INSIGHTS
FOR INSTITUTIONAL INVESTORS

SPRING 2015

POSITIVE TALK, LIMITED ACTION ON PENSION PLAN DE-RISKING

The 2015 Sun Life Investment Management Defined Benefit Pension Plan Report

Equity markets in many world regions are close to record highs, and the gains since 2009 have been substantial. Canadian defined benefit (DB) pension plan sponsors have ridden the tailwinds of these strong markets, and we see solvency funding rates having improved dramatically, with many plans now operating on a fully funded basis.

But there are clouds on the horizon. Markets don't rise forever – and interest rates have declined, straining the ability of pension funds to improve and maintain their funding levels.

It's within this environment that we sponsored a survey of 100 DB pension plan leaders in Canada about the current state of their plans – and their outlook for the future. With the lessons of 2008 still fresh, there is renewed discussion about de-risking avoiding future funding shocks. However, as this research shows, much of the talk of de-risking hasn't yet turned into action, and many plans still have nearly one-half or more of their assets exposed to equity markets.

ABOUT THE 2015 RESEARCH

- The 2015 Sun Life Investment Management Defined Benefit Pension Plan Report features key findings from an online/telephone survey of DB pension plan leaders across Canada, conducted from January to March 2015. Surveying and preliminary analysis were provided by Rogers Connect Market Research, drawing from the universe of the top 400 defined benefit pension plans in Canada. Results of the 2015 Report are being compared to the survey conducted in February and March, 2014.
- One hundred DB pension plan sponsors were surveyed, each of whom manages a minimum of $50 million in pension assets. Fifty-six of the 100 survey respondents represent a fund that manages less than $1 billion. Forty-four manage $1 billion or more.

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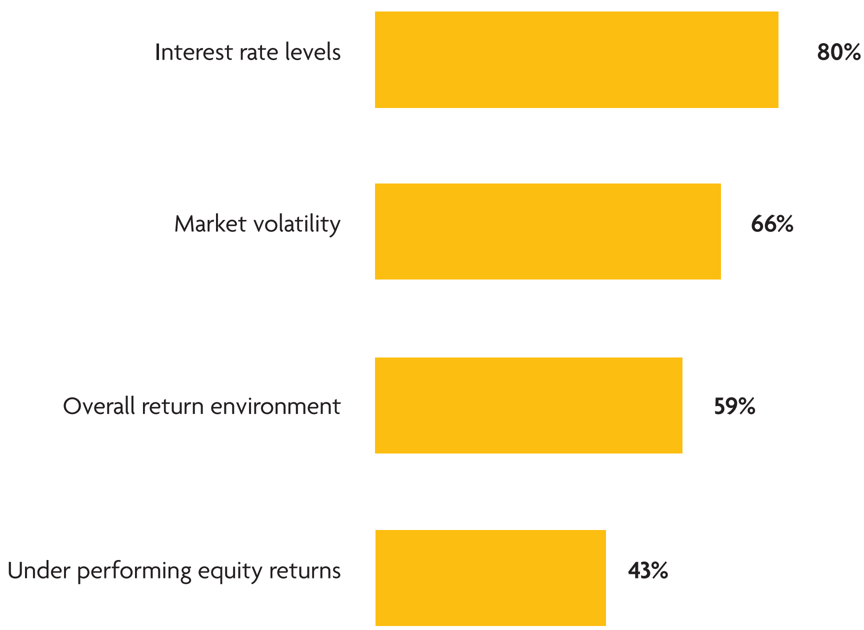
A DECLINE IN OPTIMISM

2015 saw a slight improvement in solvency funding rates, with an average of 89.8 per cent versus 87.9 per cent a year ago and 62 per cent of respondents reporting a stable or improved funding rate over the past year.

While funding levels have remained stable, the outlook for the future has not. In 2014, only 7 per cent of plans anticipated that their funding status would decline. That number nearly tripled to 19 per cent of plans this year. While average funding levels have continued to rise, there is recognition of the challenges ahead.

So what are those challenges? Plan sponsors were asked what their top risk concerns were in terms of managing their plan assets. Not surprisingly, interest rate levels were the top concern, ranked 1, 2 or 3 by 80 per cent of plans, Market volatility was the next most noted concern at 66 per cent, followed by the overall return environment at 59 per cent and under-performing equities at 43 per cent.

TOP RISK CONCERNS



Q23 When managing your DB plan assets, please rank the following risks in terms of their concern to you.
One (1) is the most important risk, 2 would be the next most important risk, etc.
All respondents answering Wave 2 n=94

KEY FINDING:

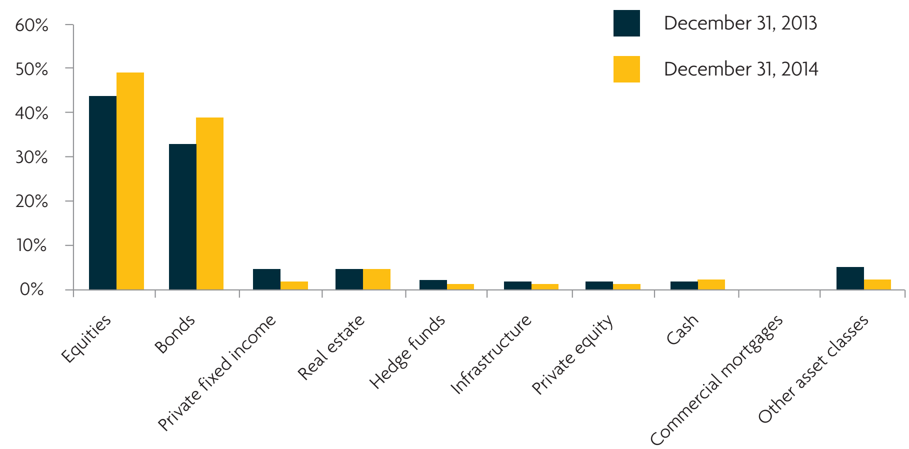
73% of plan sponsors state that their most immediate investment goal for their plan is either de-risking or increasing yields while not increasing their risk levels

A FOCUS ON DE-RISKING

With the combination of low interest rates and record high equity markets, it's not surprising that de-risking remains a top priority for pension plans. Seventy-three per cent of plan sponsors state that their most immediate investment goal for their plan is either de-risking or increasing yields while not increasing their risk levels. To that end, nearly one-half (49 per cent) of DB pension plan leaders are considering changes to their investment strategy.

The issue is that few plan sponsors appear to be taking action. In last year's survey, more than half of plan sponsors surveyed indicated that they planned to decrease their allocation to publically-traded equities, and this year nearly 40 per cent said the same. Despite a stated desire to de-risk in both surveys, equity market exposure has actually increased year-over-year rather than decreased, with nearly 50 per cent of plan assets invested in equity markets.

AVERAGE ASSET MIX COMPARISON



Q17. As of December 31, 2013/2014, what percentage of your portfolio was invested in...?
All participants answering (Wave 1 n=100; Wave 2 n=87)

KEY FINDING:

Equity market exposure has increased year-over-year, from 44% to 49% of plan assets

The allocation to many alternative investments, such as real estate, infrastructure, and private equity and fixed income, actually stayed the same or decreased over the past year.

So why hasn't the shift out of equities taken place? It's not that plan sponsors are negative on the outlook for alternatives. Four out of five DB pension plan leaders are either bullish or neutral on the outlook for these investments. And many plan to shift into other asset classes this year, with 30 per cent increasing their investment in infrastructure, 25 per cent increasing their real estate holdings, 19 per cent in public bonds, 14 per cent in private equity, and 4 per cent into private fixed income.

But while there appears to be a desire for change, DB plans remain short on action, and risk exposure is high. The barrier to change for many plans relates to an asset that most DB plans have an abundance of: liquidity.

THE LIQUIDITY ISSUE

Alternative asset classes often involve private markets, with deals that are highly customized. This customization – plus the lack of a public market – decreases investment liquidity, with the trade-off being a yield premium over public market investments of similar term and tenor.

The survey asked plan sponsors about three alternative asset classes (private fixed income, real estate, and commercial mortgages) and the reasons why they would exclude these from their portfolio. Liquidity was one of the top concerns for private fixed income (53 per cent) real estate (42 per cent) and commercial mortgages (27 per cent).

Our observation is that liquidity concerns are based on a perceived need for cash flow (whether to meet payments or for investment flexibility) ... and every plan will have different needs in this way. Plans may have more liquidity than they likely need by virtue of the high percentage of public market investments in their portfolios. For a fund with duration of 15 with pensioners and active participants, if you ignore inflows from the active participants, we estimate that the annual cash requirement as a percentage of their fund is no more than 6 per cent over the period.

KEY FINDING:

Liquidity a concern for plans sponsors when it comes to investing in alternative asset classes ... but 80% of plan sponsors are bullish or neutral on private assets

THE LIQUIDITY ISSUE *cont'd*

What this means is that liquidity is an asset that pension plans may be overlooking as a source of opportunity. It's clearly a "goldilocks" attribute – you don't want to have too little but there is a cost of having too much. For those plans with excess liquidity, they may be able to earn additional yield and reduce contributions by adding alternative investments to their asset mix.

THE INFORMATION BARRIER

A lack of information may be the biggest barrier to alternative investment adoption. It was clear from the research that more information is needed before plan sponsors consider these investments for their portfolios. For example, for commercial mortgages, 67 per cent said that more information on de-risking via commercial mortgage investments would be helpful, and 65 per cent said they needed to know more about this investment to consider it as an option. Alternative investments may provide greater diversification benefits, enhanced returns over public market benchmarks and lower risk for plans looking to de-risk.

KEY FINDING:

65% of plan sponsors surveyed want more information before considering investing in commercial mortgages

So while liquidity concerns are noted by plan sponsors as the greatest barrier to investing in alternatives, it could be the need for more information about these investments that's ultimately putting up barriers to using a plan's liquidity to its advantage.

DB pension plan leaders get their information from many sources, and, as an industry, we must work together to help address their de-risking concerns by bringing this knowledge up to date, and providing the information they need to be as comfortable with alternative investments as they are with public market equities.

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The 2014/2015 Sun Life Defined Benefits Plan Sponsor Executives study was conducted by Rogers Connect Market Research, a division of Rogers Publishing Ltd., January 19 – March 6, March 10 – 20, 2015. Rogers Connect Market Research Group has been collecting consumer and B2B decision-maker insight via interviewing and engaging elite audiences, such as those responsible for Canada's largest pension plans, and has developed and honed techniques and best practices for dealing with this type of respondent for the past 10 years.

The 100 self-selected respondents come from Rogers' Canadian Institutional Investment Network database and include persons serving in executive or management roles at the pension plans. There are 1,800+ available contacts among the database's top 400 DB funds (defined as having at least $50.0M in assets under management).

Fielding and preliminary analysis were also completed by Rogers Connect Market Research. All sample surveys and polls may be subject to other sources of error, including, but not limited to methodological change, coverage error and measurement error. The information obtained by Rogers Connect Market Research during the survey was taken "as is" and was not validated or confirmed by Sun Life Investment Management Inc.

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