INFLATION-SENSITIVE INVESTMENTS

DESCRIPTION

The Inflation-Sensitive Investments category consists of three portfolios: Real Return Bonds, Infrastructure and Real Estate. These portfolios provide exposure to markets, including inflation-indexed, income-generating investments. This can partly hedge against the inflation risk associated with the liabilities of many Caisse depositors.

The Infrastructure and Real Estate portfolios, which have $21.1 billion in net assets, are actively managed. The Real Return Bonds portfolio, which has $0.9 billion in net assets, is index managed.

MARKET CONDITIONS

In 2010, the inflation rate in Canada rose to 2.4%, less than 0.5% above the Bank of Canada’s 2% long-term target rate. Inflation-sensitive asset classes still saw considerable returns – against a backdrop of falling medium- and long-term rates and a rebound in activity in illiquid markets, such as real estate and infrastructure.

Real return bonds

In the second and third quarter, bond markets saw interest rates drop, followed by upward movement in the fourth quarter. This was also the case for the real return bond market. However, the increase in real interest rates* was slightly lower than the nominal rate hike due to upward inflation expectations for the period.

* Real interest rate equals the difference between the nominal interest rate and inflation rate over a specified period.

Infrastructure

The gradual reopening of credit markets triggered a rebound in activity in the infrastructure sector during 2010. The return of key industry players to the market led to an increase in major transactions in the second quarter. Furthermore, the money accumulated by infrastructure funds reached $19 billion, compared to $10.7 billion in 2009. In addition, the sector's resilience during the last economic cycle encouraged institutional investors to increase their infrastructure weighting in their portfolios. The sector, in particular, presents long-term investment opportunities. Given the state of public finances in developed countries, governments will have to resolve to utilize more private capital to replace their aging infrastructure.

Real Estate

In 2010, low interest rates and increased access to quality asset financing also led to a resurgence of activity in housing markets. The availability of capital and the scarcity of products on the market led to a compression of capitalization rates and, in turn, higher prices for the best assets in Canada and the United States. In contrast, the sovereign debt crisis and fiscal austerity measures in Europe undermined investor confidence in the region's growth potential, which induced a shift of investment, particularly to the United States.

On the emerging market front, their growing popularity with institutional investors also exerted upward pressure on prices.

HIGHLIGHTS

- The Inflation-Sensitive Investments category's overall return was 16.3%, 5.6% above the benchmark index.

REAL RETURN BONDS

- This portfolio posted an 11.1% return. It is identical to the DEX Real Return Bond Index and primarily due to lower long-term real interest rates.

INFRASTRUCTURE

- During the first half of the year, infrastructure and non-infrastructure investments were grouped under the Investments and Infrastructures portfolio. In the second half, infrastructure investments were transferred to the new Infrastructure portfolio.
- For the year, the combined return of these portfolios stood at 25.4%, 14.1% above its benchmark index.
- This return is due to the resilience of all the portfolio assets following the recent financial crisis, particularly the energy and airport service assets, including BAA, Enbridge Energy Partners, Interconnector UK and Noverco (Gaz Métro).
- The portfolio assets possess strong fundamentals that improved during the year and saw an increase in their EBITDA.

REAL ESTATE

- This portfolio returned 13.4%, 1.8% above its benchmark index, generating $298 million in added value.
- This performance is mainly due to the strong performance of retail properties in Canada and office buildings in Canada, the U.S. and Europe. The returns by business segment are as follows: Ivanhoe Cambridge generated 22%, SITQ (office buildings and business parks) 13%, and SITQ (apartments, hotels and investment funds) 3%.

Specialized portfolio performance

For the year ended December 31, 2010

	$BILLIONS	Weight[1] %	Return %	Index %	Variance %
Real Return Bonds	0.9	1	11.1	11.1	0.0
Infrastructure[2]	4.3	3	25.4	11.3	14.1
Real Estate	16.8	11	13.4	11.6	1.8
Total	**22.0**	**15**	**16.3**	**10.7**	**5.6**

[1] Compared to the Caisse's net assets

[2] This item includes the Investments and Infrastructures portfolio from January 1 to June 30, 2010 and the Infrastructure portfolio since July 1, 2010.