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INVESTMENT MANAGEMENT

# THE PENSION LEGACY CHALLENGE

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**It was a decade of innovation. The 1950s offered up an array of new products like colour television, microwaves and the Ford Edsel. Some were successful; others became marketing case studies with titles like "The wrong car at the wrong time." We can add the design of enhanced corporate defined benefit (DB) pension plans to the list. With the benefit of hindsight, we now understand the flaws inherent in both the Edsel and the actuarial assumptions that supported DB plans.**

Just as marketers learned from the Edsel case, institutional investors have developed enhanced strategies to address the risk-return parameters for DB pension plan management. Today, executive teams are designing and implementing solutions to legacy DB pension plan issues. Meanwhile, increased accounting disclosure from International Accounting Standard 19 has raised the profile for reporting. Shareholders are focused on risk mitigation solutions as rating agencies have published extensive guidance on pension deficits and their rating impacts. These factors have led teams to assess strategies that mitigate the volatility of plan costs and stabilize asset/liability positions.

A number of factors can be assessed in a review of DB pension plan volatility. Plan design is an important area to revisit. But aside from closing or freezing plan benefits, this review option mainly stems the tide of future exposure. A methodology to address plan volatility takes into account the solvency funding position and re-aligns the asset portfolio to specified liability characteristics.

## LOW INTEREST RATES

In today's low interest rate environment, solvency funding positions are predominantly in deficit territory. Corporations understand the impacts of this rate level all too well.

A growing practice in the pension sector is to set up investment policies with two distinct categories: a return-seeking portion and a liability hedging portfolio.

The return-seeking element – specifically equity investments – grows with an improving economic environment. As these investments rise in value, equity can be sold and the proceeds invested in fixed income. As a result, the liability hedge portfolio rises because of this transfer of funds. This rise in the liability hedge over time mitigates interest rate risk. The liability-hedge component can be aligned to a solvency, accounting or going-concern liability. A further beneficial impact of this dynamic progression towards an increased hedging position is a less volatile asset mix from the resulting lower equity position. The establishment of this dynamic hedge – also referred to as a glide path – is an important consideration for pension plan sponsors to review.

With the anticipated future growth of the liability hedge portfolio, there is an ongoing search for higher yield strategies. Proprietary asset classes such as investment-grade private fixed income and high-quality commercial mortgages add income to the portfolio as a result of the liquidity premium and credit risk. Mitigation of this risk is typically managed through appropriate diversification and by partnering with experienced asset managers.

When assessing the mix of return-seeking assets and a liability hedge portfolio, it is important to anticipate the impact of longevity risk. The historic trend has been that people continue to live longer, and this can be an unexpected expense in the longer term. Plans can address this longevity risk through risk-transfer solutions for the retirement cohort of the plan. Risk-transfer solutions exist in the form of longevity insurance, or buy-in or buy-out annuities driven by client-specific preferences. The liability hedge portfolio can be constructed to support a risk-transfer solution.

Solutions to these pension plan challenges are coming from a sector that has historically managed its own balance sheet exposures. Specifically, insurance companies are becoming actively engaged with DB pension plans as they have deep experience managing assets in concert with liabilities characteristics. Leading insurance firms have additional advantages. Their strength in derivatives management adds value. They also have advanced systems infrastructure for liability asset metrics and experience in the development of customized portfolios.

## ADVANCES IN RISK MANAGEMENT

On a final note, advances in the enterprise-wide risk management field are adding rigor to pension risk mitigation strategies. Due to its combination of accounting, investment analyst and rating agency focus, the corporate pension payout stream is viewed as having debt-like characteristics.

The debt focus applied to pension liabilities is changing views on how a risk budget should be allocated. Having the risk budget include the pension fund, where the upside surplus is not shared, triggers a rethink in corporate finance. This progressive alignment of corporate finance with pension investment management is contributing to the growth in de-risking strategies globally.

“The times, they are a changing” as Bob Dylan sang. With respect to the legacy challenge of DB pension plans, there are solutions available to plan sponsors that can provide a progressive and innovative answer to their pension challenges. Coming full circle, practitioners now have a greater awareness of specific design impacts from the decisions made in the 1950s.