INFLATION-SENSITIVE INVESTMENTS

DESCRIPTION

The Inflation-Sensitive Investments asset class consists of three portfolios: Real Return Bonds, Infrastructure and Real Estate. These portfolios provide exposure to markets offering investment income that is generally inflation-indexed so as to partially hedge the inflation risk associated with the liabilities of many Caisse depositors.

The Infrastructure and Real Estate portfolios, which have $24.3 billion of net assets, are actively managed. The Real Return Bonds portfolio, which has $1.2 billion of net assets, is index-managed.

MARKET CONDITIONS

In an environment of low interest rates, less-liquid assets, such as infrastructure and real estate, gained in popularity in 2012 because they offer a high, stable current return with a generally low risk profile. Despite the volatile credit market and the difficult economic recovery, projects and assets with excellent fundamentals were still able to obtain financing at low rates, which gave them an edge and enabled them to generate high returns.

Infrastructure

Global demand for infrastructure development, combined with governments' determination to reduce their budget deficits, should significantly increase the number of transactions in this sector in the years to come. Privatization of public assets in Europe and national infrastructure programs are driving the demand for capital in this sector. Institutional investors and sovereign wealth funds are acquiring minority interests in infrastructure projects and providing an appealing source of financing for industrial companies in the current economic environment. A number of large institutional players have expressed an interest in investing massively in this sector, which is causing prices to firm up on the infrastructure market.

Real estate

The real estate market was rather active in 2012 but the results varied from one region to another. In Canada and United States, investment in commercial real estate continued the good performance recorded in 2011, especially because of solid rental income. This performance is due mainly to the economic recovery, strength in the residential real estate sector and the gradual decrease in political uncertainty. In Europe, however, the performance was adversely affected by the economic situation and the cautious attitude of tenants who are reducing their space needs. Finally, Brazilian real estate continued to perform well, partly because of the burgeoning middle class and the availability of credit. Even so, the currency's significant depreciation limited the return obtained once it was translated into Canadian dollars.

HIGHLIGHTS

Returns on specialized portfolios

For the year ended December 31, 2012

	Net assets[1] $ billions	Weight[2] %	Net investment results[1] $ millions	Return %	Index %
Real Return Bonds	1.2	0.7	34	2.7	2.9
Infrastructure	6.3	3.6	511	8.7	15.0
Real Estate	18.0	10.2	1,969	12.4	13.2
Total[3]	**25.5**	**14.5**	**2,514**	**11.1**	**13.1**

[1]Net assets and net investment results are net of operating expenses.
[2]Percentage of the Caisse's net assets.
[3]Possible discrepancies in the totals (dollars or percentages) are due to rounding.

The overall return on the Inflation-Sensitive Investments asset class was 11.1%, for $2.5 billion of net investment results. The return obtained in 2012 fell short of the benchmark index by 2.0%.

REAL RETURN BONDS

- This index-managed portfolio returned 2.7%.
    - The return is due mainly to inflation and interest income.

INFRASTRUCTURE

- This portfolio returned 8.7%, for $511 million of net investment results. It underperformed its benchmark index by 6.3%.
    - Energy-sector assets contributed to most of the portfolio's increase in value since the beginning of the year.
    - Large transactions were carried out to rebalance the portfolio, such as the partial sale of Heathrow Airport Holdings (formerly BAA), and to reduce its concentration risk.
    - The benchmark index consists of publicly traded securities whose valuation is more volatile than that of the investments in the portfolio.
- For this type of less-liquid asset, performance has to be assessed over a longer period. Since the reorganization of the Caisse's operations in the summer of 2009, the Infrastructure portfolio has an annualized return of 26.7% and has outperformed its benchmark index by 10.4%. This return includes the results of the Investments and Infrastructure portfolio before July 1, 2010.
    - This high return is attributable to the solid operational performance of the companies in the portfolio and the decline of interest rates in recent years.

REAL ESTATE

- This portfolio is managed by Ivanhoé Cambridge, a company in which the Caisse has a 93% stake.
- This portfolio returned 12.4%, for $2.0 billion of net investment results. The return fell 0.8% short of its benchmark index.
    - The return for the year is due mainly to investments in shopping centres.
    - These results take into account the impact of the new IFRS accounting standard, which represents $637 million. This amount reflects the value of Ivanhoé Cambridge as an entity, taking into consideration the quality of it real estate portfolio and the value of its management platform as a whole.
    - Repositioning of the portfolio continued in 2012 with acquisitions of shopping centres in Canada and Brazil, office buildings in Paris and New York and residential buildings in California and London.
- For this type of less-liquid asset, performance has to be assessed over a longer period. Since the reorganization of the Caisse's operations in the summer of 2009, the Real Estate portfolio has an annualized return of 10.7%, outperforming its benchmark by 0.8%.
    - The high return obtained in the shopping centre and office building sector, primarily in Canada, also contributed a substantial portion of the return obtained in this period.