal or inappropriate activities.

On March 31, 2012, the Audit Committee was composed of the following Directors[2]:

- William A. MacKinnon, Chair
- Anthony R. Gage
- Lynn Haight
- Cheryl Barker
- Garnet Garven

All Audit Committee members are financially literate with accounting or finance expertise, and possess the requisite experience and knowledge to read and understand PSP Investments' and the Pension Plan Accounts' financial statements and properly fulfill their role. For more information on the experience of each committee member, as well as their occupations and education, please see their biographies on page 54.

GOVERNANCE COMMITTEE

The Governance Committee's role is generally to assist the Board of Directors in monitoring governance matters at PSP Investments and developing related policies. The Governance Committee has responsibility for the application of the Director Code and the Employee Code. The Governance Committee's duties also include the following:

- Monitoring and assessing the relationship between the Board of Directors and management, defining the limits to management's responsibilities and ensuring that the Board of Directors functions independently of management;
- Reviewing at least every two years, with the assistance and input of the President and CEO and the Chair of the Board of PSP Investments, the Terms of Reference for the Board of Directors and the committees of the Board, and recommending to the Board such amendments as may be necessary or advisable;
- Developing and recommending to the Board of Directors for approval new or amended by-laws and governance-related policies, including the Director Code and the Employee Code;

[2] Mr. Garnet Garven was appointed to the Audit Committee on October 6, 2011.

– Developing target recruitment skill sets and other recruiting capabilities to facilitate the identification by the independent Nominating Committee of suitable candidates for appointment as Directors of PSP Investments;

– Overseeing the implementation of procedures for assessing the effectiveness of the Board of Directors as a whole, as well as the performance of individual Directors; and

– Overseeing PSP Investments' governance risks and ensuring that an appropriate governance framework is in place.

On March 31, 2012, the Governance Committee was composed of the following Directors[3]:

– Cheryl Barker, Chair
– Michael P. Mueller
– Léon Courville

HUMAN RESOURCES AND COMPENSATION COMMITTEE

The Board of Directors strongly believes in the importance of human resources to the success of PSP Investments. Accordingly, the Human Resources and Compensation Committee assists the Board of Directors in ensuring that the necessary policies and procedures are in place to efficiently and effectively manage PSP Investments' human resources and to offer all employees fair and competitive compensation aligned with performance. The Human Resources and Compensation Committee is therefore responsible for:

– Making recommendations to the Board of Directors regarding PSP Investments' human resources, training and compensation policies, and periodically reviewing such policies and recommending changes as necessary;

– Reviewing annually, on an aggregate basis, the total compensation of all employees of PSP Investments;

– Reviewing annually, the performance evaluations of the President and CEO and other Officers of PSP Investments and making recommendations to the Board on the remuneration of these individuals;

– Overseeing PSP Investments' human resources risks and ensuring that an appropriate governance environment is in place to manage human resources risks inherent to PSP Investments' activities; and

– Reviewing and reporting to the Board on PSP Investments' succession planning.

On March 31, 2012, the Human Resources and Compensation Committee was composed of the following Directors[4].

– Michael P. Mueller, Chair
– Micheline Bouchard
– Diane Bean
– Léon Courville

All Human Resources and Compensation Committee members are knowledgeable about issues related to human resources, talent management, executive compensation and risk management. Understanding of such issues was gained by professional experience as former chief executives or senior officers with oversight of human resources functions. For more information on the experience of each committee member, as well as their occupations and education, please see their biographies on page 54.

[3] Mr. Bob Baldwin ceased to be a member of the Governance Committee on September 29, 2011.

[4] Mr. Bob Baldwin ceased to be a member of the Human Resources and Compensation Committee on September 29, 2011. Ms. Micheline Bouchard was appointed to the Human Resources and Compensation Committee on October 6, 2011.

ACCOUNTABILITY

PSP Investments is a Crown corporation with a unique governance and accountability regime which is set out in the Act. The Act provides that PSP Investments operates at arm's length from the Government of Canada and imposes on it reporting obligations to the Government of Canada and the contributors to the Plans.

The Board of Directors is responsible for the selection, appointment, performance evaluation and compensation of the President and CEO, who reports to the Board of Directors. PSP Investments reports to the ministers responsible for the Plans through its quarterly financial statements and annual report. The annual report must also be made available to contributors to the Plans and is tabled in each House of Parliament by the President of the Treasury Board, who is responsible for the Act.

The President and CEO and the Chair of the Board are required to meet once a year with advisory committees appointed to oversee the Plans. PSP Investments is also required to hold an annual public meeting. In addition, PSP Investments communicates on an ongoing basis with the Chief Actuary of the Office of the Superintendent of Financial Institutions Canada, Treasury Board officials and other Government of Canada officials in the execution of its statutory mandate.

Pursuant to the *Financial Administration Act* ("FAA"), the Auditor General of Canada and Deloitte & Touche LLP were appointed to serve as joint external auditors of PSP Investments, and are also responsible for conducting Special Examinations as stipulated in the FAA at least once every ten years. PSP Investments' joint auditors conducted a Special Examination in fiscal year 2011 to determine if PSP Investments' financial and management controls, information systems and management practices were maintained in a manner that provides reasonable assurance that they met the requirements of the FAA. The report on such Special Examination formed part of the annual report for fiscal year 2011 as required by the Act.

ASSESSMENT OF BOARD PERFORMANCE

The Governance Committee implemented a formal process to evaluate the performance of the Chair of the Board, the Chairs of Board committees, individual Directors and the Board as a whole. Every Director, as well as the President and CEO and certain members of senior management, participate in the evaluation process. The Chair of the Governance Committee presents the results of the evaluation to the Board of Directors. Ensuing Board discussions focus on concerns and opportunities for improvement, what is working properly and what has improved since previous assessments, following which any measures deemed necessary are implemented.

GOVERNANCE FRAMEWORK REVIEW

Every three years, an overall governance review is conducted to assess the extent to which PSP Investments' Terms of Reference for the Board, its committees and relevant officers are being fulfilled. Based on the review, a governance report is submitted to the Governance Committee which reports to the Board thereon. The purpose of this report is to assist the Board of Directors in ensuring that the duties and responsibilities set out in the Terms of Reference are carried out. The last governance review was conducted at the end of fiscal year 2010. The report, produced by an independent consultant, concluded that PSP Investments' Terms of Reference were consistent with the requirements of the Act and formed part of an internal framework reflecting best practices for organizations with mandates and structures similar to those of PSP Investments.

As part of the Special Examination conducted in fiscal year 2011, the Examiners reviewed PSP Investments' governance framework and concluded that the Board of Directors has clearly defined its roles and responsibilities and those of its committees in their respective Terms of Reference, and that PSP Investments has a corporate governance framework that performs well and meets industry practice expectations for board stewardship and oversight.

CODE OF CONDUCT FOR DIRECTORS

The Director Code together with the Employee Code were developed to establish and maintain a culture that guides decision-making throughout the Corporation. The purpose of the Director Code goes beyond complying with minimum statutory requirements; it reflects the expectation that Directors will have the highest level of integrity and ethical standards. The Director Code is designed to provide a workable process for identifying, minimizing and resolving potential conflicts of interest. Derived from the Act and the *Conflict of Interest Act*, the Director Code sets out in detail Directors' statutory and fiduciary duties relating to conflicts of interest and helps ensure that Directors have a full understanding and appreciation of PSP Investments' principles and values. Ultimately, the Director Code aims to assist Directors in determining appropriate business practices and behaviour.

Among other stipulations, the Director Code:

- Requires Directors to give written notice to the Board of Directors of the nature and extent of their interest in a transaction or proposed transaction;
- Prohibits Directors from voting on a resolution or participating in a discussion in any circumstances where they have a conflict of interest;
- Requires the disclosure of any other business activity in which they participate that directly or indirectly affects PSP Investments' activities or is in competition with PSP Investments' activities; and
- Requires the Directors to pre-clear all securities trades, except exempt trades, and to report quarterly to a PSP Investments auditor on their personal trading activities.

The Governance Committee is responsible for monitoring the application of the Director Code. The Director Code may be viewed in its entirety on PSP Investments' website **www.investpsp.ca**.

DIRECTOR EDUCATION AND ORIENTATION

The Act requires the Nominating Committee to have regard to the desirability of having on the Board of Directors a sufficient number of Directors with proven financial ability or relevant work experience such that PSP Investments will be able to effectively achieve its mandate. The Act also requires Directors with relevant expertise to use their knowledge or skills in exercising their duties.

To enhance Directors' financial knowledge and skills, PSP Investments created a Director Education Program. Each Director is allocated an individual education and training budget designed to be used primarily to strengthen Directors' understanding of investment management. As well as providing individual courses, conferences and reading material, the Director Education Program stages group training sessions the day before each regular Board of Directors meeting. During the sessions, industry speakers are invited to make presentations on a variety of topics that contribute to the individual and collective expertise of Board members.

Furthermore, newly appointed Directors are expected to complete an in-house Orientation Program. The purpose of the Orientation Program is to provide new Directors with the information necessary to acquaint them with the operations and culture of the organization and enable them to contribute effectively to the Board of Directors as soon as possible after their appointment.

Both the Director Education Program and the Orientation Program are monitored by the Governance Committee.

DIRECTORS' COMPENSATION

The approach to Director compensation adopted by the Board of Directors reflects the requirements of the Act. The first requirement is that the Board should include a sufficient number of Directors with proven financial ability or relevant work experience such that PSP Investments will be able to effectively achieve its mandate. The second requirement is that Directors' compensation should be set "having regard to the remuneration received by persons having similar responsibilities and engaged in similar activities".

The Board reviews Directors' compensation once every two years and considers any changes that may be warranted based on a report and recommendations provided by the Governance Committee. The following compensation for Directors was approved by the Board of Directors for FY2012:

- Annual retainer for the Board Chair: $150,000
- Annual retainer for each Director other than the Chair: $30,000
- Annual retainer for each Chair of a committee of the Board: $10,000
- Attendance fee for each Board meeting: $1,500[5]
- Attendance fee for each committee meeting: $1,500[5]
- Additional meeting fee for each Director who attends a meeting in person if the Director's primary residence is outside Québec or Ontario, or in any case where a Board of Directors or committee meeting is held in a location outside Québec and requires a Director to travel more than three hours away from his or her primary residence: $1,500.

The Chair of the Board is not entitled to any meeting fees. Directors of PSP Investments are not entitled to additional compensation in the form of retirement benefits or short-term or long-term incentives.

The Board met nine times during fiscal year 2012 and its Committees held 31 meetings. This translated into total remuneration for Directors in that capacity of $736,187. The tables on the following two pages illustrate and break down the above-mentioned information.

The Board of Directors met 9 times during fiscal year 2012 and its Committees held 31 meetings.

[5] $500 for a meeting of less than one hour.

ATTENDANCE OF DIRECTORS
BOARD AND COMMITTEE MEETINGS
FISCAL YEAR 2012

	Board of Directors		Investment Committee		Audit Committee		Governance Committee		Human Resources and Compensation Committee		Special Chairperson Nominating Committee[6]
	Regular	Special	Regular	Special	Regular	Special	Regular	Special	Regular	Special	Regular
Number of meetings Fiscal Year 2012	8	1[1]	6	4	6	N/A	4	2	6	1	2
Bob Baldwin[2]	3/3	1/1	2/2	3/3			2/2		3/3	1/1	
Cheryl Barker	8/8	1/1	6/6	4/4	6/6		4/4	2/2			2/2
Diane Bean	8/8	1/1	6/6	4/4					6/6	1/1	2/2
Micheline Bouchard[3]	2/5	–	2/4	1/1					2/3	–	
Paul Cantor[4]	7/7	1/1	4/5	4/4							
Léon Courville	8/8	0/1	6/6	3/4			4/4	2/2	6/6	1/1	
Anthony R. Gage	8/8	1/1	6/6	4/4	6/6						2/2
Garnet Garven[5]	3/5	–	3/4	1/1	3/3						
Lynn Haight	8/8	1/1	6/6	3/4	6/6						
William A. MacKinnon	7/8	1/1	5/6	4/4	6/6						
Michael P. Mueller	8/8	1/1	6/6	4/4			4/4	2/2	6/6	1/1	

1 The special meeting of the Board was held concurrently with the special meeting of the Investment Committee.

2 Mr. Baldwin ceased to be a Director and a member of the Investment Committee, Governance Committee and Human Resources and Compensation Committee on September 29, 2011.

3 Ms. Bouchard was appointed to the Board of Directors on September 29, 2011 and became a member of the Investment Committee on the same date. She was appointed to the Human Resources and Compensation Committee on October 6, 2011.

4 Mr. Cantor resigned from the Board of Directors on March 5, 2012. Mr. Cantor was not a member of the Audit Committee, the Governance Committee or the Human Resources and Compensation Committee, but as Board Chair he could attend all committee meetings.

5 Mr. Garven was appointed to the Board of Directors on September 29, 2011 and became a member of the Investment Committee on the same date. He was appointed to the Audit Committee on October 6, 2011.

6 The Special Chairperson Nominating Committee was wound up on November 8, 2011.

REMUNERATION OF DIRECTORS FISCAL YEAR 2012

Name	Remuneration[1]				
	Annual Retainer	Chair of a Committee/ Annual Retainer	Boards/ Committees Meeting Fees	Travel Fees	Total
Bob Baldwin[2]	$15,000	–	$17,000	–	$32,000
Cheryl Barker	$30,000	$11,075	$38,000	$9,000	$88,075
Diane Bean	$30,000	–	$33,500	–	$63,500
Micheline Bouchard[3]	$15,163	–	$9,500	–	$24,663
Paul Cantor[4]	$139,286 (Board Chair)	–	–	–	$232,143[4]
Léon Courville	$30,000	–	$37,000	–	$67,000
Anthony R. Gage	$30,000	$10,000	$32,000	$9,000	$81,000
Garnet Garven[5]	$15,163	–	$14,000	$4,500	$33,663
Lynn Haight	$30,000	–	$30,500	–	$60,500
William A. MacKinnon	$30,000	$10,000	$28,000	–	$68,000
Michael P. Mueller	$30,000	$10,000	$38,500	–	$78,500

1 The Directors are also entitled to reimbursement of their reasonable travel and related expenses when applicable.

2 Mr. Baldwin ceased to be a Director and a member of the Investment Committee, Governance Committee and Human Resources and Compensation Committee on September 29, 2011.

3 Ms. Bouchard was appointed to the Board of Directors on September 29, 2011 and became a member of the Investment Committee on the same date. She was appointed to the Human Resources and Compensation Committee on October 6, 2011.

4 The aggregate amount includes $92,857 paid to Mr. Cantor as Chair of Revera Inc., a wholly-owned subsidiary of PSP Investments. During fiscal year 2012, the Board of Directors of PSP Investments asked Mr. Cantor to serve in that capacity on an exceptional basis to facilitate certain matters at Revera Inc. and fixed his compensation for that role, which was paid by PSP Investments and reimbursed to PSP Investments by Revera Inc. Mr. Cantor resigned from the PSP Investments' Board of Directors on March 5, 2012. Mr. Cantor continues to act as the Chair of Revera Inc. and his compensation for that role is now fixed by the Board of Directors of Revera Inc., and is paid by Revera Inc.

5 Mr. Garven was appointed to the Board of Directors on September 29, 2011 and became a member of the Investment Committee on the same date. He was appointed to the Audit Committee on October 6, 2011.

INVESTMENT GOVERNANCE OVERSIGHT

As a long-term investor, PSP Investments believes in the importance of establishing strong governance oversight of its investments. PSP Investments actively uses its ownership positions to promote good corporate governance practices by exercising its proxy voting rights and actively engaging with companies, individually and through collaborative initiatives with other like-minded institutional investors.

PROXY VOTING

PSP Investments has adopted Proxy Voting Guidelines (the "Guidelines") addressing the areas of corporate governance with respect to which it may be requested to vote on from time to time, as well as the principles on which PSP Investments will rely in determining a response to such requests. PSP Investments will give due consideration to corporate governance principles when assessing the merits of an issue and will exercise its voting rights with a view to maximizing the value of its shareholdings.

In fiscal year 2012, PSP Investments reviewed and amended the Guidelines to take into consideration market trends.

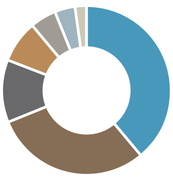
As part of the active management of its proxy voting, PSP Investments reviews proxy circulars and research from service providers when voting the equities held in accounts managed internally as well as those in segregated accounts managed by external managers.

The Guidelines may be viewed on PSP Investments' website **www.investpsp.ca**.

PROXY VOTING ACTIVITIES

In fiscal year 2012, PSP Investments exercised its voting rights at 2,902 meetings, voting against or abstaining from management's recommendations on 11.1% of the 30,350 proposed resolutions.

The issues on which PSP Investments voted against management's recommendation or abstained on such resolutions are shown below:



ISSUES
Fiscal year 2012

Board Independence and Effectiveness	39%
Compensation	30%
Capital Structure	12%
Shareholder Proposals	8%
Other	5%
Auditors and Accounting Irregularity	4%
Amendments to Articles	2%

BOARD INDEPENDENCE AND EFFECTIVENESS

PSP Investments believes that a strong independent board of directors is best positioned to successfully direct and control a company in a way that ensures the creation of long-term shareholder value. This category includes resolutions where PSP Investments withheld its votes from nominees seeking election as directors. In the latest fiscal year, PSP Investments withheld its votes from nominees because of non-independence issues, non separation of the role of Chair and CEO, poor attendance records and director time-commitment issues.

COMPENSATION

PSP Investments believes that compensation incentives to executives should be suitably structured to enhance shareholder value while rewarding performance that meets or exceeds stated objectives. During the latest fiscal year, PSP Investments voted against several compensation plans that were misaligned with performance or that failed to adequately disclose performance conditions.

CAPITAL STRUCTURE

PSP Investments is generally supportive of changes to a company's capital structure, provided there are sound business reasons for the proposed changes. In the latest fiscal year, PSP Investments voted against certain changes to capital structures because of dilution issues not justified by business considerations.

SHAREHOLDER PROPOSALS

PSP Investments reviews all shareholder proposals on a case-by-case basis. PSP Investments generally supports shareholder proposals that increase the board of directors' level of accountability to shareholders and serve the company's financial interest, without putting excessive constraints on the company, its board of directors or its management. In the latest fiscal year, PSP Investments supported shareholder proposals relating to compensation, majority voting for the election of directors, and additional disclosure with respect to risks.

AUDITORS AND ACCOUNTING IRREGULARITIES

PSP Investments supports the election of auditors where they meet generally accepted independence standards and the integrity of an audit has not been compromised. On a limited number of occasions during the past fiscal year, PSP Investments voted against auditors who, in the opinion of PSP Investments, did not meet these standards.

AMENDMENT TO ARTICLES

From time to time, PSP Investments is asked to consider resolutions regarding amendments to the articles of a company. In the past fiscal year, PSP Investments was asked to vote on amendments to articles that would limit the right to call a special meeting, that called for the adoption or elimination of cumulative voting that amended or eliminated "supermajority" requirements, or that would change the jurisdiction of incorporation of a company. All resolutions amending articles are reviewed on a case-by-case basis in light of the proposed changes to the company's governance structure. PSP Investments generally votes against amendments to articles that reduce shareholders' rights.

TAKE-OVER PROTECTION

PSP Investments always evaluates takeover-protection policies and proposals as well as shareholder rights plans on a case-by-case basis. During the past fiscal year, PSP Investments voted against takeover proposals, policies and shareholder rights plans where it felt they did not provide for an equal treatment of shareholders in the event of a takeover offer or included anti-takeover measures such as the right to issue shares should the company be subject to a bid.

RESPONSIBLE INVESTING

PSP Investments recognizes that a broad range of financial and non-financial considerations can be relevant in terms of making investment decisions. PSP Investments has adopted a Responsible Investment Policy which embodies its belief that responsible corporate behaviour with respect to environmental, social and governance ("ESG") factors can generally have a positive influence on long-term financial performance. In analyzing the risks inherent in any investment, PSP Investments looks to identify, monitor and mitigate ESG issues that are, or could become, material to long-term financial performance. Consideration of ESG risks is part of the due diligence process with respect to potential investments and the assessment of the practices of external managers. The monitoring of these risks is part of an ongoing dialogue with external managers, boards of directors and senior management of the private and public companies in which PSP Investments invests.

PSP Investments' Responsible Investment Policy may be viewed on PSP Investments' website **www.investpsp.ca**.

DIRECT ENGAGEMENT ACTIVITIES

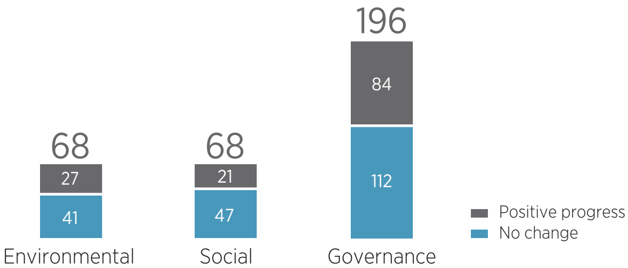
With the assistance of a service provider, PSP Investments actively engages in dialogue with public companies with a view to improving their ESG practices. Public companies are selected for engagement based on a process that takes into account elements such as a company's ability to create shareholder value, the prospects for successful engagement and the ESG issues at hand. The intensity of PSP Investments' involvement with public companies evolves over time: some engagements entail one or two meetings over a period of months, while others are more complex and entail multiple meetings with board members and senior management over several years. PSP Investments tracks its engagement objectives primarily in the context of issues where it feels changes in behavior are warranted. Often there are multiple ESG issues to be addressed within the same company, each of which may require different levels of effort and engagement approaches as well as different contact points.

When undertaking extensive engagements, a five step milestone approach is used to guide the engagement process and assess the success of the engagements:

Milestone 0	Milestone 1	Milestone 2	Milestone 3	Milestone 4
New Objective	**Raised Concerns**	**Acknowledgement of Issue**	**Develop Credible Strategy/Set Stretching Targets**	**Strategy Implemented**

In fiscal year 2012, PSP Investments made solid progress in delivering engagement objectives across regions and themes. The following chart describes for each engagement objective whether progress has been made through the achievement of new milestones:

ENGAGEMENT OBJECTIVES
Fiscal year 2012 (number)



In fiscal year 2012, PSP Investments directly engaged with 129 public companies held in PSP Investments' portfolios on a range of ESG issues.

Below is a breakdown of PSP Investments' engagement activities by issue:

ENGAGEMENTS
Fiscal year 2012

Governance	62%
Social	24%
Environmental	14%

GOVERNANCE

Governance can be defined as the framework of rules and practices by which a board of directors ensures accountability and transparency in the company's relationship with its shareholders. PSP Investments engaged with public companies on a number of governance issues during the past fiscal year. Examples of issues raised were director independence, majority voting, separation of Chair and CEO roles, succession planning, committee structures, risk management and disclosure quality.

Example of an Engagement with a Canadian Technology Company on Governance Issues

Engagement objectives

– Encourage the company to voluntarily adopt majority voting for director elections.

– Improvement in disclosure and transparency of environmental policy.

What we achieved

We met with the lead director of the company and were successful in securing the adoption of majority voting beginning at the 2012 Annual Meeting of the Shareholders. Furthermore, the company recently delivered its first sustainability report. Further to our comments on the report, the company has undertaken to improve the quality of the information available.

SOCIAL

PSP Investments engaged public companies on a variety of social issues, including labour activities in troubled regions and health-and-safety concerns.

Example of an Engagement with a Large Multinational European Food Company on Social Issues

Engagement objectives

– Pursue greater disclosure on and better management of the company's supply chain.

– Perform comprehensive review of the company's labour policies.

What we achieved

We discussed with executives of the company the commercial risks on child-labour issues resulting from the company's sourcing of certain products in African countries. Further to our discussions, the company has been collaborating with local governments and producers to implement a certification process for some products. We continue to work with the company to implement an effective monitoring of its supply chain in order to avoid significant reputational risks for the company.

We also expressed our concerns with the company's excessive decentralization of labour issues which resulted in inappropriate local management and a number of local labour disputes. The company has since introduced systematic third party audits on related issues, the findings of which are shared with the board. We welcome the progress made, and are continuing our intensive engagement to ensure the company's commitments are upheld.

ENVIRONMENTAL

PSP Investments met with a significant number of public companies on environmental-related issues in fiscal year 2012. These engagements focused mainly on climate change, water stress, oil extraction, forestry and biodiversity.

Example of an Engagement with a US Oil and Gas Company on Environmental Issues

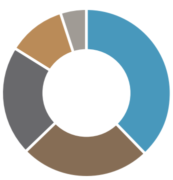
Engagement objectives

– Test the company's risk management and disaster preparedness post Gulf of Mexico oil spill-like events.

What we achieved

As part of our engagement with major international oil companies in the wake of the Gulf of Mexico oil spill, through multiple meetings with senior health and safety executives of the company we were able to ensure that risk management and disaster-recovery strategies in place are appropriate.

Below is a breakdown of PSP Investments' engagement activities by country or region:



ENGAGEMENT ACTIVITIES BY COUNTRY OR REGION

Fiscal year 2012

US & Latin America	38%
Europe	25%
Asia Pacific, Australia & New Zealand	21%
Canada	11%
Africa & Middle East	5%

COLLABORATIVE INITIATIVES

In addition to its direct-engagement efforts with public companies, PSP Investments participates in collaborative governance initiatives and engagements with other like-minded institutional investors to strengthen its voice with regard to corporate governance issues. PSP Investments is an active member of the Canadian Coalition for Good Governance, which represents 48 institutional investors managing assets of nearly $2 trillion.

PSP Investments is also a signatory of the Carbon Disclosure Project. The Carbon Disclosure Project acts on behalf of 655 institutional investors representing over $78 trillion in assets under management, to encourage public companies to disclose how they are managing climate-change risks and opportunities that may be affecting their businesses.

Since fiscal year 2010, PSP Investments has been a signatory of the CDP Water Disclosure Project, which enables institutional investors to better understand the business risks and opportunities associated with water scarcity and other water-related risks by increasing the availability of high-quality information on this issue.

PSP Investments is also a member of the Pension Investment Association of Canada (PIAC). PIAC's mission is to promote sound investment practices and good governance for the benefit of pension plan sponsors and beneficiaries.

Finally, PSP Investments' Private Equity Group played an active role in the implementation of the Institutional Limited Partners Association's Private Equity Principles, a governance best-practices undertaking designed to guide institutional investors' future investments in the private-equity sector.

PSP Investments is an active member of the Canadian Coalition for Good Governance, which represents 48 institutional investors managing assets of nearly $2 trillion.

COMPENSATION

The Board of Directors approves PSP Investments' compensation framework as well as total compensation for the President and Chief Executive Officer and other officers upon recommendation by the Human Resources and Compensation Committee (HRCC). Other compensation matters, including the total aggregate compensation for all of the Corporation's employees, are the responsibility of the HRCC.

In a highly competitive market for qualified personnel, PSP Investments' Compensation Policy is designed to attract and retain talented employees, reward performance and reinforce business strategies and priorities. The Board of Directors recognizes the fundamental value of a motivated and committed team and strongly believes that the recruitment and retention of high-performing employees is critical to achieving PSP Investments' objectives.

To that end, the Board of Directors has established a Compensation Policy that aims to maintain total compensation at a fair and competitive level. Compensation plans are aligned with PSP Investments' strategic plan and integrated with business performance measurement. PSP Investments' Compensation Policy provides balanced performance-based compensation and is effectively designed to reward prudent risk taking. Total compensation is comprised of base salary, short-term and long-term incentives, benefits, pension and other remuneration.

The Corporation's Performance Management and Professional Development process also contributes to improving business performance and employee engagement.

As part of a Special Examination conducted in fiscal year 2011 by the Office of the Auditor General of Canada and Deloitte & Touche LLP, the Examiners reviewed PSP Investments' compensation framework and practices. They concluded that the short-term and long-term incentive programs are comparable to industry practices, are designed to reduce the potential for excessive risk-taking and are aligned with the Corporation's strategic objectives and investment policies. Furthermore, in fiscal year 2010, PSP Investments completed a thorough analysis of its overall compensation practices and procedures which led to the conclusion that PSP Investments' compensation programs and policies are consistent with the G20 Working Group Recommendations which are based on the Financial Stability Forum Principles for Sound Compensation.

In order to ensure that PSP Investments offers competitive compensation to its employees, managers and officers, their compensation levels are benchmarked with those of a select group of peers — Canadian organizations in the pension fund and investment management industry, the financial-services industry and other similar industries appropriate for the positions being benchmarked. The main comparator group in fiscal year 2012 was comprised of the following pension funds: Alberta Investment Management Corporation, British Columbia Investment Management Corporation, *Caisse de dépôt et placement du Québec*, Canada Pension Plan Investment Board, Ontario Municipal Employees Retirement System and Ontario Teachers' Pension Plan. These organizations were selected based on three main criteria: the size of the assets under management, their business sector (pension fund investment) and the commonality of the talent pool.

In addition, data from these peer organizations are gathered periodically and on an ad-hoc basis using compensation surveys published by well-established, specialized compensation consulting firms, such as McLagan's Investment Management Survey, Towers Watson's Investment Management Compensation Survey, Mercer's Canadian Investment Management Compensation Survey, Executive, Management and Professionals Compensation Survey, and Information Technology Compensation Survey.

To remain competitive, PSP Investments strives to offer:

1. base salaries at the median of the comparator group;
2. incentive compensation with potential payouts superior to the median of the comparator group for superior performance; and
3. benefits that are competitive.

On an annual basis, the Board of Directors ensures that PSP Investments' executive compensation is consistent with PSP Investments' Compensation Policy. For this purpose, the services of independent compensation consulting firms were retained in fiscal year 2012 to assist the HRCC in its review of executive compensation. These compensation consulting firms report solely to the HRCC when executing their mandates.

PRINCIPLES OF PSP INVESTMENTS' COMPENSATION FRAMEWORK

PSP Investments believes that its compensation framework should be driven by a pay-for-performance approach that:

- rewards long-term performance (see *Figure A* below);
- discourages short-term decision-making and undue risk-taking;
- establishes incentive compensation as the largest component of target total compensation for executives (see *Figure B* below); and
- ensures that total fund investment performance is a component of incentive compensation at all levels of PSP Investments, in order to encourage and reinforce the benefits of teamwork.

FIGURE A: SEVEN YEARS OF INVESTMENT PERFORMANCE ARE MEASURED BY THE STIP AND THE LTIP

Both the Short-Term Incentive Plan ("STIP") and the Long-Term Incentive Plan ("LTIP") are built around rolling four-year periods spanning a total of seven years of investment performance.

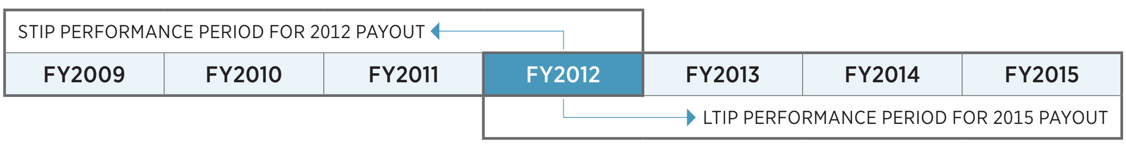


FIGURE B: COMPENSATION MIX OF TOTAL COMPENSATION FOR FISCAL YEAR 2012 (TARGET AWARDS)

Consistent with PSP Investments' pay-for-performance approach, total compensation for the President and Chief Executive Officer and for First Vice President (Investment) positions is composed primarily of incentive compensation tied to the performance of PSP Investments and, where applicable, to the investment performance of a particular asset class.

PRESIDENT AND CHIEF EXECUTIVE OFFICER

Base Salary	28%
Short-term Incentive Compensation	30%
Long-term Incentive Compensation	42%

FIRST VICE PRESIDENT POSITIONS – INVESTMENT

Base Salary	31%
Short-term Incentive Compensation	28%
Long-term Incentive Compensation	41%

BASE SALARY

Base salary reviews take place annually and any changes are effective from the beginning of each fiscal year. Adjustments to the base salary may also occur during the year to reflect significant changes in responsibility, market conditions or exceptional circumstances.

The annual budget for base salary increases in fiscal year 2012 was consistent with PSP Investments' comparator group and in accordance with the Compensation Policy.

INCENTIVE PLANS

Annually, PSP Investments reviews its incentive plans to ensure that total compensation remains competitive with the main comparator group and reflects PSP Investments' principles and objectives of attracting, retaining and motivating employees to achieve sustained high performance. The fiscal year 2012 review was conducted with the support and advice of an independent compensation consulting firm.

The following plans comprise incentive compensation at PSP Investments:

1) A Short-Term Incentive Plan ("STIP"), to recognize performance results for the current year and the previous three years;
2) A Long-Term Incentive Plan ("LTIP"), based on four-year, forward-looking cycles with possible payouts after the fourth year to recognize long-term results; and
3) A Restricted Fund Unit Plan ("RFU"), designed to help retain key employees.

SHORT-TERM INCENTIVE PLAN

PSP Investments' Short-Term Incentive Plan ("STIP") is designed to: (i) reward participants for the achievement of superior and sustained individual contributions and for PSP Investments' overall performance; (ii) help attract and retain high-calibre employees; and (iii) align the interests of participants with PSP Investments' stakeholders. PSP Investments' permanent salaried employees and any other employees designated by the President and CEO are eligible to participate in the STIP.

The STIP is a cash-based plan with a target incentive award based on a percentage of base salary. At the beginning of each fiscal year, each participant in the STIP is advised of his or her short-term incentive target amount. The target incentive amount, the performance measures and the weighting given to each measure will vary according to the participant's position level. The target incentive amount is measured on the achievement of individual objectives as well as on investment performance, which may include any combination of (i) the total fund investment performance of PSP Investments; (ii) the investment performance of a particular asset class; or (iii) the investment performance of a portfolio. Investment performance is measured against relative or absolute benchmarks (total fund, asset classes, portfolios) and thresholds below which no payments are made.

For the first four years of participation in the STIP, participants will go through a transition period building up to a rolling sequence of four consecutive years of performance. The investment performance measure is calculated on the current year as well as up to the three preceding years of investment performance, depending on the number of years an employee has participated in the STIP.

The STIP provides that the investment performance of each year is independently weighted. A greater weight is given to performance of the current year in order to more closely link shorter-term contribution and rewards, while still taking into account the investment performance of the previous three years. Investment performance floors and maximum levels are applied to the STIP calculation methodology, in order to ensure that the results of a single year's investment performance do not unduly impact the overall calculation. The HRCC reviews the annual incentive compensation payment process to ensure that payments are calculated in accordance with the terms of the STIP. In addition, the Board of Directors approves the annual incentive compensation payable to officers of PSP Investments.

FISCAL YEAR 2012 PERFORMANCE

In fiscal year 2012, the total fund investment performance of PSP Investments was above the incentive threshold and therefore, payouts were earned for that component of the STIP for eligible participants with one to four years of participation.

The one-year investment performance of Real Estate and Public Markets was above incentive thresholds and, therefore, payouts were earned for eligible participants in these asset classes. The one-year asset class performance for Infrastructure and Private Equity was below threshold and generated no incentive payout for eligible participants.

The four-year performance was above threshold for Real Estate, Private Equity and Public Markets and generated incentive payouts for eligible participants. This was not the case for participants in Infrastructure, whose performance over the same four-year period was below the threshold level.

The results of the individual objective component of the STIP were achieved and, therefore, generated, on an aggregate basis, the right for eligible employees to receive an incentive award.

The total incentive amount paid under the STIP was $23.1 million in fiscal year 2012 (362 employees), $18.8 million in fiscal year 2011 (317 employees), and $8.8 million in fiscal year 2010 (293 employees).

LONG-TERM INCENTIVE PLAN

PSP Investments' Long-Term Incentive Plan ("LTIP") is designed to: (i) reward participants for the achievement of superior and sustained investment performance by PSP Investments; (ii) attract and retain high-calibre employees; and (iii) align the interests of participants with those of PSP Investments' stakeholders. The LTIP was introduced in fiscal year 2009, replacing the former long term incentive plan, the Deferred Incentive Plan.

The LTIP is a cash-based plan that pays a percentage of base salary to participants holding senior positions, solely taking into account the achievement of investment performance on the assets managed by PSP Investments. It requires above-threshold performance over a four-year period before a payout is earned.

At the beginning of each fiscal year, each participant in the LTIP is advised of his or her target incentive amount. This target incentive amount is measured on a forward-looking, four-year investment performance, which may include any combination of: (i) the total fund investment performance of PSP Investments and (ii) for investment professionals, the investment performance of a particular asset class. The target incentive level, performance measures and the weighting given to each measure depend on the participant's position level.

The LTIP was amended in fiscal year 2012 to introduce investment performance floors and maximum levels to the LTIP calculation methodology in order to ensure that the results of a single year's investment performance do not unduly impact the overall calculation. These floors and maximums are applied to all performance years where each year has equal weight.

The incentive amount payable is determined at the end of the four-year performance period based on the amount by which the total fund actual value added and (if applicable) the asset class actual value added exceeded the incentive thresholds. In addition, the incentive amount calculated for the participant is either increased or decreased based on the total fund rate of return over the four-year performance period.

The HRCC reviews the long-term incentive compensation process to ensure that the grants are calculated in accordance with the terms of the LTIP. In addition, the Board of Directors approves long-term incentive grants to officers of PSP Investments.

LONG-TERM INCENTIVE PLAN PAYMENTS

Fiscal year 2012 represented the first potential payment opportunity as per the terms of the LTIP.

In fiscal year 2012, the four-year total fund investment performance of PSP Investments was above the incentive threshold and therefore, payouts were earned for that component of the LTIP for eligible participants.

The four-year performance was above threshold for Real Estate, Private Equity and Public Markets and generated incentive payouts for eligible participants. This was not the case for participants in Infrastructure, whose performance over the same four-year period was below the threshold level.

The total incentive amount paid under the LTIP was $6.7 million In fiscal year 2012 (42 employees).

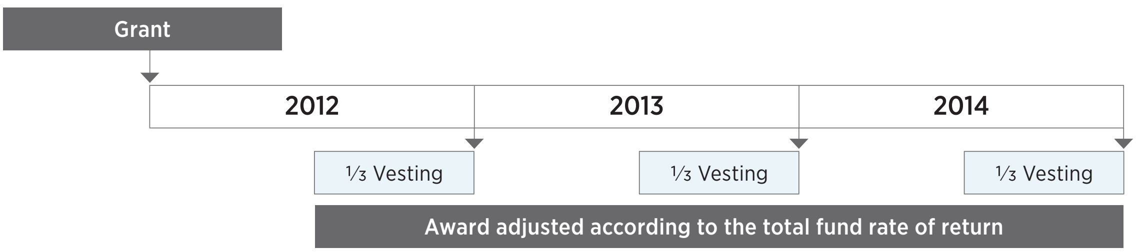
RESTRICTED FUND UNIT PLAN

PSP Investments' Restricted Fund Unit ("RFU") Plan is an incentive component of total compensation to retain key individuals in the organization.

Under the RFU Plan, grants of restricted fund units can be made to the President and Chief Executive Officer and, upon recommendation of the President and Chief Executive Officer, to other members of the senior management team. Grants may also be made to other key senior employees based on performance or market-related considerations. The HRCC reviews and approves the grants of restricted fund units. In addition, the Board of Directors approves grants to officers of PSP Investments.

Restricted fund units are a nominal investment whose value fluctuates in accordance with the total fund performance over a three-year period. One third of the award vests and is paid each year over this period, unless the participants elected to defer payment. Participants may elect to defer payment of RFUs until the end of the third year following the grant, as long as their election is made prior to the end of the fiscal year of the year of grant (see *Figure C* below).

FIGURE C: RESTRICTED FUND UNIT FRAMEWORK



The total incentive amount paid under the RFU in fiscal year 2012 was $4.0 million to recognize the contribution of key individuals to the performance of PSP Investments' results. The amount paid in fiscal year 2011 was $2.5 million.

GROUP INSURANCE BENEFITS

The Group Insurance Plan provides the following group insurance benefits: health and dental care, long-term disability, critical illness, life insurance, accidental death and dismemberment, and an employee-assistance program. The Group Insurance Plan is intended to ensure a proper balance between employee needs and competitiveness with the peer group.

OTHER REMUNERATION

PSP Investments' executives are provided with a perquisites allowance. In addition, PSP Investments offers its executives a health-and-lifestyle assessment.

RETIREMENT PLANS

All PSP Investments' eligible employees participate in the Public Sector Pension Investment Board Pension Plan (the "Employee Pension Plan") and all eligible employees participate in the Supplemental Employee Retirement Plan of the Public Sector Pension Investment Board (the "SERP").

The Employee Pension Plan provides partially indexed post-retirement pension benefits for each year of participation, calculated using 2% of the participant's average of the best consecutive three years of salary.

The benefits payable under the Employee Pension Plan are limited by the *Income Tax Act* (Canada). The SERP has been established for all employees, as an unfunded arrangement, to provide defined benefits in excess of the Employee Pension Plan, where such benefits are so limited. Employees participating in the Employee Pension Plan and the SERP contribute 3.5% of their base salary, up to the maximum contribution allowable under the *Income Tax Act* (Canada).

RETIREMENT BENEFITS

Name	Number of Years of Credited Service [1]	Annual Benefit		Accrued Obligation at Start of Year (Final Regulations) [2, 4]	Compensatory Increase [5]	Non-Compensatory Increase [6]	Accrued Obligation at Year End [2, 7]
		At Year End [2]	At Age 65 [2, 3]				
Gordon J. Fyfe	8.5	$83,200	$191,700	$921,700	$102,300	$215,400	$1,239,400
Derek Murphy	8.1	$51,200	$116,100	$576,300	$59,200	$119,000	$754,500
John Valentini	7.0	$50,400	$161,400	$488,800	$83,900	$128,900	$701,600
Daniel Garant	3.6	$20,600	$130,600	$158,700	$47,200	$69,600	$275,500
Neil Cunningham	4.4	$25,200	$92,200	$252,900	$58,500	$76,200	$387,600

1 Number of credited years of service used for both the Employee Pension Plan and the Supplemental Employee Retirement Plan.

2 Sum of benefits accrued under the Employee Pension Plan and the Supplemental Employee Retirement Plan.

3 For the purpose of calculating the annual benefits payable at age 65, the final average earnings are calculated as at March 31, 2012.

4 Accrued obligation using a discount rate of 5.4%. The obligations are calculated as at March 31, 2011 using the assumptions and methods that were used for the accounting disclosures as at December 31, 2010.

5 Includes employer service cost at the beginning of the year, the impact arising from the difference between actual pensionable earnings and those anticipated at the prior year-end and the impact of amendments to the pension plans if any.

6 Includes employee contributions and benefit payments made in the year, change in assumptions, non-pay-related experience and the interest cost for the year.

7 Accrued obligation using a discount rate of 4.7%. The obligations are calculated as at March 31, 2012 using the assumptions and methods that were used for the accounting disclosures as at December 31, 2011.

SUMMARY COMPENSATION TABLE

Total compensation paid to PSP Investments' five highest-paid officers in fiscal year 2012 totalled $10,872,612 compared to the $8,809,249 reported in the 2011 annual report. The increase is mainly due to the strong performance above benchmarks of the total fund, Public Markets and Real Estate asset classes. It was the third consecutive year that the total fund outperformed its benchmark. For the three-year period ended March 31, 2012, PSP investments generated $2.4 billion of value added over and above benchmarks returns. The strong relative performance of each of the past three years has had a positive impact on both the short – and long-term incentive compensation which are calculated over four-year periods.

Name	Fiscal Year	Base Salary	Short-term Incentive Plan	Long-Term Incentive Plan [1]	Restricted Fund Units	Benefits and Other Compensation	Pension andSERP Plans	Total Compensation
Gordon J. Fyfe President and Chief Executive Officer	2012 2011 2010	$500,000 $485,000 $485,000	$1,285,656 $1,276,763 $552,900	$1,010,092 $484,927 $37,280	$471,020 $292,238 $0	$35,678 $35,681 $35,768	$102,300 $60,800 $53,800	$3,404,746 $2,635,409 $1,164,748
Derek Murphy First Vice President, Private Equity Investments	2012 2011 2010	$320,000 $314,000 $314,000	$487,213 $716,772 $749,178	$662,516 $194,339 $400,851	$348,235 $243,278 $17,117	$25,656 $43,256 $25,619	$59,200 $41,400 $36,500	$1,902,820 $1,553,045 $1,543,265
John Valentini Executive Vice President, Chief Operating Officer and Chief Financial Officer	2012 2011 2010	$375,000 $355,000 $355,000	$667,702 $744,415 $357,840	$459,618 $220,234 $0	$261,572 $189,219 $25,150	$30,662 $30,675 $130,667	$83,900 $40,900 $33,700	$1,878,454 $1,580,443 $902,357
Daniel Garant First Vice President, Public Markets Investments	2012 2011 2010	$306,000 $300,000 $265,000	$822,578 $813,909 $393,525	$348,915 n/a n/a	$320,533 $220,489 $24,076	$23,604 $23,609 $23,656	$47,200 $49,400 $24,700	$1,868,830 $1,407,407 $730,957
Neil Cunningham First Vice President, Real Estate Investments	2012 2011 2010	$306,000 $300,000 $260,000	$789,693 $605,996 $158,600	$363,594 $345,839 $555,153	$274,321 $175,465 $9,449	$25,654 $34,663 $25,710	$58,500 $72,800 $34,100	$1,817,762 $1,534,763 $1,043,012

[1] PSP Investments' Long-Term Incentive Plan ("LTIP") was introduced in fiscal year 2009, replacing the former Long-Term Incentive Plan known as the Deferred Incentive Plan ("DIP"). The fiscal 2010 and 2011 Long-Term Incentive payments were made under the DIP. The DIP has since been discontinued. The first LTIP amounts are payable in fiscal year 2012.

LONG-TERM INCENTIVE PLAN AWARDS GRANTED FOR FISCAL YEAR 2012

The following table shows the range of future potential payouts. Payments will be based on PSP Investments' total fund investment and asset class performance.

Name	Award Type	Fiscal Year 2012 Grant	Vesting Period	Estimated Future Payouts [1]		
				Threshold [2]	Target	Maximum
Gordon J. Fyfe	LTIP	$500,000	4 years	$0	$500,000	$2,500,000
	RFU	$500,000	3 years	n/a	$500,000	$500,000
Derek Murphy	LTIP	$288,000	4 years	$0	$288,000	$1,440,000
	RFU	$288,000	3 years	n/a	$288,000	$288,000
John Valentini	LTIP	$262,500	4 years	$0	$262,500	$656,250
	RFU	$196,875	3 years	n/a	$196,875	$196,875
Daniel Garant	LTIP	$275,400	4 years	$0	$275,400	$1,377,000
	RFU	$275,400	3 years	n/a	$275,400	$275,400
Neil Cunningham	LTIP	$275,400	4 years	$0	$275,400	$1,377,000
	RFU	$275,400	3 years	n/a	$275,400	$275,400

[1] Actual payouts will be adjusted upwards or downwards by PSP Investments' compounded rate of return over the performance vesting periods.

[2] Threshold refers to the minimum amount payable for a certain level of performance, below which level no award is payable.

LONG-TERM INCENTIVE PLAN AWARDS CUMULATIVE VALUE

The total cumulative value[1] as at March 31, 2012 of all long-term incentive awards granted but not yet vested or paid to PSP Investments' five highest-paid officers is shown in the following table.

Name	Plan	Awards paying out at the end of fiscal year			Total
		2013	2014	2015	
Gordon J. Fyfe	LTIP	$1,411,350	$1,086,400	$730,000	$3,227,750
	RFU	$471,020	$254,400	$166,667	$892,087
Derek Murphy	LTIP	$676,827	$440,856	$316,800	$1,434,483
	RFU	$352,187	$170,534	$120,000	$642,721
John Valentini	LTIP	$621,250	$556,640	$383,250	$1,561,140
	RFU	$232,191	$111,108	$87,500	$430,779
Daniel Garant	LTIP	$781,088	$658,800	$451,656	$1,891,544
	RFU	$391,335	$242,724	$198,000	$832,059
Neil Cunningham	LTIP	$574,470	$707,400	$476,442	$1,758,312
	RFU	$311,254	$190,224	$144,000	$645,478

1 LTIPs' accumulated values are estimated using actual total fund and asset class performance for those years where performance is known, and a multiplier of one (1.0x) is applied for future years. RFUs' accumulated values reflect PSP Investments' total fund rate of return for fiscal years 2011 and 2012 but no returns for future years.

POST-EMPLOYMENT POLICIES

The President and CEO's severance pay is equivalent to two times his annual base salary, plus two times the average annual amount earned under the short-term and long-term incentive plans for the three-year period prior to the termination.

For First Vice Presidents, the severance pay is set at 12 months of base salary and target STIP award, plus one month of salary and target STIP award (one-twelfth of the full-year target STIP award) for every year of service, up to a maximum of 18 months. Insured benefits such as health, dental and life insurance are continued during the severance period.

The next table shows the potential payments that would be made upon termination (without cause) for the five highest-paid officers at PSP Investments.

Name	Years of service [1]	Severance [2]	Resignation
Gordon J. Fyfe	8.6 years	$3,101,395	$0
Derek Murphy	8.1 years	$912,000	$0
John Valentini	7.0 years	$1,068,750	$0
Daniel Garant	3.6 years	$726,750	$0
Neil Cunningham	7.8 years	$872,100	$0

1 Assumes a notional termination as at March 31, 2012.

2 Excludes incentive compensation amounts payable for the current year, which are included in the Summary Compensation Table.

DIRECTORS' BIOGRAPHIES

CHERYL BARKER
Interim Chair, PSP Investments

MEMBER:
Investment Committee /
Audit Committee /
Governance Committee – Chair

Board member since December 18, 2006

Ms. Barker is a member of the Board of Directors and Chair of the Audit Committee of Canada Media Fund and also serves as a trustee and Chair of the Audit Committee of Lanesborough REIT. She was President of Manitoba Telecom Services Inc. (MTS) from 2004 until her retirement in February 2006. Ms. Barker's career at MTS spanned 19 years, during which she served in a variety of key positions, including President and COO of MTS Communications Inc.; Chair, President and CEO of Bell Intrigna Inc.; and CFO and Treasurer of MTS. A Chartered Accountant (CA), Ms. Barker holds a Bachelor of Science as well as a Certificate in Education from the University of Manitoba.

DIANE BEAN
Corporate Director

MEMBER:
Investment Committee /
Human Resources and
Compensation Committee

Board member since June 18, 2010

Ms. Bean is a member of the Boards of Directors of Manulife International Ltd (Asia), The Insurance Company of the West Indies and Roy Thomson Hall/Massey Hall, and was founding Co-Chair of the Toronto Region Immigrant Employment Council. Until her retirement in 2011, she was Executive Vice-President of Manulife Financial where, over 30 years, she also served as its Regional Executive in Canada, the United States, Asia and Europe, and held senior positions in IT, Business Development, Corporate Communications and, most recently, as head of Global HR. Ms. Bean holds a Bachelor of Commerce from the University of Toronto.

MICHELINE BOUCHARD
Corporate Director

MEMBER:
Investment Committee /
Human Resources and
Compensation Committee

Board member since September 29, 2011

Ms. Bouchard is a member of the Boards of Directors of Telus and Harry Winston Diamond Corp. She has extensive experience as a director with public and private companies and volunteer boards. Past board memberships include Banque Nationale de Paris, Ford Motor Canada, London Insurance Group and Home Capital/Home Trust. Ms. Bouchard was Global Corporate Vice-President of Motorola Inc. in the U.S., after having served as President and CEO of Motorola Canada Inc. She holds a Bachelor's Degree in Applied Sciences (Engineering Physics) and a Master's Degree in Applied Sciences (Electrical Engineering) from École Polytechnique. Ms. Bouchard is a Member of the Order of Canada, a Member of the National Order of Quebec and a certified member of the Institute of Corporate Directors.

LÉON COURVILLE
Corporate Director

MEMBER:
Investment Committee /
Governance Committee /
Human Resources and
Compensation Committee

Board member since March 5, 2007

Mr. Courville has devoted his entire career to the sciences of management and finance, serving as a professor and researcher at universities in Canada and the United States before being appointed President of the National Bank of Canada. He is enjoying an active "retirement" as a corporate director, an Associate Professor at l'École des Hautes Études Commerciales and proprietor of the Domaine Les Brome vineyard, which he founded in 1999. Mr. Courville is a member of the Boards of Directors of the Institut de tourisme et d'hôtellerie du Québec and the Institut économique de Montréal. His research and publications have garnered awards and bursaries in Canada and abroad, including the Coopers & Lybrand Award for his work entitled "The Storm – Navigating the New Economy". Mr. Courville holds a Ph.D. in Economics from Carnegie-Mellon University.

ANTHONY R. GAGE *Corporate Director* **MEMBER:** Investment Committee – Chair / Audit Committee Board member since June 27, 2006	Mr. Gage is Vice Chair of the Board of Governors of the University of Victoria, a Director of Sky Investment Counsel and Head of the Management Committee of JEA Pension System Solutions. He is a former Chair of the Board of Phillips, Hager & North Investment Management. His career at Phillips, Hager & North, where he served as President and CEO from 1994 to 1999, spanned more than 20 years. Previously, Mr. Gage was Assistant Vice-President and Director of Confed Investment Counseling, the pension fund management arm of Confederation Life. Mr. Gage holds a Bachelor of Arts (Economics) from the University of Victoria and an MBA (Finance) from the University of British Columbia. He is a Chartered Financial Analyst (CFA) and an accredited Chartered Director (McMaster University).
GARNET GARVEN *Corporate Director* **MEMBER:** Investment Committee / Audit Committee Board member since September 29, 2011	Mr. Garven is Senior Fellow at Canada's Public Policy Forum, a think tank focusing on governance and public-service issues. He previously served as Deputy Minister to the Premier and Saskatchewan Cabinet Secretary. Educated in Business Administration at the Universities of Regina, Saskatchewan and Western Ontario, he holds an Honourary CMA from the Society of Management Accountants. A long-time Dean of Business at the University of Regina, Mr. Garven also was a Research Fellow in corporate governance at the Richard Ivey School of Business. A founding director of the Investment Corporation of Saskatchewan (now Greystone Managed Investments Inc.) and former Chairman and CEO of the Saskatchewan Workers' Compensation Board, he has served on a variety of other public, private and not-for-profit boards.
LYNN HAIGHT *Corporate Director* **MEMBER:** Investment Committee / Audit Committee Board member since January 14, 2010	Ms. Haight is a member of the Board of Directors and Chair of the Audit Committee of World Bank's Consultative Group on International Agricultural Research (CGIAR) and Green Shield Canada. She also sits on the Boards of the Bank of India (Canada) and Somerville College, Oxford University. Ms. Haight recently retired as Chief Operating Officer and Chief Financial Officer of the Foresters insurance organization. She previously served as Vice President, US Fixed Annuities, and Chief Accountant of Manulife Financial. She has also served as a Trustee and Chair of the Audit Committee of the Ontario Arts Council, Chair of Foresters Holdings Europe, Chair of the World Agroforestry Centre in Nairobi, Kenya, and Chair of the Sectoral Advisory Group for business services to the federal Minister of Trade. Ms. Haight holds an MA Honours from Oxford. She is a Fellow of the Canadian Institute of Chartered Accountants, a Fellow of the Canadian Association of Management Consultants and a Certified Corporate Director.

DIRECTORS' BIOGRAPHIES

WILLIAM A. MACKINNON *Corporate Director* **MEMBER:** Investment Committee / Audit Committee – Chair Board member since January 14, 2010	Mr. MacKinnon is a member of the Boards of Directors of Telus, Pioneer Petroleum, Osisko Mining Corporation and Novadaq Technologies. Very active in professional and community circles, he serves as Chair of the Board of the Canadian Institute of Chartered Accountants and Chair of The Toronto East General Hospital Board. He is also a member of the Boards of the Toronto Community Foundation and Roy Thomson Hall and a former Campaign Chair for the Toronto United Way. Mr. MacKinnon joined KPMG Canada in 1968, became a Partner in 1977 and was the firm's Chief Executive Officer from 1999 until his retirement at the end of 2008. As well, he served on the KPMG International Board of Directors. Mr. MacKinnon holds a Bachelor of Commerce from the University of Manitoba. He obtained his Chartered Accountant (CA) designation in 1971 and became a FCA in 1994.
MICHAEL P. MUELLER *Corporate Director* **MEMBER:** Investment Committee / Governance Committee / Human Resources and Compensation Committee – Chair Board member since December 18, 2006	Mr. Mueller is Chairman of Annidis Corporation and a member of the Boards of Directors of the Scarborough Hospital (past Chair), AIM Therapeutics Inc. and Biovest Corp I. He also serves as a strategic advisor to a number of Canadian, US and European companies. From 2003 to 2005, he was President and CEO of MDS Capital Corporation. Mr. Mueller previously held a series of senior executive positions at TD Bank, including Vice Chairman and Global Head of Investment and Corporate Banking. He is a former member of the Boards of Directors of the Scarborough Hospital Foundation, Budco, TM BioScience, MDS Capital and Canadian Medical Discoveries Funds I and II. Mr. Mueller holds a Bachelor of Science from the University of Western Ontario and an MBA from York University.

MANAGEMENT TEAM AND OFFICERS

GORDON J. FYFE
President and Chief Executive Officer

JOHN VALENTINI
Executive Vice President, Chief Operating Officer and Chief Financial Officer

GUY ARCHAMBAULT
First Vice President, Human Resources

NEIL CUNNINGHAM
First Vice President, Real Estate Investments

DANIEL GARANT
First Vice President, Public Market Investments

BRUNO GUILMETTE
First Vice President, Infrastructure Investments

DEREK MURPHY
First Vice President, Private Equity

MARC LACOURCIÈRE
First Vice President and Chief Legal Officer

STÉPHANIE LACHANCE
Vice President, Responsible Investment and Corporate Secretary

CONSOLIDATED TEN YEAR FINANCIAL REVIEW

($ millions)	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003
CHANGE IN NET ASSETS										
Investment income (loss)	**$ 1,888**	$ 7,043	$ 7,605	$ (9,493)	$ (197)	$ 3,414	$ 4,097	$ 1,334	$ 2,453	$ (924)
Operating expenses	**148**	114	92	86	77	52	39	21	12	9
Net income (loss) from operations and comprehensive income	**$ 1,740**	$ 6,929	$ 7,513	$ (9,579)	$ (274)	$ 3,362	$ 4,058	$ 1,313	$ 2,441	$ (933)
Fund transfers	**4,733**	4,814	4,980	4,431	4,237	3,990	4,197	3,816	3,696	3,382
Increase/(decrease) in net assets	**$ 6,473**	$11,743	$12,493	$ (5,148)	$ 3,963	$ 7,352	$ 8,255	$ 5,129	$ 6,137	$ 2,449
NET INVESTMENT ASSETS										
Investments										
World Equity										
Canadian Equity	**$14,464**	$18,665	$13,547	$ 8,815	$11,538	$10,328	$ 9,346	$ 7,758	$ 5,332	$ 3,162
Foreign Equity:										
US Large Cap Equity	**5,294**	3,829	2,111	926	1,763	2,498	2,618	2,314	2,125	1,225
EAFE Large Cap Equity	**4,760**	3,052	2,043	1,043	1,831	1,720	3,217	2,506	1,738	855
Small Cap Developed World Equity	**3,641**	3,221	1,977	781	1,930	2,936	2,006	105	65	–
Emerging Markets Equity	**4,787**	4,062	2,987	2,122	2,726	2,501	1,943	354	–	–
Private Equity	**6,444**	5,582	5,426	4,191	3,972	1,669	301	3	–	–
Nominal Fixed Income										
Cash & Cash Equivalents[1]	**1,597**	1,254	1,892	73	533	468	967	537	109	245
Fixed Income	**8,569**	7,685	6,958	6,358	7,097	7,089	5,243	5,143	4,790	2,615
Real Return Assets										
World Inflation-Linked Bonds	**3,982**	3,022	2,145	2,389	2,211	1,714	421	219	–	–
Real Estate	**7,055**	5,312	5,118	4,653	4,029	3,596	1,584	429	74	–
Infrastructure	**3,607**	2,356	2,073	2,446	1,343	479	–	–	–	–
Renewable Resources	**325**	–	–	–	–	–	–	–	–	–
Net investments	**$64,525**	**$58,040**	**$46,277**	**$33,797**	**$38,973**	**$34,998**	**$27,646**	**$19,368**	**$14,233**	**$ 8,102**
PERFORMANCE (%)										
Annual rate of return	**3.0**	14.5	21.5	(22.7)	(0.3)	11.3	19.1	7.9	26.1	(13.5)
Benchmark	**1.6**	12.7	19.8	(17.6)	1.2	10.1	18.0	7.2	25.4	(12.9)

PSP Investments' total rate of return since inception (April 2000) is 4.5%.

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

FINANCIAL STATEMENTS AND NOTES TO THE FINANCIAL STATEMENTS

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MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

The consolidated financial statements of the Public Sector Pension Investment Board ("PSP Investments") as well as the financial statements of the Public Service, the Canadian Forces, the Royal Canadian Mounted Police, and the Reserve Forces Pension Plan Accounts (the "financial statements") have been prepared by management and approved by the Board of Directors. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles. Management is responsible for the contents of the financial statements and the financial information contained in the annual report.

PSP Investments maintains records and systems of internal control and supporting procedures to provide reasonable assurance that PSP Investments' assets are safeguarded and controlled, and that transactions are 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"), the accompanying regulations, the by-laws, and the Statement of Investment Policies, Standards and Procedures (the "SIP&P").

In this regard, investments of PSP Investments held during the year ended March 31, 2012, were in accordance with the Act and the SIP&P.

The Audit Committee ("Committee") assists the Board of Directors in discharging its responsibility to approve the annual financial statements. The Committee meets regularly with both management and the external auditors to discuss the scope and findings of audits and other work that the external auditors may be requested to perform from time to time, to review financial information, and to discuss the adequacy of internal controls. The Committee reviews the annual financial statements and recommends them to the Board of Directors for approval.

PSP Investments' external "joint" auditors, the Office of the Auditor General of Canada and Deloitte & Touche LLP (the "External Auditors"), have conducted an independent examination of the financial statements in accordance with Canadian generally accepted auditing standards, performing such tests and other procedures as they consider necessary to express an opinion in their Auditors' Report. The External Auditors have full and unrestricted access to management and the Committee to discuss findings related to the integrity of PSP Investments' financial reporting and the adequacy of internal control systems.

Gordon J. Fyfe
President and
Chief Executive Officer
May 14, 2012

John Valentini
Executive Vice President,
Chief Operating Officer and Chief Financial Officer
May 14, 2012

INVESTMENT CERTIFICATE

The *Public Sector Pension Investment Board Act* (the "Act") requires that a certificate be signed by a director on behalf of the Board of Directors, stating that the investments of the Public Sector Pension Investment Board ("PSP Investments") held during the financial year were in accordance with the Act and PSP Investments' investment policies, standards and procedures. Accordingly, the Investment Certificate follows:

"The investments of PSP Investments held during the year ended March 31, 2012, were in accordance with the Act and PSP Investments' Statement of Investment Policies, Standards and Procedures".

Cheryl Barker
Interim Chair of the Board
May 14, 2012

PUBLIC SECTOR PENSION INVESTMENT BOARD CONSOLIDATED FINANCIAL STATEMENTS

INDEPENDENT AUDITORS' REPORT

To the President of the Treasury Board

REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS

We have audited the accompanying consolidated financial statements of the Public Sector Pension Investment Board (PSP Investments) and its subsidiaries, which comprise the consolidated balance sheet as at March 31, 2012, and the consolidated statement of net income from operations and comprehensive income and consolidated 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 Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated 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 consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated 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 consolidated 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 consolidated financial statements present fairly, in all material respects, the financial position of PSP Investments and its subsidiaries as at March 31, 2012, and the results of their operations and changes in their 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 PSP Investments and its wholly-owned subsidiaries that have come to our notice during our audit of the consolidated 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.

[1] Chartered accountant auditor permit No. 18527

May 14, 2012
Montréal, Canada

Michael Ferguson, FCA
Auditor General of Canada

May 14, 2012
Ottawa, Canada

CONSOLIDATED BALANCE SHEET

As at March 31

($ millions)	2012	2011
ASSETS		
Investments (Note 3 (A))	**$ 70,275**	$ 60,872
Investment-related assets (Note 3 (A))	**1,258**	1,475
Cash	**8**	4
Other assets	**65**	52
	$ 71,606	$ 62,403
LIABILITIES		
Investment-related liabilities (Note 3 (A))	**$ 7,008**	$ 4,307
Accounts payable and other liabilities	**112**	83
	$ 7,120	$ 4,390
NET ASSETS	**$ 64,486**	$ 58,013
Share capital (Note 5)	**$ –**	$ –
Public Service Pension Plan Account	**47,128**	42,299
Canadian Forces Pension Plan Account	**12,438**	11,289
Royal Canadian Mounted Police Pension Plan Account	**4,556**	4,102
Reserve Force Pension Plan Account	**364**	323
NET ASSETS	**$ 64,486**	$ 58,013

Commitments (Note 13)

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

On behalf of the Board of Directors:

Cheryl Barker
Interim Chair of the Board

William A. Mackinnon
Chair of the Audit Committee

CONSOLIDATED STATEMENT OF NET INCOME FROM OPERATIONS AND COMPREHENSIVE INCOME

For the years ended March 31

($ millions)	2012	2011
INVESTMENT INCOME (Note 7)	**$ 1,888**	$ 7,043
OPERATING EXPENSES (Note 8)	**$ 148**	$ 114
NET INCOME FROM OPERATIONS AND COMPREHENSIVE INCOME (Note 9)	**$ 1,740**	$ 6,929

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

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

For the years ended March 31

($ millions)	2012	2011
NET ASSETS, BEGINNING OF YEAR	**$ 58,013**	$ 46,270
Fund transfers (Note 6)	**4,733**	4,814
Net income from operations and comprehensive income	**1,740**	6,929
Increase in net assets for the year	**6,473**	11,743
NET ASSETS, END OF YEAR	**$ 64,486**	$ 58,013

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

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the year ended March 31, 2012

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 funds from which amounts are currently transferred to PSP Investments (individually the "Fund" and collectively the "Funds") relate to pension obligations under the Plans for service on or after April 1, 2000 except, in the case of the Reserve Force Plan, they relate to service on or after March 1, 2007. The accounts managed by PSP Investments for the Funds are herein referred to individually as the "Plan Account" and collectively as 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 *Superannuation Acts*. 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 Plans and the ability of the Plans to meet their financial obligations.

Pursuant to the *Superannuation Acts*, the Government of Canada, which administers the Funds, may call upon PSP Investments for amounts required for the purpose of paying benefits under the Plans in respect of service on or after April 1, 2000. Amounts remitted by PSP Investments for such purpose cannot exceed, at any time, the net assets of PSP Investments.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

These consolidated 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 Funds. Accordingly, they do not reflect all of the assets or the details of the pension contributions, payments and liabilities of all the Funds. The consolidated 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.

PLAN ACCOUNTS

PSP Investments maintains records of each of the Funds' net contributions, as well as the allocation of its investments and the results of its operations to each of the Plan Accounts. Separate financial statements for each Plan Account are prepared.

VALUATION OF INVESTMENTS

Investments, investment-related assets and investment-related liabilities are recorded at the date upon which PSP Investments becomes a party to the associated contractual provisions, and are carried at fair value. Purchases and sales are recorded as of the trade date. 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 year-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.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

VALUATION OF INVESTMENTS (continued)

Valuation techniques are generally applied to investments in real estate, private equity, infrastructure and renewable resources, over-the-counter (OTC) derivatives and certain fixed income securities. 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 the investments are described in Notes 3 (A) and (B).

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 directly attributable to the external management of assets on behalf of PSP Investments. Management fees incurred for investments in private markets and certain private debt portfolios are paid by the investment directly, through capital contributions by PSP Investments or offset against distributions received from the investment. Management fees are also incurred for certain public markets and alternative investments and 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

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), as well as private markets distributions from pooled funds, limited partnerships or from direct investments and co-investments. Co-investments are investments in private entities where the investment is made in conjunction with an external manager with whom PSP Investments already has committed and delegated funds.

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 year-end date. Any realized and unrealized gains (losses) on foreign exchange are included in investment income (loss).

FUND TRANSFERS

Amounts received from the Funds are recorded in their respective Plan Account.

INCOME TAXES

PSP Investments and the majority of its subsidiaries are exempt from Part I tax under paragraphs 149(1)*(d)* and 149(1)*(d.2)* of the *Income Tax Act* (Canada), respectively.

USE OF ESTIMATES

In preparing these consolidated financial statements, management makes certain estimates and assumptions which can affect the reported values of assets and liabilities. This is principally reflected in the valuation of private markets investments, certain fixed income securities, related income and expenses as well as note disclosures. Although estimates and assumptions reflect management's best judgment, actual results may differ from these estimates.

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 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, 2014. This deferral delays PSP Investments' transition to IFRS until the March 31, 2015 annual consolidated financial statements.

The AcSB's decision was in response to an announcement by the International Accounting Standards Board (IASB) in 2010, regarding an Exposure Draft (ED) being developed. The IASB proposed to define an investment entity and exempt it from consolidation by requiring it to measure all controlled investments at fair value, with changes recognized in profit or loss. The ED, *Investment Entities*, was published in August 2011 and is expected to be finalized in the second half of 2012. PSP Investments will complete the assessment of the impact of its transition to IFRS once the ED is finalized and a standard is issued.

The AcSB also announced in 2011 that it will evaluate whether entities like PSP Investments, which are separate from a pension plan and without a pension obligation, and whose sole purpose is to hold and invest assets received from one or more pension plans, would qualify as investment entities under the IASB's ED. Based on the result of this evaluation, the AcSB will then decide whether these entities would need to be included within the scope of Section 4600, "Pension Plans", where investments are accounted for at fair value.

3. INVESTMENTS

(A) INVESTMENT PORTFOLIO

The investment portfolio is organized according to the nature and common characteristics associated with the investments held. The following table presents the investment portfolio as at March 31:

	2012		2011	
($ millions)	**Fair Value**	**Cost**	Fair Value	Cost
Public markets				
Canadian equity	**$ 9,141**	**$ 8,867**	$ 14,135	$ 11,603
Foreign equity	**16,225**	**14,996**	12,977	11,845
Private markets				
Real estate	**7,452**	**6,451**	5,451	4,994
Private equity	**6,180**	**5,269**	5,189	4,502
Infrastructure	**4,268**	**4,475**	2,706	2,934
Renewable resources	**376**	**376**	–	–
Fixed income				
Cash and money market securities	**2,390**	**2,390**	2,563	2,563
Government and corporate bonds	**12,748**	**12,480**	8,075	8,126
Inflation-linked bonds	**3,950**	**3,609**	2,981	3,066
Other fixed income securities	**6,370**	**5,739**	5,681	5,467
Alternative investments	**1,175**	**927**	1,114	902
INVESTMENTS	**$ 70,275**	**$ 65,579**	$ 60,872	$ 56,002
Investment-related assets				
Amounts receivable from pending trades	**$ 629**	**$ 629**	$ 697	$ 697
Interest receivable	**160**	**160**	140	140
Dividends receivable	**59**	**59**	50	50
Derivative-related receivables	**410**	**81**	588	28
	$ 1,258	**$ 929**	$ 1,475	$ 915
Investment-related liabilities				
Amounts payable from pending trades	**$ (989)**	**$ (989)**	$ (1,084)	$ (1,084)
Interest payable	**(24)**	**(24)**	(21)	(21)
Securities sold short	**(429)**	**(415)**	(43)	(37)
Securities sold under repurchase agreements	**(1,272)**	**(1,268)**	(511)	(511)
Derivative-related payables	**(370)**	**(82)**	(198)	(24)
Capital market debt financing:				
Short-term	**(901)**	**(901)**	(702)	(702)
Long-term	**(3,023)**	**(2,959)**	(1,748)	(1,709)
	$ (7,008)	**$ (6,638)**	$ (4,307)	$ (4,088)
NET INVESTMENTS	**$ 64,525**	**$ 59,870**	$ 58,040	$ 52,829

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(i) Public Markets

Public markets consist of Canadian and foreign investments in the following securities: common shares, American depository receipts, global depository receipts, participation notes, preferred shares, income trust units, exchange traded funds units, pooled funds units, 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 using unit values obtained from each of the funds' administrators, which are derived from the fair value of the underlying investments in each pooled fund. Where necessary, the impact of restrictions on the sale or redemption of such investments is taken into consideration in determining fair value.

(ii) Private Markets

Private markets consist of investments in real estate, private equity, infrastructure and renewable resources.

Real estate investments are comprised of direct equity positions in various private entities, properties, as well as fund investments in the real estate sector. Real estate investments focus on properties, partnerships and companies operating in the office, retail, industrial, hospitality and residential sectors, as well as private funds invested in real estate assets. Real estate investments are accounted for net of all third-party financings. As at March 31, 2012, the total amount of third-party financing included as part of real estate contracted by direct investments controlled by PSP Investments was $2,662 million (2011 – $2,113 million).

Private equity investments are comprised of direct equity positions and co-investments in private entities as well as fund investments with similar objectives.

Infrastructure investments are comprised of direct equity positions and co-investments in various private entities and fund investments. Infrastructure investments focus on entities engaged in the management, ownership or operation of assets in energy, transportation and other regulated businesses. Infrastructure investments are accounted for net of all third-party financings. As at March 31, 2012, the total amount of third-party financing included as part of infrastructure contracted by direct investments controlled by PSP Investments was $285 million (2011 – $51 million).

Renewable resources investments are comprised of properties involving the production and harvesting of replenishable resources. As at March 31, 2012, renewable resources included one investment in timberlands.

Valuation Techniques

The fair value of private markets 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 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 discount rates, capitalization rates, projected cash flows and/or net operating income, which are not fully supported by prices from market observable transactions.

For direct investments in private equity, direct investments and co-investments in infrastructure and in renewable resources, 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.

In the case of private equity, real estate and 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.

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(iii) Fixed Income

Fixed income consists of cash and money market securities, government and corporate bonds, inflation-linked bonds and other fixed income securities.

Cash and money market securities include instruments having a maximum term to maturity of one year, such as treasury bills, certificates of deposit and bankers' acceptances.

Government and corporate bonds include Canadian and foreign, federal, provincial, territorial and municipal bonds. Inflation-linked bonds are fixed income securities that earn inflation adjusted returns.

Other fixed income securities consist of asset-backed securities, floating rate notes as well as private debt portfolios.

Asset-backed securities consist mainly of asset-backed term notes (ABTNs) and mortgage-backed securities. 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. Potential margin calls on the ABTNs are supported by funding facilities, as described in Note 12.

Private debt portfolios consist mainly of investments in the real estate sector in the form of third-party loans such as junior and senior debts, construction loans, bridge loans, income-participating loans, as well as other structured finance products. They also include real estate debt funds where significant portions of the value are attributed to the underlying real estate assets.

Private debt portfolios also include debt securities of private companies or other entities such as venture capital organizations, held mainly through private funds. Such debt securities take the form of senior debt, mezzanine and distressed debt.

Valuation Techniques

Cash and money market securities include short-term instruments that are recorded at cost plus accrued interest, which approximates fair value.

Fair values of government and corporate bonds, inflation-linked bonds, floating rate notes and mortgage-backed securities are based on prices obtained from third-party pricing sources. Such prices 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 whereby management relies on the valuation work performed by a recognized third-party expert. Management ensures that the valuation conducted by such expert uses acceptable industry methods. Financial information used in the valuation of ABTNs includes interest rates, credit spreads and the underlying investments' terms to maturity. In addition to the values determined by the expert, management integrated certain assumptions in the fair value of ABTNs that are not fully supported by market observable data, such as liquidity estimates and the impact of the funding facilities described in Note 12.

The fair value of private debt portfolios in the real estate sector 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.

The fair value of fund investments included as part of private debt portfolios is determined based on the audited fair values reported by the fund's general partner using acceptable industry valuation methods.

(iv) Alternative Investments

Alternative investments consist mainly of units of funds that hold a mix of equity, fixed income and derivative instruments as well as hedge funds.

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, as applicable.

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(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 and Dividends Receivable

Interest and dividends are recorded at the amounts expected to be received as at the reporting date, which approximates fair value.

(vii) Interest Payable

Interest is accrued at the amount expected to be paid as at the reporting date, which approximates fair value.

(viii) Securities Sold Short

Securities sold short reflect PSP Investments' obligation to purchase securities pursuant to short selling transactions. In such transactions, PSP Investments sells securities it does not own with an obligation to purchase 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 within public markets and fixed income.

(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 at a 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 approximates fair value.

(x) Derivative-Related Receivables and Payables

The description and valuation of derivative-related receivables and payables are described in Note 3 (B).

(xi) Capital Market Debt Financing

PSP Investments' capital market debt program is described in Note 10. Short-term promissory notes are recorded at cost plus accrued interest, which approximates fair value. The fair value of PSP Investments' medium-term notes is based on prices that are obtained from third-party pricing sources. Such prices are determined using an interest rate curve with a spread consistent with PSP Investments' credit quality.

3. INVESTMENTS (continued)

(B) DERIVATIVE FINANCIAL INSTRUMENTS

Derivative financial instruments are financial contracts that are settled at a future date. The value of such instruments 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.

(ii) Futures

Futures are standardized contracts to take or make delivery of an asset (buy or sell) at a predefined price and predefined future date. 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 at a predefined date in the future. Forwards are used to adjust exposures to specified assets without directly purchasing or selling the underlying assets.

(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.

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:

	2012				2011			
		Fair Value				Fair Value		
($ millions)	Notional Value	Assets	Liabilities	Net	Notional Value	Assets	Liabilities	Net
Equity and commodity derivatives								
Futures	$ 1,012	$ –	$ –	$ –	$ 430	$ –	$ –	$ –
Total return swaps	8,157	131	(43)	88	5,541	191	–	191
Warrants and rights	1	–	–	–	2	2	–	2
Options:								
Listed-purchased	1,128	15	–	15	442	12	–	12
Listed-written	965	–	(11)	(11)	395	–	(19)	(19)
OTC-purchased	538	6	–	6	–	–	–	–
OTC-written	495	–	(9)	(9)	–	–	–	–
Currency derivatives								
Forwards	23,088	156	(185)	(29)	17,101	316	(121)	195
Futures	152	–	–	–	–	–	–	–
Swaps	940	3	(18)	(15)	1,673	24	(11)	13
Options:								
OTC-purchased	491	5	–	5	1,010	6	–	6
OTC-written	819	–	(6)	(6)	183	–	(2)	(2)
Interest rate derivatives								
Bond forwards	1,800	4	(3)	1	993	5	(3)	2
Futures	1,564	–	–	–	1,770	–	–	–
Interest rate swaps	7,578	27	(30)	(3)	17,546	14	(17)	(3)
Total return swaps	–	–	–	–	646	–	–	–
Swaptions	808	15	(6)	9	3,522	6	(3)	3
Options:								
Listed-purchased	8,254	3	–	3	5,347	7	–	7
Listed-written	8,331	–	(5)	(5)	7,512	–	(7)	(7)
OTC-purchased	799	15	–	15	–	–	–	–
OTC-written	3,853	–	(24)	(24)	–	–	–	–
Credit derivatives[1]:								
Purchased	1,206	28	(9)	19	418	3	(4)	(1)
Sold	584	2	(21)	(19)	409	2	(11)	(9)
Total	$ 72,563	$ 410	$ (370)	$ 40	$ 64,940	$ 588	$ (198)	$ 390

[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.

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, 2012:

($ millions)

Less than 3 months	$ 41,579
3 to 12 months	17,750
Over 1 year	13,234
Total	**$ 72,563**

(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 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.

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, 2012:

($ millions)	Level 1	Level 2	Level 3	No Level	Total Fair Value
Public markets					
Canadian equity	$ 9,141	$ –	$ –	$ –	$ 9,141
Foreign equity	15,243	812	170	–	16,225
Private markets					
Real estate	–	–	7,452	–	7,452
Private equity	–	–	6,180	–	6,180
Infrastructure	–	–	4,268	–	4,268
Renewable resources	–	–	376	–	376
Fixed income					
Cash and money market securities	763	1,627	–	–	2,390
Government and corporate bonds	–	12,748	–	–	12,748
Inflation-linked bonds	–	3,950	–	–	3,950
Other fixed income securities	–	2,384	3,986	–	6,370
Alternative investments	–	871	304	–	1,175
INVESTMENTS	$ 25,147	$ 22,392	$ 22,736	$ –	$ 70,275
Investment-related assets					
Amounts receivable from pending trades[1]	$ –	$ –	$ –	$ 629	$ 629
Interest receivable[1]	–	–	–	160	160
Dividends receivable[1]	–	–	–	59	59
Derivative-related receivables	18	392	–	–	410
	$ 18	$ 392	$ –	$ 848	$ 1,258
Investment-related liabilities					
Amounts payable from pending trades[1]	$ –	$ –	$ –	$ (989)	$ (989)
Interest payable[1]	–	–	–	(24)	(24)
Securities sold short	(429)	–	–	–	(429)
Securities sold under repurchase agreements	–	(1,272)	–	–	(1,272)
Derivative-related payables	(15)	(345)	(10)	–	(370)
Capital market debt financing:					
Short-term	–	(901)	–	–	(901)
Long-term	–	(3,023)	–	–	(3,023)
	$ (444)	$ (5,541)	$ (10)	$ (1,013)	$ (7,008)
NET INVESTMENTS	$ 24,721	$ 17,243	$ 22,726	$ (165)	$ 64,525

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

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:

($ millions)	Level 1	Level 2	Level 3	No Level	Total Fair Value
Public markets					
Canadian equity	$ 14,078	$ 57	$ –	$ –	$ 14,135
Foreign equity	10,896	2,081	–	–	12,977
Private markets					
Real estate	–	–	5,451	–	5,451
Private equity	–	–	5,189	–	5,189
Infrastructure	–	–	2,706	–	2,706
Fixed income					
Cash and money market securities	583	1,980	–	–	2,563
Government and corporate bonds	–	8,075	–	–	8,075
Inflation-linked bonds	–	2,981	–	–	2,981
Other fixed income securities	–	2,003	3,678	–	5,681
Alternative investments	–	1,114	–	–	1,114
INVESTMENTS	$ 25,557	$ 18,291	$ 17,024	$ –	$ 60,872
Investment-related assets					
Amounts receivable from pending trades[1]	$ –	$ –	$ –	$ 697	$ 697
Interest receivable[1]	–	–	–	140	140
Dividends receivable[1]	–	–	–	50	50
Derivative-related receivables	20	566	2	–	588
	$ 20	$ 566	$ 2	$ 887	$ 1,475
Investment-related liabilities					
Amounts payable from pending trades[1]	$ –	$ –	$ –	$ (1,084)	$ (1,084)
Interest payable[1]	–	–	–	(21)	(21)
Securities sold short	(43)	–	–	–	(43)
Securities sold under repurchase agreements	–	(511)	–	–	(511)
Derivative-related payables	(27)	(161)	(10)	–	(198)
Capital market debt financing:					
Short-term	–	(702)	–	–	(702)
Long-term	–	(1,748)	–	–	(1,748)
	$ (70)	$ (3,122)	$ (10)	$ (1,105)	$ (4,307)
NET INVESTMENTS	$ 25,507	$ 15,735	$ 17,016	$ (218)	$ 58,040

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

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 year-end.

There were no significant transfers between Level 1 and Level 2 during the year ended March 31, 2012 (no significant transfers during the year ended March 31, 2011).

3. INVESTMENTS (continued)

(C) FAIR VALUE MEASUREMENT (continued)

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, 2012:

($ millions)	Opening Balance	Purchases	Sales	Settlements	Realized Gains	Unrealized Gains (Losses)	Transfer out of Level 3	Closing Balance
Public markets	$ –	$ 152	$ (16)	$ –	$ 2	$ 32	$ –	$ 170
Private markets	13,346	6,255	(2,257)	–	204	749	(21)	18,276
Fixed income	3,678	1,054	(978)	(221)	42	411	–	3,986
Alternative investments	–	296	–	–	–	8	–	304
Derivative-related receivables/payables (net)	(8)	–	–	(3)	3	(2)	–	(10)
Total	**$ 17,016**	**$ 7,757**	**$ (3,251)**	**$ (224)**	**$ 251**	**$ 1,198**	**$ (21)**	**$ 22,726**

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:

($ millions)	Opening Balance	Purchases	Sales	Settlements	Realized Losses	Unrealized Gains	Transfer out of Level 3	Closing Balance
Private markets	$ 12,195	$ 2,596	$ (2,365)	$ –	$ (69)	$ 1,005	$ (16)	$ 13,346
Fixed income	3,963	545	(872)	(215)	(75)	332	–	3,678
Derivative-related receivables/payables (net)	(326)	251	(4)	–	(247)	318	–	(8)
Total	$ 15,832	$ 3,392	$ (3,241)	$ (215)	$ (391)	$ 1,655	$ (16)	$ 17,016

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 (2011 – 2% increase/decrease) in the fair value of financial instruments categorized as Level 3. This excludes private debt portfolios in the real estate sector and certain fund investments, where a sensitivity analysis is not possible given the underlying assumptions used are not available to PSP Investments. In the case of 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 private debt portfolios in the real estate sector, the fair value is obtained from third-party appraisers as described in Note 3 (A).

(D) SECURITIES LENDING AND 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, 2012, PSP Investments has re-invested $1,735 million of collateral held (2011 – $1,498 million).

The following table illustrates the fair values of PSP Investments' securities and collateral associated with the lending and borrowing programs as at March 31:

($ millions)	2012	2011
Securities lending		
Securities lent	**$ 6,991**	$ 5,775
Collateral contractually receivable[1]	**7,369**	6,041
Securities borrowing		
Securities borrowed	**429**	43
Collateral contractually payable[2]	**478**	46

[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.

(E) SECURITIES SOLD AND 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 relevant 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 relevant counterparty at the end of the contract, unless an event of default occurs. PSP Investments does not sell, repledge or otherwise use collateral held.

PSP Investments pledged collateral under the repurchase agreements with a fair value of $1,272 million at March 31, 2012 (2011 – $511 million).

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 Statement of Investment Policies, Standards and Procedures (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.

(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 funding risk. Funding risk is the risk that the assets under management will be insufficient to meet the relevant pension liabilities of the Plans, which may require the contributions to the Funds of the Plans to be increased. 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. For investments that are not actively traded, the calculation of VaR uses securities with similar risk attributes as proxy.

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.

	2012	2011
Policy Portfolio VaR	**21.7 %**	22.4 %
Active VaR	**2.6**	2.2
Total VaR (undiversified)	**24.3**	24.6
Diversification effect	**(1.6)**	(2.9)
Total VaR	**22.7 %**	21.7 %

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 PSP Investments' net asset values.

The terms to maturity of the investments with the most significant exposure to interest rate risk were as follows as at March 31, 2012:

($ millions)	Less than 1 Year	1 to 5 Years	5 to 10 Years	Over 10 Years	Other	Total
Government bonds	$ 1,345	$ 4,751	$ 1,710	$ 1,813	$ –	$ 9,619
Corporate bonds	624	1,329	870	306	–	3,129
Inflation-linked bonds	–	1,042	980	1,928	–	3,950
Asset-backed securities	–	1,798	31	3	–	1,832
Private debt portfolios:						
Directly held	52	405	6	–	–	463
Held through funds [1]	–	–	–	–	1,837	1,837
Total investments with significant exposure to interest rate risk	$ 2,021	$ 9,325	$ 3,597	$ 4,050	$ 1,837	$ 20,830
Other investments [2]	$ –	$ –	$ –	$ –	$ 4,628	$ 4,628
Total fixed income	$ 2,021	$ 9,325	$ 3,597	$ 4,050	$ 6,465	$ 25,458

[1] Due to their nature, information in connection with the terms to maturity of fund investments included in the private debt portfolios is not available.

[2] Consists of $2,390 million in cash and money market securities and $2,238 million in floating rate notes, which, due to their nature, are not significantly exposed to interest rate risk.

The terms to maturity of PSP Investments' capital market debt financing are disclosed in Note 10.

Alternative investments as well as derivative contracts described in Notes 3 (A) (iv) and (B), respectively, are also subject to interest rate risk exposures. These exposures are reflected in the VaR calculation described in Note 4 (A).

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 in non-emerging countries. 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, 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:

(in millions of Canadian $)	**2012**		2011	
Currency	**Fair Value**	**% of Total**	Fair Value	% of Total
US Dollar	**$ 12,978**	**57.9 %**	$ 9,493	54.0 %
Euro	**2,660**	**11.9**	2,385	13.6
British Pound	**1,756**	**7.8**	1,331	7.6
Japanese Yen	**1,012**	**4.5**	708	4.0
Brazilian Real	**908**	**4.0**	881	5.0
Hong Kong Dollar	**675**	**3.0**	664	3.8
Korean Won	**490**	**2.2**	470	2.7
Australian Dollar	**404**	**1.8**	306	1.7
Norwegian Krone	**344**	**1.5**	104	0.6
Indian Rupee	**192**	**0.9**	141	0.8
Others	**1,012**	**4.5**	1,078	6.2
Total	**$ 22,431**	**100.0 %**	$ 17,561	100.0 %

PSP Investments and its subsidiaries also had commitments, denominated in foreign currencies of $6,471 million (US$5,667 million, €519 million, R121 million South African Rands and R186 million Brazilian Reals) which were not included in the foreign currency exposure table.

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 relevant 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.

As at March 31, 2012, PSP Investments' maximum exposure to credit risk amounted to approximately $22 billion (2011 – approximately $16 billion). This amount excludes investments in distressed debt in the amount of approximately $1.4 billion as at March 31, 2012 (2011 – approximately $1.5 billion). The maximum exposure to credit risk also excludes collateralized debt obligations, collateral held as disclosed in Notes 3 (D), 3 (E) and 4 (B) and the impact of guarantees and indemnities disclosed in Note 12.

As at March 31, 2012, PSP Investments had a net notional exposure of $168 million (2011 – $261 million) to various tranches of collateralized debt obligations, of which approximately 61% (2011 – approximately 44%) of the underlying dollar exposure was rated "Investment grade", as well as funding facilities, as described in Note 12, to support potential margin calls on the ABTNs.

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 markets investments.

PSP Investments' concentration of credit risk by credit rating, excluding the items described above and any other credit enhancement, was as follows as at March 31:

	2012	2011
Investment grade (AAA to BBB–)	**98.2 %**	97.9 %
Below investment grade (BB+ and below)	**0.7**	0.4
Not rated:		
Rated by a single credit rating agency	**0.1**	0.1
Not rated by credit rating agencies	**1.0**	1.6
Total	**100.0 %**	100.0 %

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 requires that counterparties provide adequate collateral and meet its credit rating requirements. PSP Investments frequently monitors the credit rating of its counterparties as determined by recognized credit rating agencies. With respect to derivative contracts, PSP Investments has the ability to terminate all trades with most counterparties whose credit rating is downgraded below its requirements.

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.

4. INVESTMENT RISK MANAGEMENT (continued)

(B) CREDIT RISK (continued)

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. PSP Investments pledged securities with a fair value of $3 million as collateral with respect to derivative contracts at March 31, 2012 (2011 – nil). Securities with a fair value of $104 million were received from counterparties as collateral at March 31, 2012 (2011 – $137 million). 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 (D) and 3 (E) 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.

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, 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, bonds and public equities are expected to be highly liquid as they will be invested in securities that are actively traded. Management utilizes 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 market debt program. This program allows PSP Investments to issue short-term promissory notes and medium-term notes. Note 10 provides additional information on the usage of the capital market debt program.

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

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 instruments, aggregated according to their maturities as at March 31, 2012:

($ millions)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Non-derivative-related financial liabilities[1]				
Amounts payable from pending trades	$ (989)	$ –	$ –	$ (989)
Interest payable	(21)	(3)	–	(24)
Securities sold short	(429)	–	–	(429)
Securities sold under repurchase agreements	(1,272)	–	–	(1,272)
Capital market debt financing	(832)	(69)	(3,023)	(3,924)
Accounts payable and other liabilities	(81)	–	(31)	(112)
Total	$ (3,624)	$ (72)	$ (3,054)	$ (6,750)

($ millions)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Derivative-related financial instruments				
Derivative-related receivables	$ 151	$ 170	$ 89	$ 410
Derivative-related payables[1]	(159)	(103)	(108)	(370)
Total	$ (8)	$ 67	$ (19)	$ 40

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

5. SHARE CAPITAL

Share capital consists of 10 shares having a par value of $10 that were issued to the President of the Treasury Board, to be held on behalf of Her Majesty in Right of Canada.

6. FUND TRANSFERS

PSP Investments received fund transfers of $4,733 million for the year ended March 31, 2012 (2011 – $4,814 million) from the Funds.

The breakdown of the fund transfers, for the years ended March 31, was as follows:

($ millions)	2012	2011
Public Service Pension Fund	$ 3,556	$ 3,591
Canadian Forces Pension Fund	815	828
Royal Canadian Mounted Police Pension Fund	331	341
Reserve Force Pension Fund	31	54
Total	$ 4,733	$ 4,814

7. INVESTMENT INCOME

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

($ millions)	2012	2011
Interest income	$ 664	$ 513
Dividend income	773	601
Other income	198	182
Dividend expense	(24)	(19)
Interest expense (Note 10)	(82)	(61)
Transaction costs	(64)	(57)
External investment management fees [1]	(33)	(39)
	1,432	1,120
Net realized gains [2]	1,013	1,822
Net unrealized (losses) gains	(557)	4,101
Investment income	**$ 1,888**	$ 7,043

[1] Consists of amounts incurred for investments in public markets that are paid directly by PSP Investments. This excludes investments fees related to certain pooled fund investments classified under alternative investments primarily related to performance, in the amount of $56 million for the year ended March 31, 2012 (2011 – $84 million). This also excludes management fees related to investments in private markets and other fixed income securities that are not paid directly by PSP Investments.

Such fees, which generally vary between 0.1% and 2.0% of the total invested and/or committed amount, totalled $119 million for the year ended March 31, 2012 (2011 – $140 million).

[2] Includes foreign currency losses of $45 million for the year ended March 31, 2012 (2011 – gains of $114 million).

8. OPERATING EXPENSES

Operating expenses consisted of the following for the years ended March 31:

($ thousands)	2012	2011
Salaries and benefits	$ 96,683	$ 70,134
Professional and consulting fees	10,816	8,066
Office supplies and equipment	15,050	12,593
Other operating expenses	6,433	4,893
Depreciation of fixed assets	9,257	9,841
Occupancy costs	5,531	4,804
Custodial fees	3,060	2,365
Remuneration earned by Directors	802	763
Travel and related expenses for Directors	274	189
Communication expenses	218	197
Total	**$148,124**	$113,845

Professional and consulting fees paid or accrued to the external auditors include audit fees of $406 thousand (2011 – $461 thousand), audit-related fees of $196 thousand (2011 – $681 thousand) and non-audit fees of $147 thousand (2011 – $498 thousand).

9. ALLOCATION OF NET INCOME FROM OPERATIONS AND COMPREHENSIVE INCOME

The net income from operations and comprehensive income of PSP Investments is allocated to each Plan Account as follows:

(A) INVESTMENT INCOME

The investment income is allocated proportionately based upon the asset value held by each Plan Account.

(B) 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:

	2012	2011
Public Service Pension Fund	72.9 %	72.7 %
Canadian Forces Pension Fund	19.4	19.7
Royal Canadian Mounted Police Pension Fund	7.1	7.1
Reserve Force Pension Fund	0.6	0.5
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.

10. CAPITAL MARKET DEBT FINANCING

PSP Investments' capital market debt 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 real estate, infrastructure and renewable resources. It is unconditionally and irrevocably guaranteed by PSP Investments in accordance with its corporate leverage policy.

The maximum amount authorized by the Board of Directors for the capital market debt program is 7.5% of the net investments plus all recourse debt outstanding of PSP Investments. Under this limit, the short-term promissory note component cannot exceed $3 billion.

The following outlines the terms as well as the fair value of the notes issued under the capital market debt program as at March 31:

	2012		2011
($ millions)	**Capital amounts to be paid at maturity**	**Fair Value**	Fair Value
Short-term promissory notes, bearing interest between 1% and 1.42% and maturing within 31 and 364 days of issuance (March 31, 2011 – 29 and 363 days)	**$ 902**	**$ 901**	$ 702
Medium-term notes Series 1, bearing interest of 4.57% per annum and maturing on December 9, 2013	**$ 1,000**	**$ 1,052**	$ 1,056
Medium-term notes Series 2, bearing interest of 2.94% per annum and maturing on December 3, 2015	**$ 700**	**$ 722**	$ 692
Medium-term notes Series 3, bearing variable interest of 3-month CDOR + 39 basis points and maturing on February 16, 2015	**$ 350**	**$ 350**	$ –
Medium-term notes Series 4, bearing interest of 2.26% per annum and maturing on February 16, 2017	**$ 900**	**$ 899**	$ –
Total	**$ 3,852**	**$ 3,924**	$ 2,450

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

($ thousands)	**2012**	2011
Short-term promissory notes	**$ 12,675**	$ 8,933
Medium-term notes	**69,618**	52,353
Total	**$ 82,293**	$ 61,286

The operating expenses incurred by PSP Capital Inc. were allocated to each Plan Account as described in Note 9 (B).

11. CAPITAL MANAGEMENT

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

- To invest fund transfers, outlined in Note 6, 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 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 10 provides information on the capital market debt financing and Note 4 (C) provides information on PSP Investments' liquidity.

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

12. 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.

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

PSP Capital Inc. provided funding facilities of a maximum amount of $969 million to support potential margin calls on the ABTNs. As at March 31, 2012, the margin funding facilities have not been drawn upon since inception.

In certain investment transactions, PSP Investments provided guarantees or indemnifications to third parties, the most significant of which are as follows:

As at March 31, 2012, PSP Investments agreed to guarantee, as part of an investment transaction, a non-revolving term loan. In the event of a default, PSP Investments could assume the obligation up to $403 million (2011 – $403 million) plus interest and other related costs. The loan matures in March 2015.

As at March 31, 2012, 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 (2011 – $195 million) 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.

13. 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 commitments were as follows as at March 31, 2012:

($ millions)	
Real estate	$ 1,507
Private equity	4,079
Infrastructure	870
Other fixed income securities	578
Total	**$ 7,034**

PUBLIC SERVICE PENSION PLAN ACCOUNT

INDEPENDENT AUDITORS' REPORT

To the President of the Treasury Board

REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying financial statements of the Public Sector Pension Investment Board – Public Service Pension Plan Account (the Public Service Pension Plan Account), which comprise the balance sheet as at March 31, 2012, and the statement of net income from operations and comprehensive income and 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.

Auditor's 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 auditor's 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 auditor considers 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 Public Service Pension Plan Account as at March 31, 2012, 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 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 regulations, the *Public Sector Pension Investment Board Act* and regulations and the by-laws of the Public Sector Pension Investment Board and its wholly-owned subsidiaries.

Deloitte & Touche LLP[1]

[1] Chartered accountant auditor permit No. 18527

May 14, 2012
Montréal, Canada

Michael Ferguson, FCA
Auditor General of Canada

May 14, 2012
Ottawa, Canada

BALANCE SHEET

As at March 31

($ millions)	2012	2011
ASSETS		
Investments (Note 3 (A))	$ 51,345	$ 44,375
Investment-related assets (Note 3 (A))	919	1,075
Other assets	55	36
Due from the Canadian Forces Pension Plan Account	8	9
Due from the Royal Canadian Mounted Police Pension Plan Account	3	3
	$ 52,330	$ 45,498
LIABILITIES		
Investment-related liabilities (Note 3 (A))	$ 5,120	$ 3,140
Accounts payable and other liabilities	82	59
	$ 5,202	$ 3,199
NET ASSETS	$ 47,128	$ 42,299
Accumulated net income from operations and comprehensive income	$ 11,962	$ 10,689
Accumulated fund transfers	35,166	31,610
NET ASSETS	$ 47,128	$ 42,299

Commitments (Note 11)

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

On behalf of the Board of Directors:

Cheryl Barker
Interim 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

($ millions)	2012	2011
INVESTMENT INCOME (Note 6)	$ 1,381	$ 5,130
OPERATING EXPENSES (Note 7)	$ 108	$ 83
NET INCOME FROM OPERATIONS AND COMPREHENSIVE INCOME	$ 1,273	$ 5,047

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

STATEMENT OF CHANGES IN NET ASSETS

For the years ended March 31

($ millions)	2012	2011
NET ASSETS, BEGINNING OF YEAR	$ 42,299	$ 33,661
Fund transfers (Note 5)	3,556	3,591
Net income from operations and comprehensive income	1,273	5,047
Increase in net assets for the year	4,829	8,638
NET ASSETS, END OF YEAR	$ 47,128	$ 42,299

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

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2012

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 Public Service pension plan for service on or after April 1, 2000. 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 *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, having regard to the funding, policies and requirements of the *Public Service Superannuation Act* and the Public Service pension plan's ability to meet its financial obligations.

Pursuant to the *Public Service Superannuation Act*, the Government of Canada, which administers the Fund, may call upon PSP Investments for amounts required for the purpose of paying benefits under the Plan in respect of service on or after April 1, 2000. Amounts remitted by PSP Investments for such purpose cannot exceed, at any time, the net assets of PSP Investments allocated to the Plan Account.

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 April 1, 2000. 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 at the date upon which PSP Investments becomes a party to the associated contractual provisions, and are carried at fair value. Purchases and sales are recorded as of the trade date. 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 year-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.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

VALUATION OF INVESTMENTS (continued)

Valuation techniques are generally applied to investments in real estate, private equity, infrastructure and renewable resources, over-the-counter (OTC) derivatives and certain fixed income securities. 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 the investments are described in Notes 3 (A) and (B).

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 directly attributable to the external management of assets on behalf of PSP Investments. Management fees incurred for investments in private markets and certain private debt portfolios are paid by the investment directly, through capital contributions by PSP Investments or offset against distributions received from the investment. Management fees are also incurred for certain public markets and alternative investments and 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), as well as private markets distributions from pooled funds, limited partnerships or from direct investments and co-investments. Co-investments are investments in private entities where the investment is made in conjunction with an external manager with whom PSP Investments already has committed and delegated funds.

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 year-end date. Any 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 paragraphs 149(1)*(d)* and 149(1)*(d.2)* of the *Income Tax Act* (Canada), respectively.

USE OF ESTIMATES

In preparing these financial statements, management makes certain estimates and assumptions which can affect the reported values of assets and liabilities. This is principally reflected in the valuation of private markets investments, certain fixed income securities, related income and expenses as well as note disclosures. Although estimates and assumptions reflect management's best judgment, actual results may differ from these estimates.

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 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, 2014. This deferral delays PSP Investments' transition to IFRS until the March 31, 2015 annual consolidated financial statements.

The AcSB's decision was in response to an announcement by the International Accounting Standards Board (IASB) in 2010, regarding an Exposure Draft (ED) being developed. The IASB proposed to define an investment entity and exempt it from consolidation by requiring it to measure all controlled investments at fair value, with changes recognized in profit or loss. The ED, *Investment Entities*, was published in August 2011 and is expected to be finalized in the second half of 2012. PSP Investments will complete the assessment of the impact of its transition to IFRS once the ED is finalized and a standard is issued.

The AcSB also announced in 2011 that it will evaluate whether entities like PSP Investments, which are separate from a pension plan and without a pension obligation, and whose sole purpose is to hold and invest assets received from one or more pension plans, would qualify as investment entities under the IASB's ED. Based on the result of this evaluation, the AcSB will then decide whether these entities would need to be included within the scope of Section 4600, "Pension Plans", where investments are accounted for at fair value.

3. INVESTMENTS

(A) INVESTMENT PORTFOLIO

The investment portfolio is organized according to the nature and common characteristics associated with the investments held. The following table presents the investment portfolio as at March 31:

	2012		2011	
($ millions)	Fair Value	Cost	Fair Value	Cost
Public markets				
Canadian equity	$ 6,679	$ 6,488	$ 10,304	$ 8,466
Foreign equity	11,854	10,961	9,460	8,638
Private markets				
Real estate	5,445	4,714	3,974	3,639
Private equity	4,515	3,848	3,783	3,279
Infrastructure	3,119	3,270	1,973	2,139
Renewable resources	275	275	–	–
Fixed income				
Cash and money market securities	1,746	1,746	1,868	1,868
Government and corporate bonds	9,314	9,118	5,887	5,924
Inflation-linked bonds	2,886	2,637	2,173	2,236
Other fixed income securities	4,654	4,193	4,141	3,986
Alternative investments	858	678	812	657
INVESTMENTS	$ 51,345	$ 47,928	$ 44,375	$ 40,832
Investment-related assets				
Amounts receivable from pending trades	$ 460	$ 460	$ 508	$ 508
Interest receivable	117	117	102	102
Dividends receivable	43	43	36	36
Derivative-related receivables	299	59	429	21
	$ 919	$ 679	$ 1,075	$ 667
Investment-related liabilities				
Amounts payable from pending trades	$ (722)	$ (722)	$ (790)	$ (790)
Interest payable	(18)	(18)	(16)	(16)
Securities sold short	(314)	(304)	(32)	(27)
Securities sold under repurchase agreements	(929)	(926)	(372)	(372)
Derivative-related payables	(270)	(60)	(144)	(17)
Capital market debt financing:				
Short-term	(658)	(658)	(512)	(512)
Long-term	(2,209)	(2,162)	(1,274)	(1,246)
	$ (5,120)	$ (4,850)	$ (3,140)	$ (2,980)
NET INVESTMENTS	$ 47,144	$ 43,757	$ 42,310	$ 38,519

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(i) Public Markets

Public markets consist of Canadian and foreign investments in the following securities: common shares, American depository receipts, global depository receipts, participation notes, preferred shares, income trust units, exchange traded funds units, pooled funds units, 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 using unit values obtained from each of the funds' administrators, which are derived from the fair value of the underlying investments in each pooled fund. Where necessary, the impact of restrictions on the sale or redemption of such investments is taken into consideration in determining fair value.

(ii) Private Markets

Private markets consist of investments in real estate, private equity, infrastructure and renewable resources.

Real estate investments are comprised of direct equity positions in various private entities, properties, as well as fund investments in the real estate sector. Real estate investments focus on properties, partnerships and companies operating in the office, retail, industrial, hospitality and residential sectors, as well as private funds invested in real estate assets. Real estate investments are accounted for net of all third-party financings. As at March 31, 2012, the total amount of third-party financing included as part of real estate contracted by direct investments controlled by PSP Investments for the Plan Account was $1,945 million (2011 – $1,540 million).

Private equity investments are comprised of direct equity positions and co-investments in private entities as well as fund investments with similar objectives.

Infrastructure investments are comprised of direct equity positions and co-investments in various private entities and fund investments. Infrastructure investments focus on entities engaged in the management, ownership or operation of assets in energy, transportation and other regulated businesses. Infrastructure investments are accounted for net of all third-party financings. As at March 31, 2012, the total amount of third-party financing included as part of infrastructure contracted by direct investments controlled by PSP Investments for the Plan Account was $208 million (2011 – $37 million).

Renewable resources investments are comprised of properties involving the production and harvesting of replenishable resources. As at March 31, 2012, renewable resources included one investment in timberlands.

Valuation Techniques

The fair value of private markets 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 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 discount rates, capitalization rates, projected cash flows and/or net operating income, which are not fully supported by prices from market observable transactions.

For direct investments in private equity, direct investments and co-investments in infrastructure and in renewable resources, 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.

In the case of private equity, real estate and 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.

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(iii) Fixed Income

Fixed income consists of cash and money market securities, government and corporate bonds, inflation-linked bonds and other fixed income securities.

Cash and money market securities include instruments having a maximum term to maturity of one year, such as treasury bills, certificates of deposit and bankers' acceptances.

Government and corporate bonds include Canadian and foreign, federal, provincial, territorial and municipal bonds. Inflation-linked bonds are fixed income securities that earn inflation adjusted returns.

Other fixed income securities consist of asset-backed securities, floating rate notes as well as private debt portfolios.

Asset-backed securities consist mainly of asset-backed term notes (ABTNs) and mortgage-backed securities. 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. Potential margin calls on the ABTNs are supported by funding facilities, as described in Note 10.

Private debt portfolios consist mainly of investments in the real estate sector in the form of third-party loans such as junior and senior debts, construction loans, bridge loans, income-participating loans, as well as other structured finance products. They also include real estate debt funds where significant portions of the value are attributed to the underlying real estate assets.

Private debt portfolios also include debt securities of private companies or other entities such as venture capital organizations, held mainly through private funds. Such debt securities take the form of senior debt, mezzanine and distressed debt.

Valuation Techniques

Cash and money market securities include short-term instruments that are recorded at cost plus accrued interest, which approximates fair value.

Fair values of government and corporate bonds, inflation-linked bonds, floating rate notes and mortgage-backed securities are based on prices obtained from third-party pricing sources. Such prices 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 whereby management relies on the valuation work performed by a recognized third-party expert. Management ensures that the valuation conducted by such expert uses acceptable industry methods. Financial information used in the valuation of ABTNs includes interest rates, credit spreads and the underlying investments' terms to maturity. In addition to the values determined by the expert, management integrated certain assumptions in the fair value of ABTNs that are not fully supported by market observable data, such as liquidity estimates and the impact of the funding facilities described in Note 10.

The fair value of private debt portfolios in the real estate sector 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.

The fair value of fund investments included as part of private debt portfolios is determined based on the audited fair values reported by the fund's general partner using acceptable industry valuation methods.

(iv) Alternative Investments

Alternative investments consist mainly of units of funds that hold a mix of equity, fixed income and derivative instruments as well as hedge funds.

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, as applicable.

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(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 and Dividends Receivable

Interest and dividends are recorded at the amounts expected to be received as at the reporting date, which approximates fair value.

(vii) Interest Payable

Interest is accrued at the amount expected to be paid as at the reporting date, which approximates fair value.

(viii) Securities Sold Short

Securities sold short reflect PSP Investments' obligation to purchase securities pursuant to short selling transactions. In such transactions, PSP Investments sells securities it does not own with an obligation to purchase 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 within public markets and fixed income.

(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 at a 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 approximates fair value.

(x) Derivative-Related Receivables and Payables

The description and valuation of derivative-related receivables and payables are described in Note 3 (B).

(xi) Capital Market Debt Financing

PSP Investments' capital market debt program is described in Note 8. Short-term promissory notes are recorded at cost plus accrued interest, which approximates fair value. The fair value of PSP Investments' medium-term notes is based on prices that are obtained from third-party pricing sources. Such prices are determined using an interest rate curve with a spread consistent with PSP Investments' credit quality.

3. INVESTMENTS (continued)

(B) DERIVATIVE FINANCIAL INSTRUMENTS

Derivative financial instruments are financial contracts that are settled at a future date. The value of such instruments 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.

(ii) Futures

Futures are standardized contracts to take or make delivery of an asset (buy or sell) at a predefined price and predefined future date. 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 at a predefined date in the future. Forwards are used to adjust exposures to specified assets without directly purchasing or selling the underlying assets.

(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.

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:

	2012				2011			
		Fair Value				Fair Value		
($ millions)	Notional Value	Assets	Liabilities	Net	Notional Value	Assets	Liabilities	Net
Equity and commodity derivatives								
Futures	$ 739	$ –	$ –	$ –	$ 314	$ –	$ –	$ –
Total return swaps	5,960	96	(32)	64	4,039	139	–	139
Warrants and rights	1	–	–	–	2	2	–	2
Options:								
Listed-purchased	824	11	–	11	322	9	–	9
Listed-written	706	–	(8)	(8)	288	–	(14)	(14)
OTC-purchased	393	4	–	4	–	–	–	–
OTC-written	362	–	(6)	(6)	–	–	–	–
Currency derivatives								
Forwards	16,869	114	(135)	(21)	12,466	230	(88)	142
Futures	111	–	–	–	–	–	–	–
Swaps	687	2	(13)	(11)	1,219	18	(8)	10
Options:								
OTC-purchased	358	4	–	4	736	4	–	4
OTC-written	598	–	(5)	(5)	133	–	(2)	(2)
Interest rate derivatives								
Bond forwards	1,315	3	(2)	1	724	4	(2)	2
Futures	1,143	–	–	–	1,290	–	–	–
Interest rate swaps	5,536	19	(22)	(3)	12,791	10	(12)	(2)
Total return swaps	–	–	–	–	471	–	–	–
Swaptions	590	11	(4)	7	2,568	5	(2)	3
Options:								
Listed-purchased	6,030	2	–	2	3,898	5	–	5
Listed-written	6,087	–	(4)	(4)	5,476	–	(5)	(5)
OTC-purchased	584	11	–	11	–	–	–	–
OTC-written	2,815	–	(17)	(17)	–	–	–	–
Credit derivatives[1]:								
Purchased	881	20	(6)	14	305	2	(3)	(1)
Sold	427	2	(16)	(14)	298	1	(8)	(7)
Total	$ 53,016	$ 299	$ (270)	$ 29	$ 47,340	$ 429	$ (144)	$ 285

[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.

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, 2012:

($ millions)

Less than 3 months	$ 30,378
3 to 12 months	12,969
Over 1 year	9,669
Total	**$ 53,016**

(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 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.

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, 2012:

($ millions)	Level 1	Level 2	Level 3	No Level	Total Fair Value
Public markets					
Canadian equity	$ 6,679	$ –	$ –	$ –	$ 6,679
Foreign equity	11,137	593	124	–	11,854
Private markets					
Real estate	–	–	5,445	–	5,445
Private equity	–	–	4,515	–	4,515
Infrastructure	–	–	3,119	–	3,119
Renewable resources	–	–	275	–	275
Fixed income					
Cash and money market securities	557	1,189	–	–	1,746
Government and corporate bonds	–	9,314	–	–	9,314
Inflation-linked bonds	–	2,886	–	–	2,886
Other fixed income securities	–	1,742	2,912	–	4,654
Alternative investments	–	636	222	–	858
INVESTMENTS	$ 18,373	$ 16,360	$ 16,612	$ –	$ 51,345
Investment-related assets					
Amounts receivable from pending trades[1]	$ –	$ –	$ –	$ 460	$ 460
Interest receivable[1]	–	–	–	117	117
Dividends receivable[1]	–	–	–	43	43
Derivative-related receivables	13	286	–	–	299
	$ 13	$ 286	$ –	$ 620	$ 919
Investment-related liabilities					
Amounts payable from pending trades[1]	$ –	$ –	$ –	$ (722)	$ (722)
Interest payable[1]	–	–	–	(18)	(18)
Securities sold short	(314)	–	–	–	(314)
Securities sold under repurchase agreements	–	(929)	–	–	(929)
Derivative-related payables	(11)	(252)	(7)	–	(270)
Capital market debt financing:					
Short-term	–	(658)	–	–	(658)
Long-term	–	(2,209)	–	–	(2,209)
	$ (325)	$ (4,048)	$ (7)	$ (740)	$ (5,120)
NET INVESTMENTS	$ 18,061	$ 12,598	$ 16,605	$ (120)	$ 47,144

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

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:

($ millions)	Level 1	Level 2	Level 3	No Level	Total Fair Value
Public markets					
Canadian equity	$ 10,262	$ 42	$ –	$ –	$ 10,304
Foreign equity	7,943	1,517	–	–	9,460
Private markets					
Real estate	–	–	3,974	–	3,974
Private equity	–	–	3,783	–	3,783
Infrastructure	–	–	1,973	–	1,973
Fixed income					
Cash and money market securities	425	1,443	–	–	1,868
Government and corporate bonds	–	5,887	–	–	5,887
Inflation-linked bonds	–	2,173	–	–	2,173
Other fixed income securities	–	1,461	2,680	–	4,141
Alternative investments	–	812	–	–	812
INVESTMENTS	$ 18,630	$ 13,335	$ 12,410	$ –	$ 44,375
Investment-related assets					
Amounts receivable from pending trades[1]	$ –	$ –	$ –	$ 508	$ 508
Interest receivable[1]	–	–	–	102	102
Dividends receivable[1]	–	–	–	36	36
Derivative-related receivables	15	412	2	–	429
	$ 15	$ 412	$ 2	$ 646	$ 1,075
Investment-related liabilities					
Amounts payable from pending trades[1]	$ –	$ –	$ –	$ (790)	$ (790)
Interest payable[1]	–	–	–	(16)	(16)
Securities sold short	(32)	–	–	–	(32)
Securities sold under repurchase agreements	–	(372)	–	–	(372)
Derivative-related payables	(19)	(118)	(7)	–	(144)
Capital market debt financing:					
Short-term	–	(512)	–	–	(512)
Long-term	–	(1,274)	–	–	(1,274)
	$ (51)	$ (2,276)	$ (7)	$ (806)	$ (3,140)
NET INVESTMENTS	$ 18,594	$ 11,471	$ 12,405	$ (160)	$ 42,310

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

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 year-end.

There were no significant transfers between Level 1 and Level 2 during the year ended March 31, 2012 (no significant transfers during the year ended March 31, 2011).

3. INVESTMENTS (continued)

(C) FAIR VALUE MEASUREMENT (continued)

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, 2012:

($ millions)	Opening Balance	Purchases	Sales	Settlements[1]	Realized Gains	Unrealized Gains (Losses)	Transfer out of Level 3	Closing Balance
Public markets	$ –	$ 110	$ (12)	$ –	$ 2	$ 24	$ –	$ 124
Private markets	9,730	4,571	(1,648)	–	149	568	(16)	13,354
Fixed income	2,680	770	(713)	(161)	30	306	–	2,912
Alternative investments	–	216	–	–	–	6	–	222
Derivative-related receivables/payables (net)	(5)	–	–	(2)	2	(2)	–	(7)
Total	**$ 12,405**	**$ 5,667**	**$ (2,373)**	**$ (163)**	**$ 183**	**$ 902**	**$ (16)**	**$ 16,605**

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:

($ millions)	Opening Balance	Purchases	Sales	Settlements[1]	Realized Losses	Unrealized Gains	Transfer out of Level 3	Closing Balance
Private markets	$ 8,870	$ 1,932	$ (1,744)	$ –	$ (49)	$ 733	$ (12)	$ 9,730
Fixed income	2,883	411	(642)	(161)	(55)	244	–	2,680
Derivative-related receivables/payables (net)	(237)	193	(3)	–	(180)	222	–	(5)
Total	$ 11,516	$ 2,536	$ (2,389)	$ (161)	$ (284)	$ 1,199	$ (12)	$ 12,405

[1] Includes Plan Account allocation adjustments.

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 (2011 - 2% increase/decrease) in the fair value of financial instruments categorized as Level 3. This excludes private debt portfolios in the real estate sector and certain fund investments, where a sensitivity analysis is not possible given the underlying assumptions used are not available to PSP Investments. In the case of 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 private debt portfolios in the real estate sector, the fair value is obtained from third-party appraisers as described in Note 3 (A).

(D) SECURITIES LENDING AND 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, 2012, PSP Investments, on behalf of the Plan Account, has re-invested $1,268 million of collateral held (2011 – $1,092 million).

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:

($ millions)	2012	2011
Securities lending		
Securities lent	$ 5,108	$ 4,210
Collateral contractually receivable[1]	5,384	4,404
Securities borrowing		
Securities borrowed	314	32
Collateral contractually payable[2]	349	34

[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.

(E) SECURITIES SOLD AND 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 relevant 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 relevant 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 $929 million at March 31, 2012 (2011 – $372 million).

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 Statement of Investment Policies, Standards and Procedures (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.

(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 funding risk. Funding risk is the risk that the assets under management will be insufficient to meet the relevant pension liabilities of the Plans, which may require the contributions to the Funds of the Plans to be increased. 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. For investments that are not actively traded, the calculation of VaR uses securities with similar risk attributes as proxy.

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.

	2012	2011
Policy Portfolio VaR	**21.7 %**	22.4 %
Active VaR	**2.6**	2.2
Total VaR (undiversified)	**24.3**	24.6
Diversification effect	**(1.6)**	(2.9)
Total VaR	**22.7 %**	21.7 %

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 terms to maturity of the investments with the most significant exposure to interest rate risk were as follows as at March 31, 2012:

($ millions)	Less than 1 Year	1 to 5 Years	5 to 10 Years	Over 10 Years	Other	Total
Government bonds	$ 983	$ 3,471	$ 1,249	$ 1,325	$ –	$ 7,028
Corporate bonds	456	971	636	223	–	2,286
Inflation-linked bonds	–	761	716	1,409	–	2,886
Asset-backed securities	–	1,314	23	2	–	1,339
Private debt portfolios:						
Directly held	38	296	4	–	–	338
Held through funds [1]	–	–	–	–	1,342	1,342
Total investments with significant exposure to interest rate risk	**$ 1,477**	**$ 6,813**	**$ 2,628**	**$ 2,959**	**$ 1,342**	**$ 15,219**
Other investments [2]	**$ –**	**$ –**	**$ –**	**$ –**	**$ 3,381**	**$ 3,381**
Total fixed income	**$ 1,477**	**$ 6,813**	**$ 2,628**	**$ 2,959**	**$ 4,723**	**$ 18,600**

[1] Due to their nature, information in connection with the terms to maturity of fund investments included in the private debt portfolios is not available.

[2] Consists of $1,746 million in cash and money market securities and $1,635 million in floating rate notes, which, due to their nature, are not significantly exposed to interest rate risk.

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

Alternative investments as well as derivative contracts described in Notes 3 (A) (iv) and (B), respectively, are also subject to interest rate risk exposures. These exposures are reflected in the VaR calculation described in Note 4 (A).

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 in non-emerging countries. 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:

(in millions of Canadian $)	**2012**		2011	
Currency	**Fair Value**	**% of Total**	Fair Value	% of Total
US Dollar	**$ 9,482**	**57.9 %**	$ 6,920	54.0 %
Euro	**1,943**	**11.9**	1,739	13.6
British Pound	**1,283**	**7.8**	971	7.6
Japanese Yen	**740**	**4.5**	516	4.0
Brazilian Real	**664**	**4.0**	642	5.0
Hong Kong Dollar	**493**	**3.0**	484	3.8
Korean Won	**358**	**2.2**	342	2.7
Australian Dollar	**295**	**1.8**	223	1.7
Norwegian Krone	**252**	**1.5**	76	0.6
Indian Rupee	**140**	**0.9**	103	0.8
Others	**739**	**4.5**	786	6.2
Total	**$ 16,389**	**100.0 %**	$ 12,802	100.0 %

PSP Investments and its subsidiaries also had commitments, denominated in foreign currencies of $4,728 million (US$4,140 million, €379 million, R88 million South African Rands and R136 million Brazilian Reals) for the Plan Account which were not included in the foreign currency exposure table.

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 relevant 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.

As at March 31, 2012, the Plan Account's maximum exposure to credit risk amounted to approximately $16 billion (2011 – approximately $12 billion). This amount excludes investments in distressed debt in the amount of approximately $1 billion as at March 31, 2012 (2011 – approximately $1.1 billion). The maximum exposure to credit risk also excludes collateralized debt obligations, collateral held as disclosed in Notes 3 (D), 3 (E) and 4 (B) and the impact of guarantees and indemnities disclosed in Note 10.

As at March 31, 2012, the Plan Account had a net notional exposure of $123 million (2011 – $190 million) to various tranches of collateralized debt obligations, of which approximately 61% (2011 – approximately 44%) of the underlying dollar exposure was rated "Investment grade", as well as funding facilities, as described in Note 10, to support potential margin calls on the ABTNs.

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 markets investments.

PSP Investments' concentration of credit risk by credit rating, excluding the items described above and any other credit enhancement, for the Plan Account was as follows as at March 31:

	2012	2011
Investment grade (AAA to BBB–)	**98.2 %**	97.9 %
Below investment grade (BB+ and below)	**0.7**	0.4
Not rated:		
Rated by a single credit rating agency	**0.1**	0.1
Not rated by credit rating agencies	**1.0**	1.6
Total	**100.0 %**	100.0 %

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 requires that counterparties provide adequate collateral and meet its credit rating requirements. PSP Investments frequently monitors the credit rating of its counterparties as determined by recognized credit rating agencies. With respect to derivative contracts, PSP Investments has the ability to terminate all trades with most counterparties whose credit rating is downgraded below its requirements.

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.

4. INVESTMENT RISK MANAGEMENT (continued)

(B) CREDIT RISK (continued)

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 pledged securities with a fair value of $2 million as collateral with respect to derivative contracts at March 31, 2012 (2011 – nil). Securities with a fair value of $76 million were received from counterparties as collateral at March 31, 2012 (2011 – $100 million). 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 (D) and 3 (E) 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.

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, 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, bonds and public equities are expected to be highly liquid as they will be invested in securities that are actively traded. Management utilizes 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 market 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 market debt program.

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

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 instruments, aggregated according to their maturities as at March 31, 2012:

($ millions)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Non-derivative-related financial liabilities[1]				
Amounts payable from pending trades	$ (722)	$ –	$ –	$ (722)
Interest payable	(16)	(2)	–	(18)
Securities sold short	(314)	–	–	(314)
Securities sold under repurchase agreements	(929)	–	–	(929)
Capital market debt financing	(607)	(51)	(2,209)	(2,867)
Accounts payable and other liabilities	(59)	–	(23)	(82)
Total	$ (2,647)	$ (53)	$ (2,232)	$ (4,932)

($ millions)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Derivative-related financial instruments				
Derivative-related receivables	$ 110	$ 124	$ 65	$ 299
Derivative-related payables[1]	(116)	(75)	(79)	(270)
Total	$ (6)	$ 49	$ (14)	$ 29

[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 $3,556 million for the year ended March 31, 2012 (2011 – $3,591 million) from the Fund.

6. INVESTMENT INCOME

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

($ millions)	2012	2011
Interest income	$ 485	$ 374
Dividend income	565	438
Other income	145	132
Dividend expense	(18)	(14)
Interest expense (Note 8)	(60)	(45)
Transaction costs	(47)	(41)
External investment management fees[1]	(24)	(28)
	1,046	816
Net realized gains[2]	740	1,328
Net unrealized (losses) gains	(405)	2,986
Investment income	**$ 1,381**	$ 5,130

[1] Consists of amounts incurred for investments in public markets that are paid directly by PSP Investments. This excludes investments fees related to certain pooled fund investments classified under alternative investments primarily related to performance, in the amount of $41 million for the year ended March 31, 2012 (2011 – $62 million). This also excludes management fees related to investments in private markets and other fixed income securities that are not paid directly by PSP Investments.

Such fees, which generally vary between 0.1% and 2.0% of the total invested and/or committed amount, totalled $87 million for the year ended March 31, 2012 (2011 – $102 million).

[2] Includes foreign currency losses of $34 million for the year ended March 31, 2012 (2011 – gains of $83 million).

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:

	2012	2011
Public Service Pension Plan Account	72.9 %	72.7 %
Canadian Forces Pension Plan Account	19.4	19.7
Royal Canadian Mounted Police Pension Plan Account	7.1	7.1
Reserve Force Pension Plan Account	0.6	0.5
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)	2012	2011
Salaries and benefits	$ 70,482	$ 51,015
Professional and consulting fees	7,885	5,867
Office supplies and equipment	10,971	9,160
Other operating expenses	4,690	3,559
Depreciation of fixed assets	6,749	7,158
Occupancy costs	4,032	3,495
Custodial fees	2,231	1,720
Remuneration earned by Directors	585	556
Travel and related expenses for Directors	199	138
Communication expenses	160	144
Total	**$107,984**	$ 82,812

8. CAPITAL MARKET DEBT FINANCING

PSP Investments' capital market debt 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 real estate, infrastructure and renewable resources. It is unconditionally and irrevocably guaranteed by PSP Investments in accordance with its corporate leverage policy.

The maximum amount authorized by the Board of Directors for the capital market debt program is 7.5% of the net investments plus all recourse debt outstanding of PSP Investments. Under this limit, the short-term promissory note component cannot exceed $3 billion.

The following outlines the terms as well as the fair value of the notes issued under the capital market debt program allocated to the Plan Account as at March 31:

	2012		2011
($ millions)	**Capital amounts to be paid at maturity**	**Fair Value**	Fair Value
Short-term promissory notes, bearing interest between 1% and 1.42% and maturing within 31 and 364 days of issuance (March 31, 2011 – 29 and 363 days)	**$ 659**	**$ 658**	$ 512
Medium-term notes Series 1, bearing interest of 4.57% per annum and maturing on December 9, 2013	**$ 730**	**$ 769**	$ 770
Medium-term notes Series 2, bearing interest of 2.94% per annum and maturing on December 3, 2015	**$ 512**	**$ 528**	$ 504
Medium-term notes Series 3, bearing variable interest of 3–month CDOR + 39 basis points and maturing on February 16, 2015	**$ 256**	**$ 255**	$ –
Medium-term notes Series 4, bearing interest of 2.26% per annum and maturing on February 16, 2017	**$ 658**	**$ 657**	$ –
Total	**$ 2,815**	**$ 2,867**	$ 1,786

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)	**2012**	2011
Short-term promissory notes	**$ 9,252**	$ 6,508
Medium-term notes	**50,816**	38,133
Total	**$ 60,068**	$ 44,641

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 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 market debt financing and Note 4 (C) provides information on PSP Investments' liquidity.

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

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.

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

PSP Capital Inc. provided funding facilities of a maximum amount of $969 million to support potential margin calls on the ABTNs, of which $705 million has been allocated to the Plan Account. As at March 31, 2012, the margin funding facilities have not been drawn upon since inception.

In certain investment transactions, PSP Investments provided guarantees or indemnifications to third parties, the most significant of which are as follows:

As at March 31, 2012, 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 $292 million (2011 – $292 million) plus interest and other related costs. The loan matures in March 2015.

As at March 31, 2012, 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 (2011 – $195 million), of which $142 million (2011 – $142 million) 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.

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, 2012:

($ millions)	
Real estate	$ 1,101
Private equity	2,980
Infrastructure	636
Other fixed income securities	422
Total	**$ 5,139**

CANADIAN FORCES 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 – Canadian Forces Pension Plan Account (the Canadian Forces Pension Plan Account), which comprise the balance sheet as at March 31, 2012, and the statement of net income from operations and comprehensive income and 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.

Auditor's 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 auditor's 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 auditor considers 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 Canadian Forces Pension Plan Account as at March 31, 2012, 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 Canadian Forces 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 the Public Sector Pension Investment Board and its wholly-owned subsidiaries.

Deloitte & Touche LLP[1]

[1] Chartered accountant auditor permit No. 18527

May 14, 2012
Montréal, Canada

Michael Ferguson, FCA
Auditor General of Canada

May 14, 2012
Ottawa, Canada

BALANCE SHEET

As at March 31

($ millions)	2012	2011
ASSETS		
Investments (Note 3 (A))	**$ 13,565**	$ 11,852
Investment-related assets (Note 3 (A))	**243**	287
Other assets	**13**	10
	$ 13,821	$ 12,149
LIABILITIES		
Investment-related liabilities (Note 3 (A))	**$ 1,353**	$ 839
Accounts payable and other liabilities	**22**	12
Due to the Public Service Pension Plan Account	**8**	9
	$ 1,383	$ 860
NET ASSETS	**$ 12,438**	$ 11,289
Accumulated net income from operations and comprehensive income	**$ 3,275**	$ 2,941
Accumulated fund transfers	**9,163**	8,348
NET ASSETS	**$ 12,438**	$ 11,289

Commitments (Note 11)

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

On behalf of the Board of Directors:

Cheryl Barker
Interim 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

($ millions)	2012	2011
INVESTMENT INCOME (Note 6)	**$ 363**	$ 1,376
OPERATING EXPENSES (Note 7)	**$ 29**	$ 22
NET INCOME FROM OPERATIONS AND COMPREHENSIVE INCOME	**$ 334**	$ 1,354

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

STATEMENT OF CHANGES IN NET ASSETS

For the years ended March 31

($ millions)	2012	2011
NET ASSETS, BEGINNING OF YEAR	**$ 11,289**	$ 9,107
Fund transfers (Note 5)	**815**	828
Net income from operations and comprehensive income	**334**	1,354
Increase in net assets for the year	**1,149**	2,182
NET ASSETS, END OF YEAR	**$ 12,438**	$ 11,289

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

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2012

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 Canadian Forces pension plan for service on or after April 1, 2000. 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 Canadian Forces pension plan's ability to meet its financial obligations.

Pursuant to the *Canadian Forces Superannuation Act*, the Government of Canada, which administers the Fund, may call upon PSP Investments for amounts required for the purpose of paying benefits under the Plan in respect of service on or after April 1, 2000. Amounts remitted by PSP Investments for such purpose cannot exceed, at any time, the net assets of PSP Investments allocated to the Plan Account.

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 April 1, 2000. 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 at the date upon which PSP Investments becomes a party to the associated contractual provisions, and are carried at fair value. Purchases and sales are recorded as of the trade date. 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 year-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.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

VALUATION OF INVESTMENTS (continued)

Valuation techniques are generally applied to investments in real estate, private equity, infrastructure and renewable resources, over-the-counter (OTC) derivatives and certain fixed income securities. 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 the investments are described in Notes 3 (A) and (B).

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 directly attributable to the external management of assets on behalf of PSP Investments. Management fees incurred for investments in private markets and certain private debt portfolios are paid by the investment directly, through capital contributions by PSP Investments or offset against distributions received from the investment. Management fees are also incurred for certain public markets and alternative investments and 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), as well as private markets distributions from pooled funds, limited partnerships or from direct investments and co-investments. Co-investments are investments in private entities where the investment is made in conjunction with an external manager with whom PSP Investments already has committed and delegated funds.

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 year-end date. Any 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 paragraphs 149(1)*(d)* and 149(1)*(d.2)* of the *Income Tax Act* (Canada), respectively.

USE OF ESTIMATES

In preparing these financial statements, management makes certain estimates and assumptions which can affect the reported values of assets and liabilities. This is principally reflected in the valuation of private markets investments, certain fixed income securities, related income and expenses as well as note disclosures. Although estimates and assumptions reflect management's best judgment, actual results may differ from these estimates.

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 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, 2014. This deferral delays PSP Investments' transition to IFRS until the March 31, 2015 annual consolidated financial statements.

The AcSB's decision was in response to an announcement by the International Accounting Standards Board (IASB) in 2010, regarding an Exposure Draft (ED) being developed. The IASB proposed to define an investment entity and exempt it from consolidation by requiring it to measure all controlled investments at fair value, with changes recognized in profit or loss. The ED, *Investment Entities*, was published in August 2011 and is expected to be finalized in the second half of 2012. PSP Investments will complete the assessment of the impact of its transition to IFRS once the ED is finalized and a standard is issued.

The AcSB also announced in 2011 that it will evaluate whether entities like PSP Investments, which are separate from a pension plan and without a pension obligation, and whose sole purpose is to hold and invest assets received from one or more pension plans, would qualify as investment entities under the IASB's ED. Based on the result of this evaluation, the AcSB will then decide whether these entities would need to be included within the scope of Section 4600, "Pension Plans", where investments are accounted for at fair value.

3. INVESTMENTS

(A) INVESTMENT PORTFOLIO

The investment portfolio is organized according to the nature and common characteristics associated with the investments held. The following table presents the investment portfolio as at March 31:

	2012		2011	
($ millions)	**Fair Value**	**Cost**	Fair Value	Cost
Public markets				
Canadian equity	**$ 1,764**	**$ 1,706**	$ 2,752	$ 2,255
Foreign equity	**3,132**	**2,894**	2,527	2,306
Private markets				
Real estate	**1,438**	**1,241**	1,061	970
Private equity	**1,193**	**1,017**	1,010	878
Infrastructure	**823**	**864**	527	571
Renewable resources	**72**	**72**	–	–
Fixed income				
Cash and money market securities	**462**	**462**	500	500
Government and corporate bonds	**2,461**	**2,408**	1,572	1,581
Inflation-linked bonds	**763**	**696**	580	596
Other fixed income securities	**1,230**	**1,108**	1,106	1,064
Alternative investments	**227**	**182**	217	181
INVESTMENTS	**$ 13,565**	**$ 12,650**	$ 11,852	$ 10,902
Investment-related assets				
Amounts receivable from pending trades	**$ 121**	**$ 121**	$ 136	$ 136
Interest receivable	**31**	**31**	27	27
Dividends receivable	**12**	**12**	10	10
Derivative-related receivables	**79**	**16**	114	5
	$ 243	**$ 180**	$ 287	$ 178
Investment–related liabilities				
Amounts payable from pending trades	**$ (191)**	**$ (191)**	$ (211)	$ (211)
Interest payable	**(5)**	**(5)**	(4)	(4)
Securities sold short	**(83)**	**(80)**	(8)	(7)
Securities sold under repurchase agreements	**(246)**	**(245)**	(100)	(100)
Derivative-related payables	**(71)**	**(15)**	(39)	(5)
Capital market debt financing:				
Short-term	**(174)**	**(174)**	(137)	(137)
Long-term	**(583)**	**(571)**	(340)	(332)
	$ (1,353)	**$ (1,281)**	$ (839)	$ (796)
NET INVESTMENTS	**$ 12,455**	**$ 11,549**	$ 11,300	$ 10,284

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(i) Public Markets

Public markets consist of Canadian and foreign investments in the following securities: common shares, American depository receipts, global depository receipts, participation notes, preferred shares, income trust units, exchange traded funds units, pooled funds units, 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 using unit values obtained from each of the funds' administrators, which are derived from the fair value of the underlying investments in each pooled fund. Where necessary, the impact of restrictions on the sale or redemption of such investments is taken into consideration in determining fair value.

(ii) Private Markets

Private markets consist of investments in real estate, private equity, infrastructure and renewable resources.

Real estate investments are comprised of direct equity positions in various private entities, properties, as well as fund investments in the real estate sector. Real estate investments focus on properties, partnerships and companies operating in the office, retail, industrial, hospitality and residential sectors, as well as private funds invested in real estate assets. Real estate investments are accounted for net of all third-party financings. As at March 31, 2012, the total amount of third-party financing included as part of real estate contracted by direct investments controlled by PSP Investments for the Plan Account was $514 million (2011 – $411 million).

Private equity investments are comprised of direct equity positions and co-investments in private entities as well as fund investments with similar objectives.

Infrastructure investments are comprised of direct equity positions and co-investments in various private entities and fund investments. Infrastructure investments focus on entities engaged in the management, ownership or operation of assets in energy, transportation and other regulated businesses. Infrastructure investments are accounted for net of all third-party financings. As at March 31, 2012, the total amount of third-party financing included as part of infrastructure contracted by direct investments controlled by PSP Investments for the Plan Account was $55 million (2011 – $10 million).

Renewable resources investments are comprised of properties involving the production and harvesting of replenishable resources. As at March 31, 2012, renewable resources included one investment in timberlands.

Valuation Techniques

The fair value of private markets 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 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 discount rates, capitalization rates, projected cash flows and/or net operating income, which are not fully supported by prices from market observable transactions.

For direct investments in private equity, direct investments and co-investments in infrastructure and in renewable resources, 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.

In the case of private equity, real estate and 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.

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(iii) Fixed Income

Fixed income consists of cash and money market securities, government and corporate bonds, inflation-linked bonds and other fixed income securities.

Cash and money market securities include instruments having a maximum term to maturity of one year, such as treasury bills, certificates of deposit and bankers' acceptances.

Government and corporate bonds include Canadian and foreign, federal, provincial, territorial and municipal bonds. Inflation-linked bonds are fixed income securities that earn inflation adjusted returns.

Other fixed income securities consist of asset-backed securities, floating rate notes as well as private debt portfolios.

Asset-backed securities consist mainly of asset-backed term notes (ABTNs) and mortgage-backed securities. 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. Potential margin calls on the ABTNs are supported by funding facilities, as described in Note 10.

Private debt portfolios consist mainly of investments in the real estate sector in the form of third-party loans such as junior and senior debts, construction loans, bridge loans, income-participating loans, as well as other structured finance products. They also include real estate debt funds where significant portions of the value are attributed to the underlying real estate assets.

Private debt portfolios also include debt securities of private companies or other entities such as venture capital organizations, held mainly through private funds. Such debt securities take the form of senior debt, mezzanine and distressed debt.

Valuation Techniques

Cash and money market securities include short-term instruments that are recorded at cost plus accrued interest, which approximates fair value.

Fair values of government and corporate bonds, inflation-linked bonds, floating rate notes and mortgage-backed securities are based on prices obtained from third-party pricing sources. Such prices 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 whereby management relies on the valuation work performed by a recognized third-party expert. Management ensures that the valuation conducted by such expert uses acceptable industry methods. Financial information used in the valuation of ABTNs includes interest rates, credit spreads and the underlying investments' terms to maturity. In addition to the values determined by the expert, management integrated certain assumptions in the fair value of ABTNs that are not fully supported by market observable data, such as liquidity estimates and the impact of the funding facilities described in Note 10.

The fair value of private debt portfolios in the real estate sector 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.

The fair value of fund investments included as part of private debt portfolios is determined based on the audited fair values reported by the fund's general partner using acceptable industry valuation methods.

(iv) Alternative Investments

Alternative investments consist mainly of units of funds that hold a mix of equity, fixed income and derivative instruments as well as hedge funds.

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, as applicable.

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(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 and Dividends Receivable

Interest and dividends are recorded at the amounts expected to be received as at the reporting date, which approximates fair value.

(vii) Interest Payable

Interest is accrued at the amount expected to be paid as at the reporting date, which approximates fair value.

(viii) Securities Sold Short

Securities sold short reflect PSP Investments' obligation to purchase securities pursuant to short selling transactions. In such transactions, PSP Investments sells securities it does not own with an obligation to purchase 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 within public markets and fixed income.

(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 at a 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 approximates fair value.

(x) Derivative-Related Receivables and Payables

The description and valuation of derivative-related receivables and payables are described in Note 3 (B).

(xi) Capital Market Debt Financing

PSP Investments' capital market debt program is described in Note 8. Short-term promissory notes are recorded at cost plus accrued interest, which approximates fair value. The fair value of PSP Investments' medium-term notes is based on prices that are obtained from third-party pricing sources. Such prices are determined using an interest rate curve with a spread consistent with PSP Investments' credit quality.

3. INVESTMENTS (continued)

(B) DERIVATIVE FINANCIAL INSTRUMENTS

Derivative financial instruments are financial contracts that are settled at a future date. The value of such instruments 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.

(ii) Futures

Futures are standardized contracts to take or make delivery of an asset (buy or sell) at a predefined price and predefined future date. 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 at a predefined date in the future. Forwards are used to adjust exposures to specified assets without directly purchasing or selling the underlying assets.

(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.

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:

	2012				2011			
		Fair Value				Fair Value		
($ millions)	Notional Value	Assets	Liabilities	Net	Notional Value	Assets	Liabilities	Net
Equity and commodity derivatives								
Futures	$ 195	$ –	$ –	$ –	$ 84	$ –	$ –	$ –
Total return swaps	1,574	25	(8)	17	1,079	37	–	37
Options:								
Listed-purchased	218	3	–	3	86	2	–	2
Listed-written	186	–	(2)	(2)	77	–	(4)	(4)
OTC-purchased	104	1	–	1	–	–	–	–
OTC-written	95	–	(2)	(2)	–	–	–	–
Currency derivatives								
Forwards	4,457	30	(36)	(6)	3,330	62	(24)	38
Futures	29	–	–	–	–	–	–	–
Swaps	182	1	(3)	(2)	326	4	(2)	2
Options:								
OTC-purchased	95	1	–	1	197	1	–	1
OTC-written	158	–	(1)	(1)	36	–	–	–
Interest rate derivatives								
Bond forwards	348	1	(1)	–	193	1	(1)	–
Futures	301	–	–	–	345	–	–	–
Interest rate swaps	1,463	5	(6)	(1)	3,416	3	(3)	–
Total return swaps	–	–	–	–	125	–	–	–
Swaptions	156	3	(1)	2	685	1	(1)	–
Options:								
Listed-purchased	1,593	1	–	1	1,041	1	–	1
Listed-written	1,608	–	(1)	(1)	1,463	–	(1)	(1)
OTC-purchased	154	3	–	3	–	–	–	–
OTC-written	744	–	(5)	(5)	–	–	–	–
Credit derivatives[1]:								
Purchased	233	5	(1)	4	81	1	(1)	–
Sold	113	–	(4)	(4)	80	1	(2)	(1)
Total	$ 14,006	$ 79	$ (71)	$ 8	$ 12,644	$ 114	$ (39)	$ 75

[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.

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, 2012:

($ millions)

Less than 3 months	$ 8,026
3 to 12 months	3,426
Over 1 year	2,554
Total	**$ 14,006**

(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 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.

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, 2012:

($ millions)	Level 1	Level 2	Level 3	No Level	Total Fair Value
Public markets					
Canadian equity	$ 1,764	$ –	$ –	$ –	$ 1,764
Foreign equity	2,942	157	33	–	3,132
Private markets					
Real estate	–	–	1,438	–	1,438
Private equity	–	–	1,193	–	1,193
Infrastructure	–	–	823	–	823
Renewable resources	–	–	72	–	72
Fixed income					
Cash and money market securities	148	314	–	–	462
Government and corporate bonds	–	2,461	–	–	2,461
Inflation-linked bonds	–	763	–	–	763
Other fixed income securities	–	460	770	–	1,230
Alternative investments	–	168	59	–	227
INVESTMENTS	$ 4,854	$ 4,323	$ 4,388	$ –	$ 13,565
Investment-related assets					
Amounts receivable from pending trades[1]	$ –	$ –	$ –	$ 121	$ 121
Interest receivable[1]	–	–	–	31	31
Dividends receivable[1]	–	–	–	12	12
Derivative-related receivables	4	75	–	–	79
	$ 4	$ 75	$ –	$ 164	$ 243
Investment-related liabilities					
Amounts payable from pending trades[1]	$ –	$ –	$ –	$ (191)	$ (191)
Interest payable[1]	–	–	–	(5)	(5)
Securities sold short	(83)	–	–	–	(83)
Securities sold under repurchase agreements	–	(246)	–	–	(246)
Derivative-related payables	(3)	(66)	(2)	–	(71)
Capital market debt financing:					
Short-term	–	(174)	–	–	(174)
Long-term	–	(583)	–	–	(583)
	$ (86)	$ (1,069)	$ (2)	$ (196)	$ (1,353)
NET INVESTMENTS	$ 4,772	$ 3,329	$ 4,386	$ (32)	$ 12,455

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

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:

($ millions)	Level 1	Level 2	Level 3	No Level	Total Fair Value
Public markets					
Canadian equity	$ 2,741	$ 11	$ –	$ –	$ 2,752
Foreign equity	2,122	405	–	–	2,527
Private markets					
Real estate	–	–	1,061	–	1,061
Private equity	–	–	1,010	–	1,010
Infrastructure	–	–	527	–	527
Fixed income					
Cash and money market securities	113	387	–	–	500
Government and corporate bonds	–	1,572	–	–	1,572
Inflation-linked bonds	–	580	–	–	580
Other fixed income securities	–	389	717	–	1,106
Alternative investments	–	217	–	–	217
INVESTMENTS	$ 4,976	$ 3,561	$ 3,315	$ –	$ 11,852
Investment-related assets					
Amounts receivable from pending trades[1]	$ –	$ –	$ –	$ 136	$ 136
Interest receivable[1]	–	–	–	27	27
Dividends receivable[1]	–	–	–	10	10
Derivative-related receivables	4	110	–	–	114
	$ 4	$ 110	$ –	$ 173	$ 287
Investment-related liabilities					
Amounts payable from pending trades[1]	$ –	$ –	$ –	$ (211)	$ (211)
Interest payable[1]	–	–	–	(4)	(4)
Securities sold short	(8)	–	–	–	(8)
Securities sold under repurchase agreements	–	(100)	–	–	(100)
Derivative-related payables	(6)	(31)	(2)	–	(39)
Capital market debt financing:					
Short-term	–	(137)	–	–	(137)
Long-term	–	(340)	–	–	(340)
	$ (14)	$ (608)	$ (2)	$ (215)	$ (839)
NET INVESTMENTS	$ 4,966	$ 3,063	$ 3,313	$ (42)	$ 11,300

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

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 year-end.

There were no significant transfers between Level 1 and Level 2 during the year ended March 31, 2012 (no significant transfers during the year ended March 31, 2011).

3. INVESTMENTS (continued)

(C) FAIR VALUE MEASUREMENT (continued)

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, 2012:

($ millions)	Opening Balance	Purchases	Sales	Settlements[1]	Realized Gains	Unrealized Gains	Transfer out of Level 3	Closing Balance
Public markets	$ –	$ 30	$ (3)	$ –	$ –	$ 6	$ –	$ 33
Private markets	2,598	1,208	(437)	–	40	121	(4)	3,526
Fixed income	717	204	(190)	(43)	8	74	–	770
Alternative investments	–	57	–	–	–	2	–	59
Derivative-related receivables/payables (net)	(2)	–	–	(1)	1	–	–	(2)
Total	$ 3,313	$ 1,499	$ (630)	$ (44)	$ 49	$ 203	$ (4)	$ 4,386

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:

($ millions)	Opening Balance	Purchases	Sales	Settlements[1]	Realized Losses	Unrealized Gains	Transfer out of Level 3	Closing Balance
Private markets	$ 2,401	$ 451	$ (422)	$ –	$ (14)	$ 185	$ (3)	$ 2,598
Fixed income	780	93	(152)	(37)	(15)	48	–	717
Derivative-related receivables/payables (net)	(64)	40	(1)	–	(48)	71	–	(2)
Total	$ 3,117	$ 584	$ (575)	$ (37)	$ (77)	$ 304	$ (3)	$ 3,313

[1] Includes Plan Account allocation adjustments.

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 (2011 - 2% increase/decrease) in the fair value of financial instruments categorized as Level 3. This excludes private debt portfolios in the real estate sector and certain fund investments, where a sensitivity analysis is not possible given the underlying assumptions used are not available to PSP Investments. In the case of 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 private debt portfolios in the real estate sector, the fair value is obtained from third-party appraisers as described in Note 3 (A).

(D) SECURITIES LENDING AND 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, 2012, PSP Investments, on behalf of the Plan Account, has re-invested $335 million of collateral held (2011 – $292 million).

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:

($ millions)	2012	2011
Securities lending		
Securities lent	**$ 1,350**	$ 1,124
Collateral contractually receivable[1]	**1,422**	1,176
Securities borrowing		
Securities borrowed	**83**	8
Collateral contractually payable[2]	**92**	9

[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.

(E) SECURITIES SOLD AND 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 relevant 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 relevant 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 $246 million at March 31, 2012 (2011 – $100 million).

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 Statement of Investment Policies, Standards and Procedures (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.

(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 funding risk. Funding risk is the risk that the assets under management will be insufficient to meet the relevant pension liabilities of the Plans, which may require the contributions to the Funds of the Plans to be increased. 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. For investments that are not actively traded, the calculation of VaR uses securities with similar risk attributes as proxy.

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.

	2012	2011
Policy Portfolio VaR	**21.7 %**	22.4 %
Active VaR	**2.6**	2.2
Total VaR (undiversified)	**24.3**	24.6
Diversification effect	**(1.6)**	(2.9)
Total VaR	**22.7 %**	21.7 %

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 terms to maturity of the investments with the most significant exposure to interest rate risk were as follows as at March 31, 2012:

($ millions)	Less than 1 Year	1 to 5 Years	5 to 10 Years	Over 10 Years	Other	Total
Government bonds	$ 260	$ 917	$ 330	$ 350	$ –	$ 1,857
Corporate bonds	120	257	168	59	–	604
Inflation-linked bonds	–	201	190	372	–	763
Asset-backed securities	–	347	6	1	–	354
Private debt portfolios:						
Directly held	10	78	1	–	–	89
Held through funds[1]	–	–	–	–	355	355
Total investments with significant exposure to interest rate risk	$ 390	$ 1,800	$ 695	$ 782	$ 355	$ 4,022
Other investments[2]	$ –	$ –	$ –	$ –	$ 894	$ 894
Total fixed income	$ 390	$ 1,800	$ 695	$ 782	$ 1,249	$ 4,916

[1] Due to their nature, information in connection with the terms to maturity of fund investments included in the private debt portfolios is not available.

[2] Consists of $462 million in cash and money market securities and $432 million in floating rate notes, which, due to their nature, are not significantly exposed to interest rate risk.

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

Alternative investments as well as derivative contracts described in Notes 3 (A) (iv) and (B), respectively, are also subject to interest rate risk exposures. These exposures are reflected in the VaR calculation described in Note 4 (A).

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 in non-emerging countries. 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:

(in millions of Canadian $)	2012		2011	
Currency	**Fair Value**	**% of Total**	Fair Value	% of Total
US Dollar	**$ 2,505**	**57.9 %**	$ 1,848	54.0 %
Euro	**514**	**11.9**	464	13.6
British Pound	**339**	**7.8**	259	7.6
Japanese Yen	**195**	**4.5**	138	4.0
Brazilian Real	**175**	**4.0**	172	5.0
Hong Kong Dollar	**130**	**3.0**	129	3.8
Korean Won	**95**	**2.2**	92	2.7
Australian Dollar	**78**	**1.8**	60	1.7
Norwegian Krone	**66**	**1.5**	20	0.6
Indian Rupee	**37**	**0.9**	27	0.8
Others	**195**	**4.5**	210	6.2
Total	**$ 4,329**	**100.0 %**	$ 3,419	100.0 %

PSP Investments and its subsidiaries also had commitments, denominated in foreign currencies of $1,249 million (US$1,094 million, €100 million, R23 million South African Rands and R36 million Brazilian Reals) for the Plan Account which were not included in the foreign currency exposure table.

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 relevant 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.

As at March 31, 2012, the Plan Account's maximum exposure to credit risk amounted to approximately $4 billion (2011 – approximately $3 billion). This amount excludes investments in distressed debt in the amount of approximately $0.3 billion as at March 31, 2012 (2011 – approximately $0.3 billion). The maximum exposure to credit risk also excludes collateralized debt obligations, collateral held as disclosed in Notes 3 (D), 3 (E) and 4 (B) and the impact of guarantees and indemnities disclosed in Note 10.

As at March 31, 2012, the Plan Account had a net notional exposure of $32 million (2011 – $51 million) to various tranches of collateralized debt obligations, of which approximately 61% (2011 – approximately 44%) of the underlying dollar exposure was rated "Investment grade", as well as funding facilities, as described in Note 10, to support potential margin calls on the ABTNs.

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 markets investments.

PSP Investments' concentration of credit risk by credit rating, excluding the items described above and any other credit enhancement, for the Plan Account was as follows as at March 31:

	2012	2011
Investment grade (AAA to BBB–)	**98.2 %**	97.9 %
Below investment grade (BB+ and below)	**0.7**	0.4
Not rated:		
Rated by a single credit rating agency	**0.1**	0.1
Not rated by credit rating agencies	**1.0**	1.6
Total	**100.0 %**	100.0 %

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 requires that counterparties provide adequate collateral and meet its credit rating requirements. PSP Investments frequently monitors the credit rating of its counterparties as determined by recognized credit rating agencies. With respect to derivative contracts, PSP Investments has the ability to terminate all trades with most counterparties whose credit rating is downgraded below its requirements.

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.

4. INVESTMENT RISK MANAGEMENT (continued)

(B) CREDIT RISK (continued)

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 pledged securities with a fair value of $1 million as collateral with respect to derivative contracts at March 31, 2012 (2011 – nil). Securities with a fair value of $20 million were received from counterparties as collateral at March 31, 2012 (2011 – $26 million). 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 (D) and 3 (E) 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.

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, 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, bonds and public equities are expected to be highly liquid as they will be invested in securities that are actively traded. Management utilizes 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 market 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 market debt program.

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

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 instruments, aggregated according to their maturities as at March 31, 2012:

($ millions)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Non-derivative-related financial liabilities [1]				
Amounts payable from pending trades	$ (191)	$ –	$ –	$ (191)
Interest payable	(4)	(1)	–	(5)
Securities sold short	(83)	–	–	(83)
Securities sold under repurchase agreements	(246)	–	–	(246)
Capital market debt financing	(161)	(13)	(583)	(757)
Accounts payable and other liabilities	(16)	–	(6)	(22)
Total	$ (701)	$ (14)	$ (589)	$ (1,304)

($ millions)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Derivative-related financial instruments				
Derivative-related receivables	$ 29	$ 33	$ 17	$ 79
Derivative-related payables [1]	(31)	(20)	(20)	(71)
Total	$ (2)	$ 13	$ (3)	$ 8

[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 $815 million for the year ended March 31, 2012 (2011 – $828 million) from the Fund.

6. INVESTMENT INCOME

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

($ millions)	2012	2011
Interest income	$ 128	$ 100
Dividend income	150	118
Other income	38	36
Dividend expense	(5)	(4)
Interest expense (Note 8)	(16)	(12)
Transaction costs	(12)	(11)
External investment management fees[1]	(7)	(8)
	276	219
Net realized gains[2]	197	355
Net unrealized (losses) gains	(110)	802
Investment income	**$ 363**	$ 1,376

[1] Consists of amounts incurred for investments in public markets that are paid directly by PSP Investments. This excludes investments fees related to certain pooled fund investments classified under alternative investments primarily related to performance, in the amount of $11 million for the year ended March 31, 2012 (2011 – $16 million). This also excludes management fees related to investments in private markets and other fixed income securities that are not paid directly by PSP Investments.

Such fees, which generally vary between 0.1% and 2.0% of the total invested and/or committed amount, totalled $23 million for the year ended March 31, 2012 (2011 – $27 million).

[2] Includes foreign currency losses of $8 million for the year ended March 31, 2012 (2011 – gains of $22 million).

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:

	2012	2011
Public Service Pension Plan Account	72.9 %	72.7 %
Canadian Forces Pension Plan Account	19.4	19.7
Royal Canadian Mounted Police Pension Plan Account	7.1	7.1
Reserve Force Pension Plan Account	0.6	0.5
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)	2012	2011
Salaries and benefits	$ 18,824	$ 13,810
Professional and consulting fees	2,106	1,588
Office supplies and equipment	2,930	2,479
Other operating expenses	1,252	963
Depreciation of fixed assets	1,801	1,938
Occupancy costs	1,077	946
Custodial fees	596	465
Remuneration earned by Directors	156	150
Travel and related expenses for Directors	54	37
Communication expenses	42	38
Total	**$ 28,838**	$ 22,414

8. CAPITAL MARKET DEBT FINANCING

PSP Investments' capital market debt 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 real estate, infrastructure and renewable resources. It is unconditionally and irrevocably guaranteed by PSP Investments in accordance with its corporate leverage policy.

The maximum amount authorized by the Board of Directors for the capital market debt program is 7.5% of the net investments plus all recourse debt outstanding of PSP Investments. Under this limit, the short-term promissory note component cannot exceed $3 billion.

The following outlines the terms as well as the fair value of the notes issued under the capital market debt program allocated to the Plan Account as at March 31:

	2012		2011
($ millions)	**Capital amounts to be paid at maturity**	**Fair Value**	Fair Value
Short-term promissory notes, bearing interest between 1% and 1.42% and maturing within 31 and 364 days of issuance (March 31, 2011 – 29 and 363 days)	**$ 174**	**$ 174**	$ 137
Medium-term notes Series 1, bearing interest of 4.57% per annum and maturing on December 9, 2013	**$ 193**	**$ 203**	$ 205
Medium-term notes Series 2, bearing interest of 2.94% per annum and maturing on December 3, 2015	**$ 135**	**$ 139**	$ 135
Medium-term notes Series 3, bearing variable interest of 3–month CDOR + 39 basis points and maturing on February 16, 2015	**$ 67**	**$ 68**	$ –
Medium-term notes Series 4, bearing interest of 2.26% per annum and maturing on February 16, 2017	**$ 174**	**$ 173**	$ –
Total	**$ 743**	**$ 757**	$ 477

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)	**2012**	2011
Short-term promissory notes	**$ 2,454**	$ 1,745
Medium-term notes	**13,483**	10,235
Total	**$ 15,937**	$ 11,980

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 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 market debt financing and Note 4 (C) provides information on PSP Investments' liquidity.

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

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.

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

PSP Capital Inc. provided funding facilities of a maximum amount of $969 million to support potential margin calls on the ABTNs, of which $190 million has been allocated to the Plan Account. As at March 31, 2012, the margin funding facilities have not been drawn upon since inception.

In certain investment transactions, PSP Investments provided guarantees or indemnifications to third parties, the most significant of which are as follows:

As at March 31, 2012, 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 $81 million (2011 – $81 million) plus interest and other related costs. The loan matures in March 2015.

As at March 31, 2012, 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 (2011 – $195 million), of which $38 million (2011 – $38 million) 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.

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, 2012:

($ millions)	
Real estate	$ 290
Private equity	788
Infrastructure	168
Other fixed income securities	112
Total	**$ 1,358**

ROYAL CANADIAN MOUNTED POLICE PENSION PLAN ACCOUNT

INDEPENDENT AUDITORS' REPORT

To the Minister of Public Safety

REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying financial statements of the Public Sector Pension Investment Board – Royal Canadian Mounted Police Pension Plan Account (the Royal Canadian Mounted Police Pension Plan Account), which comprise the balance sheet as at March 31, 2012, and the statement of net income from operations and comprehensive income and 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.

Auditor's 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 auditor's 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 auditor considers 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 Royal Canadian Mounted Police Pension Plan Account as at March 31, 2012, 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 Royal Canadian Mounted Police 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 the Public Sector Pension Investment Board and its wholly-owned subsidiaries.

Deloitte & Touche LLP[1]

[1] Chartered accountant auditor permit No. 18527

May 14, 2012
Montréal, Canada

Michael Ferguson, FCA
Auditor General of Canada

May 14, 2012
Ottawa, Canada

BALANCE SHEET

As at March 31

($ millions)	2012	2011
ASSETS		
Investments (Note 3 (A))	$ 4,968	$ 4,306
Investment-related assets (Note 3 (A))	89	105
Other assets	5	3
	$ 5,062	$ 4,414
LIABILITIES		
Investment-related liabilities (Note 3 (A))	$ 495	$ 305
Accounts payable and other liabilities	8	4
Due to the Public Service Pension Plan Account	3	3
	$ 506	$ 312
NET ASSETS	$ 4,556	$ 4,102
Accumulated net income from operations and comprehensive income	$ 1,181	$ 1,058
Accumulated fund transfers	3,375	3,044
NET ASSETS	$ 4,556	$ 4,102

Commitments (Note 11)

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

On behalf of the Board of Directors:

Cheryl Barker
Interim 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

($ millions)	2012	2011
INVESTMENT INCOME (Note 6)	**$ 133**	$ 498
OPERATING EXPENSES (Note 7)	**$ 10**	$ 8
NET INCOME FROM OPERATIONS AND COMPREHENSIVE INCOME	**$ 123**	$ 490

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

STATEMENT OF CHANGES IN NET ASSETS

For the years ended March 31

($ millions)	2012	2011
NET ASSETS, BEGINNING OF YEAR	**$ 4,102**	$ 3,271
Fund transfers (Note 5)	**331**	341
Net income from operations and comprehensive income	**123**	490
Increase in net assets for the year	**454**	831
NET ASSETS, END OF YEAR	**$ 4,556**	$ 4,102

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

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2012

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 Royal Canadian Mounted Police pension plan for service on or after April 1, 2000. 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 *Royal Canadian Mounted Police 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 *Royal Canadian Mounted Police Superannuation Act* and the Royal Canadian Mounted Police pension plan's ability to meet its financial obligations.

Pursuant to the *Royal Canadian Mounted Police Superannuation Act*, the Government of Canada, which administers the Fund, may call upon PSP Investments for amounts required for the purpose of paying benefits under the Plan in respect of service on or after April 1, 2000. Amounts remitted by PSP Investments for such purpose cannot exceed, at any time, the net assets of PSP Investments allocated to the Plan Account.

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 April 1, 2000. 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 at the date upon which PSP Investments becomes a party to the associated contractual provisions, and are carried at fair value. Purchases and sales are recorded as of the trade date. 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 year-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.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

VALUATION OF INVESTMENTS (continued)

Valuation techniques are generally applied to investments in real estate, private equity, infrastructure and renewable resources, over-the-counter (OTC) derivatives and certain fixed income securities. 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 the investments are described in Notes 3 (A) and (B).

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 directly attributable to the external management of assets on behalf of PSP Investments. Management fees incurred for investments in private markets and certain private debt portfolios are paid by the investment directly, through capital contributions by PSP Investments or offset against distributions received from the investment. Management fees are also incurred for certain public markets and alternative investments and 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), as well as private markets distributions from pooled funds, limited partnerships or from direct investments and co-investments. Co-investments are investments in private entities where the investment is made in conjunction with an external manager with whom PSP Investments already has committed and delegated funds.

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 year-end date. Any 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 paragraphs 149(1)*(d)* and 149(1)*(d.2)* of the *Income Tax Act* (Canada), respectively.

USE OF ESTIMATES

In preparing these financial statements, management makes certain estimates and assumptions which can affect the reported values of assets and liabilities. This is principally reflected in the valuation of private markets investments, certain fixed income securities, related income and expenses as well as note disclosures. Although estimates and assumptions reflect management's best judgment, actual results may differ from these estimates.

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 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, 2014. This deferral delays PSP Investments' transition to IFRS until the March 31, 2015 annual consolidated financial statements.

The AcSB's decision was in response to an announcement by the International Accounting Standards Board (IASB) in 2010, regarding an Exposure Draft (ED) being developed. The IASB proposed to define an investment entity and exempt it from consolidation by requiring it to measure all controlled investments at fair value, with changes recognized in profit or loss. The ED, *Investment Entities*, was published in August 2011 and is expected to be finalized in the second half of 2012. PSP Investments will complete the assessment of the impact of its transition to IFRS once the ED is finalized and a standard is issued.

The AcSB also announced in 2011 that it will evaluate whether entities like PSP Investments, which are separate from a pension plan and without a pension obligation, and whose sole purpose is to hold and invest assets received from one or more pension plans, would qualify as investment entities under the IASB's ED. Based on the result of this evaluation, the AcSB will then decide whether these entities would need to be included within the scope of Section 4600, "Pension Plans", where investments are accounted for at fair value.

3. INVESTMENTS

(A) INVESTMENT PORTFOLIO

The investment portfolio is organized according to the nature and common characteristics associated with the investments held. The following table presents the investment portfolio as at March 31:

	2012		2011	
($ millions)	Fair Value	Cost	Fair Value	Cost
Public markets				
Canadian equity	$ 646	$ 620	$ 1,001	$ 815
Foreign equity	1,147	1,058	919	837
Private markets				
Real estate	527	456	386	353
Private equity	437	375	367	321
Infrastructure	302	316	191	207
Renewable resources	27	27	–	–
Fixed income				
Cash and money market securities	169	169	181	181
Government and corporate bonds	901	884	571	576
Inflation-linked bonds	279	256	211	217
Other fixed income securities	450	406	401	387
Alternative investments	83	65	78	64
INVESTMENTS	$ 4,968	$ 4,632	$ 4,306	$ 3,958
Investment-related assets				
Amounts receivable from pending trades	$ 44	$ 44	$ 49	$ 49
Interest receivable	11	11	10	10
Dividends receivable	4	4	4	4
Derivative-related receivables	30	6	42	2
	$ 89	$ 65	$ 105	$ 65
Investment-related liabilities				
Amounts payable from pending trades	$ (70)	$ (70)	$ (77)	$ (77)
Interest payable	(1)	(1)	(1)	(1)
Securities sold short	(30)	(29)	(4)	(3)
Securities sold under repurchase agreements	(90)	(90)	(36)	(36)
Derivative-related payables	(26)	(6)	(14)	(2)
Capital market debt financing:				
Short-term	(64)	(64)	(49)	(49)
Long-term	(214)	(209)	(124)	(121)
	$ (495)	$ (469)	$ (305)	$ (289)
NET INVESTMENTS	$ 4,562	$ 4,228	$ 4,106	$ 3,734

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(i) Public Markets

Public markets consist of Canadian and foreign investments in the following securities: common shares, American depository receipts, global depository receipts, participation notes, preferred shares, income trust units, exchange traded funds units, pooled funds units, 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 using unit values obtained from each of the funds' administrators, which are derived from the fair value of the underlying investments in each pooled fund. Where necessary, the impact of restrictions on the sale or redemption of such investments is taken into consideration in determining fair value.

(ii) Private Markets

Private markets consist of investments in real estate, private equity, infrastructure and renewable resources.

Real estate investments are comprised of direct equity positions in various private entities, properties, as well as fund investments in the real estate sector. Real estate investments focus on properties, partnerships and companies operating in the office, retail, industrial, hospitality and residential sectors, as well as private funds invested in real estate assets. Real estate investments are accounted for net of all third-party financings. As at March 31, 2012, the total amount of third-party financing included as part of real estate contracted by direct investments controlled by PSP Investments for the Plan Account was $188 million (2011 – $150 million).

Private equity investments are comprised of direct equity positions and co-investments in private entities as well as fund investments with similar objectives.

Infrastructure investments are comprised of direct equity positions and co-investments in various private entities and fund investments. Infrastructure investments focus on entities engaged in the management, ownership or operation of assets in energy, transportation and other regulated businesses. Infrastructure investments are accounted for net of all third-party financings. As at March 31, 2012, the total amount of third-party financing included as part of infrastructure contracted by direct investments controlled by PSP Investments for the Plan Account was $20 million (2011 – $4 million).

Renewable resources investments are comprised of properties involving the production and harvesting of replenishable resources. As at March 31, 2012, renewable resources included one investment in timberlands.

Valuation Techniques

The fair value of private markets 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 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 discount rates, capitalization rates, projected cash flows and/or net operating income, which are not fully supported by prices from market observable transactions.

For direct investments in private equity, direct investments and co-investments in infrastructure and in renewable resources, 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.

In the case of private equity, real estate and 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.

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(iii) Fixed Income

Fixed income consists of cash and money market securities, government and corporate bonds, inflation-linked bonds and other fixed income securities.

Cash and money market securities include instruments having a maximum term to maturity of one year, such as treasury bills, certificates of deposit and bankers' acceptances.

Government and corporate bonds include Canadian and foreign, federal, provincial, territorial and municipal bonds. Inflation-linked bonds are fixed income securities that earn inflation adjusted returns.

Other fixed income securities consist of asset-backed securities, floating rate notes as well as private debt portfolios.

Asset-backed securities consist mainly of asset-backed term notes (ABTNs) and mortgage-backed securities. 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. Potential margin calls on the ABTNs are supported by funding facilities, as described in Note 10.

Private debt portfolios consist mainly of investments in the real estate sector in the form of third-party loans such as junior and senior debts, construction loans, bridge loans, income-participating loans, as well as other structured finance products. They also include real estate debt funds where significant portions of the value are attributed to the underlying real estate assets.

Private debt portfolios also include debt securities of private companies or other entities such as venture capital organizations, held mainly through private funds. Such debt securities take the form of senior debt, mezzanine and distressed debt.

Valuation Techniques

Cash and money market securities include short-term instruments that are recorded at cost plus accrued interest, which approximates fair value.

Fair values of government and corporate bonds, inflation-linked bonds, floating rate notes and mortgage-backed securities are based on prices obtained from third-party pricing sources. Such prices 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 whereby management relies on the valuation work performed by a recognized third-party expert. Management ensures that the valuation conducted by such expert uses acceptable industry methods. Financial information used in the valuation of ABTNs includes interest rates, credit spreads and the underlying investments' terms to maturity. In addition to the values determined by the expert, management integrated certain assumptions in the fair value of ABTNs that are not fully supported by market observable data, such as liquidity estimates and the impact of the funding facilities described in Note 10.

The fair value of private debt portfolios in the real estate sector 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.

The fair value of fund investments included as part of private debt portfolios is determined based on the audited fair values reported by the fund's general partner using acceptable industry valuation methods.

(iv) Alternative Investments

Alternative investments consist mainly of units of funds that hold a mix of equity, fixed income and derivative instruments as well as hedge funds.

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, as applicable.

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(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 and Dividends Receivable

Interest and dividends are recorded at the amounts expected to be received as at the reporting date, which approximates fair value.

(vii) Interest Payable

Interest is accrued at the amount expected to be paid as at the reporting date, which approximates fair value.

(viii) Securities Sold Short

Securities sold short reflect PSP Investments' obligation to purchase securities pursuant to short selling transactions. In such transactions, PSP Investments sells securities it does not own with an obligation to purchase 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 within public markets and fixed income.

(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 at a 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 approximates fair value.

(x) Derivative-Related Receivables and Payables

The description and valuation of derivative-related receivables and payables are described in Note 3 (B).

(xi) Capital Market Debt Financing

PSP Investments' capital market debt program is described in Note 8. Short-term promissory notes are recorded at cost plus accrued interest, which approximates fair value. The fair value of PSP Investments' medium-term notes is based on prices that are obtained from third-party pricing sources. Such prices are determined using an interest rate curve with a spread consistent with PSP Investments' credit quality.

3. INVESTMENTS (continued)

(B) DERIVATIVE FINANCIAL INSTRUMENTS

Derivative financial instruments are financial contracts that are settled at a future date. The value of such instruments 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.

(ii) Futures

Futures are standardized contracts to take or make delivery of an asset (buy or sell) at a predefined price and predefined future date. 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 at a predefined date in the future. Forwards are used to adjust exposures to specified assets without directly purchasing or selling the underlying assets.

(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.

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:

	2012				2011			
		Fair Value				Fair Value		
($ millions)	Notional Value	Assets	Liabilities	Net	Notional Value	Assets	Liabilities	Net
Equity and commodity derivatives								
Futures	$ 72	$ –	$ –	$ –	$ 30	$ –	$ –	$ –
Total return swaps	577	10	(3)	7	392	14	–	14
Options:								
Listed-purchased	80	1	–	1	32	1	–	1
Listed-written	68	–	(1)	(1)	28	–	(1)	(1)
OTC-purchased	38	1	–	1	–	–	–	–
OTC-written	35	–	(1)	(1)	–	–	–	–
Currency derivatives								
Forwards	1,632	11	(13)	(2)	1,210	22	(8)	14
Futures	11	–	–	–	–	–	–	–
Swaps	67	–	(2)	(2)	119	2	(1)	1
Options:								
OTC-purchased	35	–	–	–	71	1	–	1
OTC-written	58	–	–	–	13	–	–	–
Interest rate derivatives								
Bond forwards	127	–	–	–	70	–	–	–
Futures	111	–	–	–	125	–	–	–
Interest rate swaps	536	3	(2)	1	1,241	1	(2)	(1)
Total return swaps	–	–	–	–	46	–	–	–
Swaptions	57	1	–	1	249	–	–	–
Options:								
Listed-purchased	584	–	–	–	378	1	–	1
Listed-written	589	–	–	–	531	–	(1)	(1)
OTC-purchased	56	1	–	1	–	–	–	–
OTC-written	272	–	(2)	(2)	–	–	–	–
Credit derivatives[1]:								
Purchased	85	2	(1)	1	30	–	–	–
Sold	41	–	(1)	(1)	29	–	(1)	(1)
Total	$ 5,131	$ 30	$ (26)	$ 4	$ 4,594	$ 42	$ (14)	$ 28

[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.

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, 2012:

($ millions)

Less than 3 months	$ 2,940
3 to 12 months	1,255
Over 1 year	936
Total	**$ 5,131**

(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 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.

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, 2012:

($ millions)	Level 1	Level 2	Level 3	No Level	Total Fair Value
Public markets					
Canadian equity	$ 646	$ –	$ –	$ –	$ 646
Foreign equity	1,078	57	12	–	1,147
Private markets					
Real estate	–	–	527	–	527
Private equity	–	–	437	–	437
Infrastructure	–	–	302	–	302
Renewable resources	–	–	27	–	27
Fixed income					
Cash and money market securities	54	115	–	–	169
Government and corporate bonds	–	901	–	–	901
Inflation-linked bonds	–	279	–	–	279
Other fixed income securities	–	168	282	–	450
Alternative investments	–	62	21	–	83
INVESTMENTS	$ 1,778	$ 1,582	$ 1,608	$ –	$ 4,968
Investment-related assets					
Amounts receivable from pending trades[1]	$ –	$ –	$ –	$ 44	$ 44
Interest receivable[1]	–	–	–	11	11
Dividends receivable[1]	–	–	–	4	4
Derivative-related receivables	1	29	–	–	30
	$ 1	$ 29	$ –	$ 59	$ 89
Investment-related liabilities					
Amounts payable from pending trades[1]	$ –	$ –	$ –	$ (70)	$ (70)
Interest payable[1]	–	–	–	(1)	(1)
Securities sold short	(30)	–	–	–	(30)
Securities sold under repurchase agreements	–	(90)	–	–	(90)
Derivative-related payables	(1)	(24)	(1)	–	(26)
Capital market debt financing:					
Short-term	–	(64)	–	–	(64)
Long-term	–	(214)	–	–	(214)
	$ (31)	$ (392)	$ (1)	$ (71)	$ (495)
NET INVESTMENTS	$ 1,748	$ 1,219	$ 1,607	$ (12)	$ 4,562

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

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:

($ millions)	Level 1	Level 2	Level 3	No Level	Total Fair Value
Public markets					
Canadian equity	$ 997	$ 4	$ –	$ –	$ 1,001
Foreign equity	771	148	–	–	919
Private markets					
Real estate	–	–	386	–	386
Private equity	–	–	367	–	367
Infrastructure	–	–	191	–	191
Fixed income					
Cash and money market securities	41	140	–	–	181
Government and corporate bonds	–	571	–	–	571
Inflation-linked bonds	–	211	–	–	211
Other fixed income securities	–	141	260	–	401
Alternative investments	–	78	–	–	78
INVESTMENTS	$ 1,809	$ 1,293	$ 1,204	$ –	$ 4,306
Investment-related assets					
Amounts receivable from pending trades[1]	$ –	$ –	$ –	$ 49	$ 49
Interest receivable[1]	–	–	–	10	10
Dividends receivable[1]	–	–	–	4	4
Derivative-related receivables	1	41	–	–	42
	$ 1	$ 41	$ –	$ 63	$ 105
Investment-related liabilities					
Amounts payable from pending trades[1]	$ –	$ –	$ –	$ (77)	$ (77)
Interest payable[1]	–	–	–	(1)	(1)
Securities sold short	(4)	–	–	–	(4)
Securities sold under repurchase agreements	–	(36)	–	–	(36)
Derivative-related payables	(1)	(12)	(1)	–	(14)
Capital market debt financing:					
Short-term	–	(49)	–	–	(49)
Long-term	–	(124)	–	–	(124)
	$ (5)	$ (221)	$ (1)	$ (78)	$ (305)
NET INVESTMENTS	$ 1,805	$ 1,113	$ 1,203	$ (15)	$ 4,106

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

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 year-end.

There were no significant transfers between Level 1 and Level 2 during the year ended March 31, 2012 (no significant transfers during the year ended March 31, 2011).

3. INVESTMENTS (continued)

(C) FAIR VALUE MEASUREMENT (continued)

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, 2012:

($ millions)	Opening Balance	Purchases	Sales	Settlements[1]	Realized Gains	Unrealized Gains	Transfer out of Level 3	Closing Balance
Public markets	$ –	$ 11	$ (1)	$ –	$ –	$ 2	$ –	$ 12
Private markets	944	440	(159)	–	14	55	(1)	1,293
Fixed income	260	74	(69)	(16)	4	29	–	282
Alternative investments	–	21	–	–	–	–	–	21
Derivative-related receivables/payables (net)	(1)	–	–	–	–	–	–	(1)
Total	**$ 1,203**	**$ 546**	**$ (229)**	**$ (16)**	**$ 18**	**$ 86**	**$ (1)**	**$ 1,607**

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:

($ millions)	Opening Balance	Purchases	Sales	Settlements[1]	Realized Losses	Unrealized Gains	Transfer out of Level 3	Closing Balance
Private markets	$ 863	$ 179	$ (170)	$ –	$ (5)	$ 78	$ (1)	$ 944
Fixed income	280	34	(69)	(15)	(5)	35	–	260
Derivative-related receivables/payables (net)	(23)	16	–	–	(18)	24	–	(1)
Total	$ 1,120	$ 229	$ (239)	$ (15)	$ (28)	$ 137	$ (1)	$ 1,203

[1] Includes Plan Account allocation adjustments.

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 (2011 - 2% increase/decrease) in the fair value of financial instruments categorized as Level 3. This excludes private debt portfolios in the real estate sector and certain fund investments, where a sensitivity analysis is not possible given the underlying assumptions used are not available to PSP Investments. In the case of 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 private debt portfolios in the real estate sector, the fair value is obtained from third-party appraisers as described in Note 3 (A).

(D) SECURITIES LENDING AND 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, 2012, PSP Investments, on behalf of the Plan Account, has re-invested $122 million of collateral held (2011 – $106 million).

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:

($ millions)	2012	2011
Securities lending		
Securities lent	$ 494	$ 409
Collateral contractually receivable[1]	521	427
Securities borrowing		
Securities borrowed	30	4
Collateral contractually payable[2]	34	3

[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.

(E) SECURITIES SOLD AND 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 relevant 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 relevant 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 $90 million at March 31, 2012 (2011 – $36 million).

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 Statement of Investment Policies, Standards and Procedures (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.

(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 funding risk. Funding risk is the risk that the assets under management will be insufficient to meet the relevant pension liabilities of the Plans, which may require the contributions to the Funds of the Plans to be increased. 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. For investments that are not actively traded, the calculation of VaR uses securities with similar risk attributes as proxy.

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.

	2012	2011
Policy Portfolio VaR	**21.7 %**	22.4 %
Active VaR	**2.6**	2.2
Total VaR (undiversified)	**24.3**	24.6
Diversification effect	**(1.6)**	(2.9)
Total VaR	**22.7 %**	21.7 %

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 terms to maturity of the investments with the most significant exposure to interest rate risk were as follows as at March 31, 2012:

($ millions)	Less than 1 Year	1 to 5 Years	5 to 10 Years	Over 10 Years	Other	Total
Government bonds	$ 95	$ 336	$ 121	$ 128	$ –	$ 680
Corporate bonds	44	93	62	22	–	221
Inflation-linked bonds	–	74	69	136	–	279
Asset-backed securities	–	127	2	–	–	129
Private debt portfolios:						
Directly held	4	29	–	–	–	33
Held through funds [1]	–	–	–	–	130	130
Total investments with significant exposure to interest rate risk	$ 143	$ 659	$ 254	$ 286	$ 130	$ 1,472
Other investments [2]	$ –	$ –	$ –	$ –	$ 327	$ 327
Total fixed income	$ 143	$ 659	$ 254	$ 286	$ 457	$ 1,799

[1] Due to their nature, information in connection with the terms to maturity of fund investments included in the private debt portfolios is not available.

[2] Consists of $169 million in cash and money market securities and $158 million in floating rate notes, which, due to their nature, are not significantly exposed to interest rate risk.

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

Alternative investments as well as derivative contracts described in Notes 3 (A) (iv) and (B), respectively, are also subject to interest rate risk exposures. These exposures are reflected in the VaR calculation described in Note 4 (A).

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 in non-emerging countries. 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:

(in millions of Canadian $)	2012		2011	
Currency	**Fair Value**	**% of Total**	Fair Value	% of Total
US Dollar	**$ 918**	**57.9 %**	$ 672	54.0 %
Euro	**188**	**11.9**	169	13.6
British Pound	**124**	**7.8**	94	7.6
Japanese Yen	**71**	**4.5**	50	4.0
Brazilian Real	**64**	**4.0**	62	5.0
Hong Kong Dollar	**48**	**3.0**	47	3.8
Korean Won	**34**	**2.2**	33	2.7
Australian Dollar	**29**	**1.8**	21	1.7
Norwegian Krone	**24**	**1.5**	7	0.6
Indian Rupee	**14**	**0.9**	10	0.8
Others	**72**	**4.5**	77	6.2
Total	**$ 1,586**	**100.0 %**	$ 1,242	100.0 %

PSP Investments and its subsidiaries also had commitments, denominated in foreign currencies of $457 million (US$401 million, €37 million, R9 million South African Rands and R13 million Brazilian Reals) for the Plan Account which were not included in the foreign currency exposure table.

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 relevant 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.

As at March 31, 2012, the Plan Account's maximum exposure to credit risk amounted to approximately $2 billion (2011 – approximately $1 billion). This amount excludes investments in distressed debt in the amount of approximately $0.1 billion as at March 31, 2012 (2011 – approximately $0.1 billion). The maximum exposure to credit risk also excludes collateralized debt obligations, collateral held as disclosed in Notes 3 (D), 3 (E) and 4 (B) and the impact of guarantees and indemnities disclosed in Note 10.

As at March 31, 2012, the Plan Account had a net notional exposure of $12 million (2011 – $19 million) to various tranches of collateralized debt obligations, of which approximately 61% (2011 – approximately 44%) of the underlying dollar exposure was rated "Investment grade", as well as funding facilities, as described in Note 10, to support potential margin calls on the ABTNs.

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 markets investments.

PSP Investments' concentration of credit risk by credit rating, excluding the items described above and any other credit enhancement, for the Plan Account was as follows as at March 31:

	2012	2011
Investment grade (AAA to BBB–)	**98.2 %**	97.9 %
Below investment grade (BB+ and below)	**0.7**	0.4
Not rated:		
Rated by a single credit rating agency	**0.1**	0.1
Not rated by credit rating agencies	**1.0**	1.6
Total	**100.0 %**	100.0 %

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 requires that counterparties provide adequate collateral and meet its credit rating requirements. PSP Investments frequently monitors the credit rating of its counterparties as determined by recognized credit rating agencies. With respect to derivative contracts, PSP Investments has the ability to terminate all trades with most counterparties whose credit rating is downgraded below its requirements.

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.

4. INVESTMENT RISK MANAGEMENT (continued)

(B) CREDIT RISK (continued)

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 pledged securities with a fair value of $193 thousand as collateral with respect to derivative contracts at March 31, 2012 (2011 – nil). Securities with a fair value of $7 million were received from counterparties as collateral at March 31, 2012 (2011 – $10 million). 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 (D) and 3 (E) 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.

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, 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, bonds and public equities are expected to be highly liquid as they will be invested in securities that are actively traded. Management utilizes 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 market 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 market debt program.

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

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 instruments, aggregated according to their maturities as at March 31, 2012:

($ millions)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Non-derivative-related financial liabilities[1]				
Amounts payable from pending trades	$ (70)	$ –	$ –	$ (70)
Interest payable	(1)	–	–	(1)
Securities sold short	(30)	–	–	(30)
Securities sold under repurchase agreements	(90)	–	–	(90)
Capital market debt financing	(59)	(5)	(214)	(278)
Accounts payable and other liabilities	(6)	–	(2)	(8)
Total	$ (256)	$ (5)	$ (216)	$ (477)

($ millions)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Derivative-related financial instruments				
Derivative-related receivables	$ 11	$ 12	$ 7	$ 30
Derivative-related payables[1]	(11)	(7)	(8)	(26)
Total	$ –	$ 5	$ (1)	$ 4

[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 $331 million for the year ended March 31, 2012 (2011 – $341 million) from the Fund.

6. INVESTMENT INCOME

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

($ millions)	2012	2011
Interest income	$ 47	$ 36
Dividend income	54	42
Other income	14	13
Dividend expense	(1)	(1)
Interest expense (Note 8)	(6)	(4)
Transaction costs	(5)	(4)
External investment management fees[1]	(2)	(3)
	101	79
Net realized gains[2]	71	129
Net unrealized (losses) gains	(39)	290
Investment income	**$ 133**	$ 498

[1] Consists of amounts incurred for investments in public markets that are paid directly by PSP Investments. This excludes investments fees related to certain pooled fund investments classified under alternative investments primarily related to performance, in the amount of $4 million for the year ended March 31, 2012 (2011 – $6 million). This also excludes management fees related to investments in private markets and other fixed income securities that are not paid directly by PSP Investments.

Such fees, which generally vary between 0.1% and 2.0% of the total invested and/or committed amount, totalled $8 million for the year ended March 31, 2012 (2011 – $10 million).

[2] Includes foreign currency losses of $3 million for the year ended March 31, 2012 (2011 – gains of $8 million).

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:

	2012	2011
Public Service Pension Plan Account	72.9 %	72.7 %
Canadian Forces Pension Plan Account	19.4	19.7
Royal Canadian Mounted Police Pension Plan Account	7.1	7.1
Reserve Force Pension Plan Account	0.6	0.5
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)	2012	2011
Salaries and benefits	$ 6,836	$ 4,958
Professional and consulting fees	764	571
Office supplies and equipment	1,064	891
Other operating expenses	455	346
Depreciation of fixed assets	655	695
Occupancy costs	391	339
Custodial fees	216	168
Remuneration earned by Directors	57	54
Travel and related expenses for Directors	19	13
Communication expenses	15	14
Total	**$ 10,472**	$ 8,049

8. CAPITAL MARKET DEBT FINANCING

PSP Investments' capital market debt 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 real estate, infrastructure and renewable resources. It is unconditionally and irrevocably guaranteed by PSP Investments in accordance with its corporate leverage policy.

The maximum amount authorized by the Board of Directors for the capital market debt program is 7.5% of the net investments plus all recourse debt outstanding of PSP Investments. Under this limit, the short-term promissory note component cannot exceed $3 billion.

The following outlines the terms as well as the fair value of the notes issued under the capital market debt program allocated to the Plan Account as at March 31:

	2012		2011
($ millions)	**Capital amounts to be paid at maturity**	**Fair Value**	Fair Value
Short-term promissory notes, bearing interest between 1% and 1.42% and maturing within 31 and 364 days of issuance (March 31, 2011 – 29 and 363 days)	**$ 64**	**$ 64**	$ 49
Medium-term notes Series 1, bearing interest of 4.57% per annum and maturing on December 9, 2013	**$ 71**	**$ 74**	$ 75
Medium-term notes Series 2, bearing interest of 2.94% per annum and maturing on December 3, 2015	**$ 49**	**$ 51**	$ 49
Medium-term notes Series 3, bearing variable interest of 3–month CDOR + 39 basis points and maturing on February 16, 2015	**$ 25**	**$ 25**	$ –
Medium-term notes Series 4, bearing interest of 2.26% per annum and maturing on February 16, 2017	**$ 63**	**$ 64**	$ –
Total	**$ 272**	**$ 278**	$ 173

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)	**2012**	2011
Short-term promissory notes	**$ 896**	$ 631
Medium-term notes	**4,920**	3,699
Total	**$ 5,816**	$ 4,330

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 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 market debt financing and Note 4 (C) provides information on PSP Investments' liquidity.

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

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.

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

PSP Capital Inc. provided funding facilities of a maximum amount of $969 million to support potential margin calls on the ABTNs, of which $69 million has been allocated to the Plan Account. As at March 31, 2012, the margin funding facilities have not been drawn upon since inception.

In certain investment transactions, PSP Investments provided guarantees or indemnifications to third parties, the most significant of which are as follows:

As at March 31, 2012, 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 $29 million (2011 – $29 million) plus interest and other related costs. The loan matures in March 2015.

As at March 31, 2012, 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 (2011 – $195 million), of which $14 million (2011 – $14 million) 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.

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, 2012:

($ millions)

Real estate	$ 107
Private equity	288
Infrastructure	61
Other fixed income securities	41
Total	**$ 497**

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, 2012, and the statement of net income from operations and comprehensive income and 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.

Auditor's 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 auditor's 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 auditor considers 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, 2012, 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 the Public Sector Pension Investment Board and its wholly-owned subsidiaries.

Deloitte & Touche LLP[1]

[1] Chartered accountant auditor permit No. 18527

May 14, 2012
Montréal, Canada

Michael Ferguson, FCA
Auditor General of Canada

May 14, 2012
Ottawa, Canada

BALANCE SHEET

As at March 31

($ thousands)	**2012**	2011
ASSETS		
Investments (Note 3 (A))	**$397,229**	$339,327
Investment-related assets (Note 3 (A))	**7,107**	8,223
Other assets	**180**	85
	$404,516	$347,635
LIABILITIES		
Investment-related liabilities (Note 3 (A))	**$ 39,585**	$ 24,008
Accounts payable and other liabilities	**437**	139
Due to the Public Service Pension Plan Account	**221**	241
	$ 40,243	$ 24,388
NET ASSETS	**$364,273**	$323,247
Accumulated net income from operations and comprehensive income	**$ 53,701**	$ 43,730
Accumulated fund transfers	**310,572**	279,517
NET ASSETS	**$364,273**	$323,247

Commitments (Note 11)

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

On behalf of the Board of Directors:

Cheryl Barker
Interim 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)	2012	2011
INVESTMENT INCOME (Note 6)	$ 10,801	$ 38,759
OPERATING EXPENSES (Note 7)	$ 830	$ 570
NET INCOME FROM OPERATIONS AND COMPREHENSIVE INCOME	$ 9,971	$ 38,189

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

STATEMENT OF CHANGES IN NET ASSETS

For the years ended March 31

($ thousands)	2012	2011
NET ASSETS, BEGINNING OF YEAR	$323,247	$231,013
Fund transfers (Note 5)	31,055	54,045
Net income from operations and comprehensive income	9,971	38,189
Increase in net assets for the year	41,026	92,234
NET ASSETS, END OF YEAR	$364,273	$323,247

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

NOTES TO THE FINANCIAL STATEMENTS

For the year ended March 31, 2012

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.

Pursuant to the CFSA and the CFSA Regulations, the Government of Canada, which administers the Fund, may call upon PSP Investments for amounts required for the purpose of paying benefits under the Plan in respect of service on or after March 1, 2007. Amounts remitted by PSP Investments for such purpose cannot exceed, at any time, the net assets of PSP Investments allocated to the Plan Account.

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 at the date upon which PSP Investments becomes a party to the associated contractual provisions, and are carried at fair value. Purchases and sales are recorded as of the trade date. 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 year-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.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

VALUATION OF INVESTMENTS (continued)

Valuation techniques are generally applied to investments in real estate, private equity, infrastructure and renewable resources, over-the-counter (OTC) derivatives and certain fixed income securities. 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 the investments are described in Notes 3 (A) and (B).

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 directly attributable to the external management of assets on behalf of PSP Investments. Management fees incurred for investments in private markets and certain private debt portfolios are paid by the investment directly, through capital contributions by PSP Investments or offset against distributions received from the investment. Management fees are also incurred for certain public markets and alternative investments and 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), as well as private markets distributions from pooled funds, limited partnerships or from direct investments and co-investments. Co-investments are investments in private entities where the investment is made in conjunction with an external manager with whom PSP Investments already has committed and delegated funds.

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 year-end date. Any 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 paragraphs 149(1)*(d)* and 149(1)*(d.2)* of the *Income Tax Act* (Canada), respectively.

USE OF ESTIMATES

In preparing these financial statements, management makes certain estimates and assumptions which can affect the reported values of assets and liabilities. This is principally reflected in the valuation of private markets investments, certain fixed income securities, related income and expenses as well as note disclosures. Although estimates and assumptions reflect management's best judgment, actual results may differ from these estimates.

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 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, 2014. This deferral delays PSP Investments' transition to IFRS until the March 31, 2015 annual consolidated financial statements.

The AcSB's decision was in response to an announcement by the International Accounting Standards Board (IASB) in 2010, regarding an Exposure Draft (ED) being developed. The IASB proposed to define an investment entity and exempt it from consolidation by requiring it to measure all controlled investments at fair value, with changes recognized in profit or loss. The ED, *Investment Entities*, was published in August 2011 and is expected to be finalized in the second half of 2012. PSP Investments will complete the assessment of the impact of its transition to IFRS once the ED is finalized and a standard is issued.

The AcSB also announced in 2011 that it will evaluate whether entities like PSP Investments, which are separate from a pension plan and without a pension obligation, and whose sole purpose is to hold and invest assets received from one or more pension plans, would qualify as investment entities under the IASB's ED. Based on the result of this evaluation, the AcSB will then decide whether these entities would need to be included within the scope of Section 4600, "Pension Plans", where investments are accounted for at fair value.

3. INVESTMENTS

(A) INVESTMENT PORTFOLIO

The investment portfolio is organized according to the nature and common characteristics associated with the investments held. The following table presents the investment portfolio as at March 31:

	2012		2011	
($ thousands)	**Fair Value**	**Cost**	Fair Value	Cost
Public markets				
Canadian equity	**$ 51,632**	**$ 52,862**	$ 78,794	$ 67,062
Foreign equity	**91,648**	**82,727**	72,337	63,941
Private markets				
Real estate	**42,091**	**40,083**	30,390	31,511
Private equity	**34,909**	**28,534**	28,925	23,779
Infrastructure	**24,109**	**25,436**	15,086	16,513
Renewable resources	**2,122**	**2,122**	–	–
Fixed income				
Cash and money market securities	**13,787**	**13,787**	14,287	14,287
Government and corporate bonds	**72,005**	**70,080**	45,013	44,994
Inflation-linked bonds	**22,309**	**20,094**	16,616	16,881
Other fixed income securities	**35,982**	**32,419**	31,669	30,474
Alternative investments	**6,635**	**759**	6,210	478
INVESTMENTS	**$397,229**	**$368,903**	$339,327	$309,920
Investment-related assets				
Amounts receivable from pending trades	**$ 3,554**	**$ 3,554**	$ 3,886	$ 3,886
Interest receivable	**902**	**902**	780	780
Dividends receivable	**336**	**336**	279	279
Derivative-related receivables	**2,315**	**458**	3,278	156
	$ 7,107	**$ 5,250**	$ 8,223	$ 5,101
Investment-related liabilities				
Amounts payable from pending trades	**$ (5,584)**	**$ (5,584)**	$ (6,043)	$ (6,043)
Interest payable	**(137)**	**(137)**	(117)	(117)
Securities sold short	**(2,425)**	**(2,345)**	(240)	(207)
Securities sold under repurchase agreements	**(7,186)**	**(7,160)**	(2,847)	(2,847)
Derivative-related payables	**(2,090)**	**(464)**	(1,101)	(133)
Capital market debt financing:				
Short-term	**(5,088)**	**(5,088)**	(3,916)	(3,916)
Long-term	**(17,075)**	**(16,728)**	(9,744)	(9,542)
	$ (39,585)	**$ (37,506)**	$ (24,008)	$ (22,805)
NET INVESTMENTS	**$364,751**	**$336,647**	$323,542	$292,216

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(i) Public Markets

Public markets consist of Canadian and foreign investments in the following securities: common shares, American depository receipts, global depository receipts, participation notes, preferred shares, income trust units, exchange traded funds units, pooled funds units, 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 using unit values obtained from each of the funds' administrators, which are derived from the fair value of the underlying investments in each pooled fund. Where necessary, the impact of restrictions on the sale or redemption of such investments is taken into consideration in determining fair value.

(ii) Private Markets

Private markets consist of investments in real estate, private equity, infrastructure and renewable resources.

Real estate investments are comprised of direct equity positions in various private entities, properties, as well as fund investments in the real estate sector. Real estate investments focus on properties, partnerships and companies operating in the office, retail, industrial, hospitality and residential sectors, as well as private funds invested in real estate assets. Real estate investments are accounted for net of all third-party financings. As at March 31, 2012, the total amount of third-party financing included as part of real estate contracted by direct investments controlled by PSP Investments for the Plan Account was $15,037 thousand (2011 – $11,778 thousand).

Private equity investments are comprised of direct equity positions and co-investments in private entities as well as fund investments with similar objectives.

Infrastructure investments are comprised of direct equity positions and co-investments in various private entities and fund investments. Infrastructure investments focus on entities engaged in the management, ownership or operation of assets in energy, transportation and other regulated businesses. Infrastructure investments are accounted for net of all third-party financings. As at March 31, 2012, the total amount of third-party financing included as part of infrastructure contracted by direct investments controlled by PSP Investments for the Plan Account was $1,612 thousand (2011 – $285 thousand).

Renewable resources investments are comprised of properties involving the production and harvesting of replenishable resources. As at March 31, 2012, renewable resources included one investment in timberlands.

Valuation Techniques

The fair value of private markets 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 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 discount rates, capitalization rates, projected cash flows and/or net operating income, which are not fully supported by prices from market observable transactions.

For direct investments in private equity, direct investments and co-investments in infrastructure and in renewable resources, 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.

In the case of private equity, real estate and 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.

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(iii) Fixed Income

Fixed income consists of cash and money market securities, government and corporate bonds, inflation-linked bonds and other fixed income securities.

Cash and money market securities include instruments having a maximum term to maturity of one year, such as treasury bills, certificates of deposit and bankers' acceptances.

Government and corporate bonds include Canadian and foreign, federal, provincial, territorial and municipal bonds. Inflation-linked bonds are fixed income securities that earn inflation adjusted returns.

Other fixed income securities consist of asset-backed securities, floating rate notes as well as private debt portfolios.

Asset-backed securities consist mainly of asset-backed term notes (ABTNs) and mortgage-backed securities. 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. Potential margin calls on the ABTNs are supported by funding facilities, as described in Note 10.

Private debt portfolios consist mainly of investments in the real estate sector in the form of third-party loans such as junior and senior debts, construction loans, bridge loans, income-participating loans, as well as other structured finance products. They also include real estate debt funds where significant portions of the value are attributed to the underlying real estate assets.

Private debt portfolios also include debt securities of private companies or other entities such as venture capital organizations, held mainly through private funds. Such debt securities take the form of senior debt, mezzanine and distressed debt.

Valuation Techniques

Cash and money market securities include short-term instruments that are recorded at cost plus accrued interest, which approximates fair value.

Fair values of government and corporate bonds, inflation-linked bonds, floating rate notes and mortgage-backed securities are based on prices obtained from third-party pricing sources. Such prices 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 whereby management relies on the valuation work performed by a recognized third-party expert. Management ensures that the valuation conducted by such expert uses acceptable industry methods. Financial information used in the valuation of ABTNs includes interest rates, credit spreads and the underlying investments' terms to maturity. In addition to the values determined by the expert, management integrated certain assumptions in the fair value of ABTNs that are not fully supported by market observable data, such as liquidity estimates and the impact of the funding facilities described in Note 10.

The fair value of private debt portfolios in the real estate sector 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.

The fair value of fund investments included as part of private debt portfolios is determined based on the audited fair values reported by the fund's general partner using acceptable industry valuation methods.

(iv) Alternative Investments

Alternative investments consist mainly of units of funds that hold a mix of equity, fixed income and derivative instruments as well as hedge funds.

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, as applicable.

3. INVESTMENTS (continued)

(A) INVESTMENT PORTFOLIO (continued)

(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 and Dividends Receivable

Interest and dividends are recorded at the amounts expected to be received as at the reporting date, which approximates fair value.

(vii) Interest Payable

Interest is accrued at the amount expected to be paid as at the reporting date, which approximates fair value.

(viii) Securities Sold Short

Securities sold short reflect PSP Investments' obligation to purchase securities pursuant to short selling transactions. In such transactions, PSP Investments sells securities it does not own with an obligation to purchase 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 within public markets and fixed income.

(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 at a 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 approximates fair value.

(x) Derivative-Related Receivables and Payables

The description and valuation of derivative-related receivables and payables are described in Note 3 (B).

(xi) Capital Market Debt Financing

PSP Investments' capital market debt program is described in Note 8. Short-term promissory notes are recorded at cost plus accrued interest, which approximates fair value. The fair value of PSP Investments' medium-term notes is based on prices that are obtained from third-party pricing sources. Such prices are determined using an interest rate curve with a spread consistent with PSP Investments' credit quality.

3. INVESTMENTS (continued)

(B) DERIVATIVE FINANCIAL INSTRUMENTS

Derivative financial instruments are financial contracts that are settled at a future date. The value of such instruments 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.

(ii) Futures

Futures are standardized contracts to take or make delivery of an asset (buy or sell) at a predefined price and predefined future date. 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 at a predefined date in the future. Forwards are used to adjust exposures to specified assets without directly purchasing or selling the underlying assets.

(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.

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:

	2012				2011			
		Fair Value				Fair Value		
($ thousands)	Notional Value	Assets	Liabilities	Net	Notional Value	Assets	Liabilities	Net
Equity and commodity derivatives								
Futures	$ 5,718	$ –	$ –	$ –	$ 2,398	$ –	$ –	$ –
Total return swaps	46,073	737	(244)	493	30,891	1,064	(1)	1,063
Warrants and rights	6	3	–	3	12	11	–	11
Options:								
Listed-purchased	6,371	84	–	84	2,466	69	–	69
Listed-written	5,453	–	(59)	(59)	2,204	–	(106)	(106)
OTC-purchased	3,040	33	–	33	–	–	–	–
OTC-written	2,797	–	(52)	(52)	–	–	–	–
Currency derivatives								
Forwards	130,411	880	(1,047)	(167)	95,329	1,762	(675)	1,087
Futures	856	–	–	–	–	–	–	–
Swaps	5,310	19	(100)	(81)	9,323	135	(61)	74
Options:								
OTC-purchased	2,770	29	–	29	5,628	32	–	32
OTC-written	4,627	–	(36)	(36)	1,019	–	(10)	(10)
Interest rate derivatives								
Bond forwards	10,167	21	(19)	2	5,536	29	(15)	14
Futures	8,836	–	–	–	9,867	–	–	–
Interest rate swaps	42,802	150	(169)	(19)	97,808	78	(92)	(14)
Total return swaps	–	–	–	–	3,599	–	(1)	(1)
Swaptions	4,561	85	(33)	52	19,635	35	(17)	18
Options:								
Listed-purchased	46,619	19	–	19	29,805	36	–	36
Listed-written	47,059	–	(26)	(26)	41,876	–	(39)	(39)
OTC-purchased	4,511	87	–	87	–	–	–	–
OTC-written	21,764	–	(134)	(134)	–	–	–	–
Credit derivatives[1]:								
Purchased	6,815	157	(51)	106	2,331	17	(21)	(4)
Sold	3,297	11	(120)	(109)	2,278	10	(63)	(53)
Total	$ 409,863	$ 2,315	$ (2,090)	$ 225	$ 362,005	$ 3,278	$ (1,101)	$ 2,177

[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.

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, 2012:

($ thousands)

Less than 3 months	$234,853
3 to 12 months	100,260
Over 1 year	74,750
Total	$409,863

(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 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.

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, 2012:

($ thousands)	Level 1	Level 2	Level 3	No Level	Total Fair Value
Public markets					
Canadian equity	$ 51,632	$ –	$ –	$ –	$ 51,632
Foreign equity	86,098	4,590	960	–	91,648
Private markets					
Real estate	–	–	42,091	–	42,091
Private equity	–	–	34,909	–	34,909
Infrastructure	–	–	24,109	–	24,109
Renewable resources	–	–	2,122	–	2,122
Fixed income					
Cash and money market securities	4,599	9,188	–	–	13,787
Government and corporate bonds	–	72,005	–	–	72,005
Inflation-linked bonds	–	22,309	–	–	22,309
Other fixed income securities	–	13,465	22,517	–	35,982
Alternative investments	–	4,921	1,714	–	6,635
INVESTMENTS	$142,329	$126,478	$128,422	$ –	$397,229
Investment-related assets					
Amounts receivable from pending trades[1]	$ –	$ –	$ –	$ 3,554	$ 3,554
Interest receivable[1]	–	–	–	902	902
Dividends receivable[1]	–	–	–	336	336
Derivative-related receivables	103	2,212	–	–	2,315
	$ 103	$ 2,212	$ –	$ 4,792	$ 7,107
Investment-related liabilities					
Amounts payable from pending trades[1]	$ –	$ –	$ –	$ (5,584)	$ (5,584)
Interest payable[1]	–	–	–	(137)	(137)
Securities sold short	(2,425)	–	–	–	(2,425)
Securities sold under repurchase agreements	–	(7,186)	–	–	(7,186)
Derivative-related payables	(85)	(1,945)	(60)	–	(2,090)
Capital market debt financing:					
Short-term	–	(5,088)	–	–	(5,088)
Long-term	–	(17,075)	–	–	(17,075)
	$ (2,510)	$ (31,294)	$ (60)	$ (5,721)	$ (39,585)
NET INVESTMENTS	$139,922	$ 97,396	$128,362	$ (929)	$364,751

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

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
Public markets					
Canadian equity	$ 78,477	$ 317	$ –	$ –	$ 78,794
Foreign equity	60,736	11,601	–	–	72,337
Private markets					
Real estate	–	–	30,390	–	30,390
Private equity	–	–	28,925	–	28,925
Infrastructure	–	–	15,086	–	15,086
Fixed income					
Cash and money market securities	3,250	11,037	–	–	14,287
Government and corporate bonds	–	45,013	–	–	45,013
Inflation-linked bonds	–	16,616	–	–	16,616
Other fixed income securities	–	11,172	20,497	–	31,669
Alternative investments	–	6,210	–	–	6,210
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
	$ 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 market debt financing:					
Short-term	–	(3,916)	–	–	(3,916)
Long-term	–	(9,744)	–	–	(9,744)
	$ (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.

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 year-end.

There were no significant transfers between Level 1 and Level 2 during the year ended March 31, 2012 (no significant transfers during the year ended March 31, 2011).

3. INVESTMENTS (continued)

(C) FAIR VALUE MEASUREMENT (continued)

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, 2012:

($ thousands)	Opening Balance	Purchases	Sales	Settlements[1]	Realized Gains	Unrealized Gains (Losses)	Transfer out of Level 3	Closing Balance
Public markets	$ –	$ 880	$ (92)	$ –	$ 12	$ 160	$ –	$ 960
Private markets	74,401	36,134	(12,948)	–	1,176	4,596	(128)	103,231
Fixed income	20,497	6,066	(5,630)	(1,271)	255	2,600	–	22,517
Alternative investments	–	1,672	–	–	–	42	–	1,714
Derivative-related receivables/payables (net)	(43)	–	–	(18)	17	(16)	–	(60)
Total	**$ 94,855**	**$ 44,752**	**$ (18,670)**	**$ (1,289)**	**$ 1,460**	**$ 7,382**	**$ (128)**	**$ 128,362**

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)	Opening Balance	Purchases	Sales	Settlements[1]	Realized Losses	Unrealized Gains	Transfer out of Level 3	Closing Balance
Private markets	$ 60,906	$ 34,026	$ (28,598)	$ –	$ (425)	$ 8,800	$ (308)	$ 74,401
Fixed income	19,793	7,045	(8,765)	(2,489)	(399)	5,312	–	20,497
Derivative-related receivables/payables (net)	(1,627)	2,400	(70)	–	(1,270)	524	–	(43)
Total	$ 79,072	$ 43,471	$ (37,433)	$ (2,489)	$ (2,094)	$ 14,636	$ (308)	$ 94,855

[1] Includes Plan Account allocation adjustments.

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 (2011 - 2% increase/decrease) in the fair value of financial instruments categorized as Level 3. This excludes private debt portfolios in the real estate sector and certain fund investments, where a sensitivity analysis is not possible given the underlying assumptions used are not available to PSP Investments. In the case of 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 private debt portfolios in the real estate sector, the fair value is obtained from third-party appraisers as described in Note 3 (A).

(D) SECURITIES LENDING AND 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, 2012, PSP Investments, on behalf of the Plan Account, has re-invested $9,803 thousand of collateral held (2011 – $8,348 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)	2012	2011
Securities lending		
Securities lent	**$ 39,490**	$ 32,192
Collateral contractually receivable[1]	**41,621**	33,676
Securities borrowing		
Securities borrowed	**2,425**	240
Collateral contractually payable[2]	**2,700**	254

[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.

(E) SECURITIES SOLD AND 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 relevant 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 relevant 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 $7,186 thousand at March 31, 2012 (2011 – $2,847 thousand).

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 Statement of Investment Policies, Standards and Procedures (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.

(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 funding risk. Funding risk is the risk that the assets under management will be insufficient to meet the relevant pension liabilities of the Plans, which may require the contributions to the Funds of the Plans to be increased. 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. For investments that are not actively traded, the calculation of VaR uses securities with similar risk attributes as proxy.

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.

	2012	2011
Policy Portfolio VaR	**21.7 %**	22.4 %
Active VaR	**2.6**	2.2
Total VaR (undiversified)	**24.3**	24.6
Diversification effect	**(1.6)**	(2.9)
Total VaR	**22.7 %**	21.7 %

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 terms to maturity of the investments with the most significant exposure to interest rate risk were as follows as at March 31, 2012:

($ thousands)	Less than 1 Year	1 to 5 Years	5 to 10 Years	Over 10 Years	Other	Total
Government bonds	$ 7,595	$ 26,837	$ 9,656	$ 10,246	$ –	$ 54,334
Corporate bonds	3,523	7,506	4,915	1,727	–	17,671
Inflation-linked bonds	1	5,882	5,534	10,892	–	22,309
Asset-backed securities	2	10,160	172	15	–	10,349
Private debt portfolios:						
Directly held	296	2,284	35	–	–	2,615
Held through funds[1]	–	–	–	–	10,376	10,376
Total investments with significant exposure to interest rate risk	**$ 11,417**	**$ 52,669**	**$ 20,312**	**$ 22,880**	**$ 10,376**	**$117,654**
Other investments[2]	**$ –**	**$ –**	**$ –**	**$ –**	**$ 26,429**	**$ 26,429**
Total fixed income	**$ 11,417**	**$ 52,669**	**$ 20,312**	**$ 22,880**	**$ 36,805**	**$144,083**

[1] Due to their nature, information in connection with the terms to maturity of fund investments included in the private debt portfolios is not available.

[2] Consists of $13,787 thousand in cash and money market securities and $12,642 thousand in floating rate notes, which, due to their nature, are not significantly exposed to interest rate risk.

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

Alternative investments as well as derivative contracts described in Notes 3 (A) (iv) and (B), respectively, are also subject to interest rate risk exposures. These exposures are reflected in the VaR calculation described in Note 4 (A).

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 in non-emerging countries. 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:

(in thousands of Canadian $)	2012		2011	
Currency	**Fair Value**	**% of Total**	Fair Value	% of Total
US Dollar	**$ 73,305**	**57.9 %**	$ 52,917	54.0 %
Euro	**15,025**	**11.9**	13,297	13.6
British Pound	**9,919**	**7.8**	7,422	7.6
Japanese Yen	**5,720**	**4.5**	3,948	4.0
Brazilian Real	**5,133**	**4.0**	4,909	5.0
Hong Kong Dollar	**3,812**	**3.0**	3,702	3.8
Korean Won	**2,768**	**2.2**	2,618	2.7
Australian Dollar	**2,282**	**1.8**	1,704	1.7
Norwegian Krone	**1,941**	**1.5**	582	0.6
Indian Rupee	**1,083**	**0.9**	785	0.8
Others	**5,714**	**4.5**	6,011	6.2
Total	**$126,702**	**100.0 %**	$ 97,895	100.0 %

PSP Investments and its subsidiaries also had commitments, denominated in foreign currencies of $36,553 thousand (US$32,007 thousand, €2,930 thousand, R682 thousand South African Rands and R1,050 thousand Brazilian Reals) for the Plan Account which were not included in the foreign currency exposure table.

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 relevant 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.

As at March 31, 2012, the Plan Account's maximum exposure to credit risk amounted to approximately $125 million (2011 – approximately $89 million). This amount excludes investments in distressed debt in the amount of approximately $7.9 million as at March 31, 2012 (2011 – approximately $8.4 million). The maximum exposure to credit risk also excludes collateralized debt obligations, collateral held as disclosed in Notes 3 (D), 3 (E) and 4 (B) and the impact of guarantees and indemnities disclosed in Note 10.

As at March 31, 2012, the Plan Account had a net notional exposure of $948 thousand (2011 – $1,453 thousand) to various tranches of collateralized debt obligations, of which approximately 61% (2011 – approximately 44%) of the underlying dollar exposure was rated "Investment grade", as well as funding facilities, as described in Note 10, to support potential margin calls on the ABTNs.

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 markets investments.

PSP Investments' concentration of credit risk by credit rating, excluding the items described above and any other credit enhancement, for the Plan Account was as follows as at March 31:

	2012	2011
Investment grade (AAA to BBB–)	**98.2 %**	97.9 %
Below investment grade (BB+ and below)	**0.7**	0.4
Not rated:		
Rated by a single credit rating agency	**0.1**	0.1
Not rated by credit rating agencies	**1.0**	1.6
Total	**100.0 %**	100.0 %

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 requires that counterparties provide adequate collateral and meet its credit rating requirements. PSP Investments frequently monitors the credit rating of its counterparties as determined by recognized credit rating agencies. With respect to derivative contracts, PSP Investments has the ability to terminate all trades with most counterparties whose credit rating is downgraded below its requirements.

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.

4. INVESTMENT RISK MANAGEMENT (continued)

(B) CREDIT RISK (continued)

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 pledged securities with a fair value of $15 thousand as collateral with respect to derivative contracts at March 31, 2012 (2011 – nil). Securities with a fair value of $589 thousand were received from counterparties as collateral at March 31, 2012 (2011 – $762 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 (D) and 3 (E) 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.

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, 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, bonds and public equities are expected to be highly liquid as they will be invested in securities that are actively traded. Management utilizes 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 market 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 market debt program.

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

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 instruments, aggregated according to their maturities as at March 31, 2012:

($ thousands)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Non-derivative-related financial liabilities[1]				
Amounts payable from pending trades	$ (5,584)	$ –	$ –	$ (5,584)
Interest payable	(119)	(18)	–	(137)
Securities sold short	(2,425)	–	–	(2,425)
Securities sold under repurchase agreements	(7,186)	–	–	(7,186)
Capital market debt financing	(4,699)	(389)	(17,075)	(22,163)
Accounts payable and other liabilities	(313)	–	(124)	(437)
Total	$ (20,326)	$ (407)	$ (17,199)	$ (37,932)

($ thousands)	Less than 3 Months	3 to 12 Months	Over 1 Year	Total
Derivative-related financial instruments				
Derivative-related receivables	$ 848	$ 961	$ 506	$ 2,315
Derivative-related payables[1]	(895)	(582)	(613)	(2,090)
Total	$ (47)	$ 379	$ (107)	$ 225

[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 $31,055 thousand for the year ended March 31, 2012 (2011 – $54,045 thousand) from the Fund.

6. INVESTMENT INCOME

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

($ thousands)	2012	2011
Interest income	$ 3,835	$ 2,770
Dividend income	4,461	3,239
Other income	1,144	968
Dividend expense	(139)	(106)
Interest expense (Note 8)	(472)	(335)
Transaction costs	(363)	(295)
External investment management fees[1]	(186)	(210)
	8,280	6,031
Net realized gains[2]	5,743	9,959
Net unrealized (losses) gains	(3,222)	22,769
Investment income	**$ 10,801**	$ 38,759

[1] Consists of amounts incurred for investments in public markets that are paid directly by PSP Investments. This excludes investments fees related to certain pooled fund investments classified under alternative investments primarily related to performance, in the amount of $314 thousand for the year ended March 31, 2012 (2011 – $470 thousand). This also excludes management fees related to investments in private markets and other fixed income securities that are not paid directly by PSP Investments.

Such fees, which generally vary between 0.1% and 2.0% of the total invested and/or committed amount, totalled $672 thousand for the year ended March 31, 2012 (2011 – $781 thousand).

[2] Includes foreign currency losses of $281 thousand for the year ended March 31, 2012 (2011 – gains of $577 thousand).

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:

	2012	2011
Public Service Pension Plan Account	72.9 %	72.7 %
Canadian Forces Pension Plan Account	19.4	19.7
Royal Canadian Mounted Police Pension Plan Account	7.1	7.1
Reserve Force Pension Plan Account	0.6	0.5
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)	2012	2011
Salaries and benefits	$ 541	$ 351
Professional and consulting fees	61	40
Office supplies and equipment	85	63
Other operating expenses	36	25
Depreciation of fixed assets	52	50
Occupancy costs	31	24
Custodial fees	17	12
Remuneration earned by Directors	4	3
Travel and related expenses for Directors	2	1
Communication expenses	1	1
Total	**$ 830**	$ 570

8. CAPITAL MARKET DEBT FINANCING

PSP Investments' capital market debt 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 real estate, infrastructure and renewable resources. It is unconditionally and irrevocably guaranteed by PSP Investments in accordance with its corporate leverage policy.

The maximum amount authorized by the Board of Directors for the capital market debt program is 7.5% of the net investments plus all recourse debt outstanding of PSP Investments. Under this limit, the short-term promissory note component cannot exceed $3 billion.

The following outlines the terms as well as the fair value of the notes issued under the capital market debt program allocated to the Plan Account as at March 31:

	2012		2011
($ thousands)	**Capital amounts to be paid at maturity**	**Fair Value**	Fair Value
Short-term promissory notes, bearing interest between 1% and 1.42% and maturing within 31 and 364 days of issuance (March 31, 2011 – 29 and 363 days)	**$ 5,097**	**$ 5,088**	$ 3,916
Medium-term notes Series 1, bearing interest of 4.57% per annum and maturing on December 9, 2013	**$ 5,648**	**$ 5,941**	$ 5,885
Medium-term notes Series 2, bearing interest of 2.94% per annum and maturing on December 3, 2015	**$ 3,954**	**$ 4,080**	$ 3,859
Medium-term notes Series 3, bearing variable interest of 3-month CDOR + 39 basis points and maturing on February 16, 2015	**$ 1,977**	**$ 1,977**	$ –
Medium-term notes Series 4, bearing interest of 2.26% per annum and maturing on February 16, 2017	**$ 5,084**	**$ 5,077**	$ –
Total	**$ 21,760**	**$ 22,163**	$ 13,660

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)	**2012**	2011
Short-term promissory notes	**$ 73**	$ 49
Medium-term notes	**399**	286
Total	**$ 472**	$ 335

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 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 market debt financing and Note 4 (C) provides information on PSP Investments' liquidity.

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

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.

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

PSP Capital Inc. provided funding facilities of a maximum amount of $969 million to support potential margin calls on the ABTNs, of which $4,840 thousand has been allocated to the Plan Account. As at March 31, 2012, the margin funding facilities have not been drawn upon since inception.

In certain investment transactions, PSP Investments provided guarantees or indemnifications to third parties, the most significant of which are as follows:

As at March 31, 2012, 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 (2011 – $1,375 thousand) plus interest and other related costs. The loan matures in March 2015.

As at March 31, 2012, 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 (2011 – $195 million), of which $1,088 thousand (2011 – $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.

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, 2012:

($ thousands)	
Real estate	$ 8,512
Private equity	23,041
Infrastructure	4,913
Other fixed income securities	3,264
Total	**$ 39,730**

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