INSIGHTS
FOR INSTITUTIONAL INVESTORS

SPRING 2016

NATIONAL INVESTMENT ROUNDTABLE

Straight talk on the issues that concern Canadian defined benefit pension plan sponsors

In November 2015, Sun Life Institutional Investments Inc. travelled across Canada hosting five intimate roundtable discussions to find out what's on the minds of some of the country's leading defined benefit (DB) pension plan sponsors. While we've successfully gathered this information in the past through telephone and on-line surveys, we wanted a deeper exchange of ideas and the opportunity for immediate follow-up that a face-to-face forum allows.

While the roundtable participants knew – or knew of – one another in each location, we soon discovered that the opportunity for this type of discussion outside each roundtable participant's own internal circle was rare. The ability to learn what their peers are thinking about and doing turned out to be an appreciated benefit for participating.

Now we bring that benefit to you.

ABOUT THE ROUNDTABLE DISCUSSIONS

- Roundtable participants included board members and staff representing some of Canada's top DB pension plans, with an average of $3.4 billion in DB assets under management. The discussions were moderated by independent global pension expert Don Ezra.
- Roundtable discussions were held in Halifax, Montreal, Toronto, Calgary and Vancouver, November 9 – 19, 2015.
- Public, private, DB, defined contribution (DC), shared risk and multi-employer pension plans and endowment boards were represented.
- As a condition of participation, roundtable participants were free to use the information received, but neither the identity nor the affiliation of the speaker, nor that of any other roundtable participant, could be revealed. We have stayed true to those rules in this summary.

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SHARING THE TOP SIX

Six themes emerged from our discussions:

1. Asset allocation reflects pension plan circumstances

Not surprisingly, we found that the asset allocations made by each roundtable participant reflected the circumstances of their pension plan. What may be surprising to some is the lack of differentiation between pension plans, despite the differences in funded status.

Many studies bemoan the lack of asset allocation differentiation, believing that funded status ought to be more of a driver. We think there is a more subtle explanation.

While there were a few extremes in asset allocation, the allocation for most of the roundtable participants' pension plans focused on something close to a 50/50 split between defensive (or liability-matching) assets and growth-seeking assets. That's because most pension plans look for both defense and growth, so both elements play a significant role in the allocation. It's in departures from 50/50 that we saw a pension plan's circumstances and the plan sponsor's circumstances express themselves.

TOP 6

1. **Asset allocation reflects plan circumstances**
2. **The challenges of today's economic and investment environment**
3. **The importance of risk awareness and risk management**
4. **Key areas of focus in a tough environment**
5. **Decumulation policy – a growing concern for DC plans**
6. **Endowments – less constrained than DB plans in responding to current challenges**

2. The challenges of today's economic and investment environment

After the global financial crisis of 2007-8, few expected financial repression (where governments take measures to artificially depress interest rates, usually to below the rate of inflation) to last as long as it has. But this condition has now become the new normal.

> "Financial repression is the new normal"

Effectively, this constitutes a tax on savers and a transfer of benefits from lenders to borrowers. While the intent is to restore economic growth, institutions like pension plans, for which present and future interest rates are critical, suffer significant negative side effects. For example, a reduction of two per cent in interest rates has the same effect on pension plan funds as leaving interest rates where they would normally be, combined with a one hundred per cent tax on the last two per cent of interest income. Either way, it makes the amount of assets they need to fund their benefits that much larger. The market value of liabilities increases, with a corresponding stress on contributions and/or benefits.

Even though risky assets have, in general, increased in value, roundtable participants indicated that this has not nearly compensated for the increase in liabilities.

In particular, with negative real rates a reality, the possibility of negative nominal rates is being considered by some of our roundtable participants. We heard more than once that there have been, and indeed are, negative nominal rates in many parts of the world. Since we now find nominal rates in the western world so low – even years after the financial crisis – and the global economy far from roaring ahead, the next downturn may well see negative nominal rates contemplated more broadly.

This is, of course, far from a certainty. The global economy is not growing as fast as we want and need, and government debt needs inflation to reduce its real value, but then the cost of the debt rises. So there's no easy solution for governments, and it may well be that we'll simply continue to muddle through.

Roundtable participants observed that we've recently encountered four instances of what previously might have been considered "black swan events":

1. The fall in commodity prices and oil specifically.
2. The slowdown in China.
3. Persistently low to negative interest rates, and;
4. A further, albeit short, Canadian recession, even with interest rates close to zero.

What we once thought of as normal times may yet be a long way off. So, with no prospect of truly higher interest rates, there's nothing to gain by postponing decisions. We may as well make them now – this was a perspective that a number of roundtable participants endorsed. Some roundtable participants explicitly mentioned revisiting their assumptions following the financial crisis.

One consequence of the current environment is that there has been a structural change in liquidity. Due to changes for financial institutions after the 2008 financial crisis, corporate bonds are no longer as liquid as they have been historically. But this is not generally perceived, so there isn't a corresponding premium for the illiquidity. The same holds true for some currencies, where trades in and out can take some time.

3. The importance of risk awareness and risk management

The mantra of our roundtable discussions was risk management, not necessarily risk minimization. Minimization is just one extreme end of the risk management spectrum.

Risk awareness was also a prominent theme. How much risk are we exposed to? Obviously there's no unique measure, and in the absence of an ability to predict the future with certainty, it's necessary for pension plans to explore a number of possible future scenarios.

For that reason, stress tests are now common. This involves considering what would happen to the assets (including specific asset strategies) and liabilities if any number of historical scenarios occurred, including a repeat of the global financial crisis.

More than one roundtable participant is considering what might happen if nominal yields turn negative. As mentioned earlier, what we used to consider "tail risk" is now seen as being much less unlikely than before.

More generally, we asked, what would you do if returns stay low for an extended period? The bottom line thinking was that no strategy can adequately compensate for that environment. But among the far from adequate sources of assistance, the following are being considered by roundtable participants:

- Alpha becomes much more important when returns are low than when returns are high.

- Cap-weighted benchmarks are a convenience rather than a necessity. Other benchmarks, sometimes called "smart beta," may be more appropriate. The whole subject of benchmarks needs to be reassessed.

- The illiquidity premium helps.

- It may be necessary to change a pension plan's design. Reducing future benefit accruals, making inflation-indexing contingent on investment returns, moving to some form of risk-sharing – all of these approaches came up at some point. A significant challenge may arise when stakeholders representing different interests are unable to reach consensus with respect to changing a pension plan's design.

> **"Risk management, not necessarily risk minimization"**

Some roundtable participants observed the need to look beyond traditional measures of credit and equity risk to expand asset class definitions and consider absolute return strategies.

In addition to stress testing, Boards and staff are trying to quantify downside risk. Even if there is no single measure that dominates the consideration of downside exposure, it's still a worthwhile exercise, because it establishes a direction, and Boards need to know how the downside measures are moving.

An interesting consequence may be that, even as Boards seek higher returns, their risk tolerance may decline with increasing awareness of downside risk measures. Some Boards now look at the downside potential even before they consider the expected return from an asset class or strategy. This led to a discussion of a dashboard of factors to report to Boards.

There was also talk of looking at factor exposures, but not a lot of clarity or uniformity emerged in explaining exactly what this means. This is clearly in its infancy, and an area for much future exploration and learning.

In Montreal there was some discussion of the intent and impact of Quebec's Bill 57. Of course, the only genuine solution is for the economic reality to change. There was some discussion of whether, in attempting to alleviate the short-term financial impact on the sponsor, that the legislation might make things worse in the long term.

4. Key areas of focus in a tough environment

This was a large part of our discussions in every location, with conversations ranging widely. Five main themes emerged:

The connection between interest rates and liability-driven investing
As mentioned earlier, low interest rates increase the amount needed to fund DB liabilities and also raise bond prices. But the two effects, while in opposite directions, are not of the same magnitude. Liabilities increase much more than the bond values. And even though risky asset prices rise, the overall funded ratio falls – an effect observed across the country.

Participants who recognize this effect are focused on raising the extent of matching their assets to their liabilities, which effectively means lengthening the duration of their bond portfolios and increasing the allocation to those matching bonds. This is commonly known as liability-driven investing ("LDI").

FOCUS ON 5

1. **The connection between interest rates and liability-driven investing**
2. **The search for uncorrelated asset classes**
3. **Strong disagreement on illiquidity and alternative assets**
4. **Foreign exchange (FX)**
5. **Governance and related issues**

This approach appeals to those who believe that now is the time for decisive action, and also to those who don't foresee any imminent (substantial) increase in rates.

Some have a "glide path" towards increasing the commitment to LDI. In other words, as they see their funded ratio rising (probably through equity gains), they increase their LDI commitment. Their goal, whether explicit or implicit (and it's explicit when the defined benefit pension plan is either closed to new entrants or has its benefits frozen), is to reach or go a bit beyond 100% funding, and see if they can escape from the DB pension plan risk business completely.

Not every pension plan is taking this approach. There are some that are deliberately underweighting long duration fixed income relative to their policy stance. Clearly, they're hoping to see interest rates rise, and their funded status, or the solid status of their sponsor, gives them the luxury of focusing mainly on their assets, because the liabilities will be whatever they are, over the long term. They may have a relatively immature pension plan, or be less sensitive to a volatile funded ratio.

In situations where there's no benefit guarantor – for example, with multi-employer "target benefit" plans – the risk is that the current benefit level isn't sustainable, so LDI may be used as a means of strengthening sustainability.

We saw many examples of the fact that one policy "glove" doesn't fit everyone. The way roundtable participants view interest rate risk is a strong example of this. But regardless of specific reactions, everyone agreed that interest rate risk is a crucial issue for DB pension plans.

> **"Finding genuinely uncorrelated asset classes is a very valuable thing"**

The search for uncorrelated asset classes
One of the unfortunate surprises of the global financial crisis was that, as prices fell, asset class correlations all tended towards 100 per cent and diversification didn't provide its hoped-for benefit. A strong lesson, then, was that finding genuinely uncorrelated (or at least, less than perfectly correlated) asset classes is a very valuable thing. The search for them is going strong in most pension plans.

An interesting angle is that this is more difficult for large pension plans, because they have no choice but to be largely invested in publicly traded assets, whereas the search for uncorrelated asset classes leads inevitably to privately traded assets.

The conceptual argument in favour of relatively uncorrelated asset classes is that, when held in combination, they reduce the total pension plan's risk, whether measured by volatility of returns or volatility of funded ratios. If they also enhance the expected return, there's a "double whammy", and the entire efficient frontier moves towards the northwest (as traditionally drawn). Where does the enhanced expected return come from? It comes from the illiquidity premium that privately traded assets have to offer to attract investors.

It's certainly observed that illiquid asset classes offer relatively low correlations when traditional asset classes are falling together. But, to a greater or lesser extent, some of this is an artificial phenomenon, with illiquid assets appearing to hold steady as a consequence of infrequent trading, rather than because the underlying assets are themselves less volatile. Even though this is fully recognized, some opined that in bad times, help is acceptable from any source and for any reason. Regardless, there is no doubt that the illiquidity premium, which enhances expected return, is real.

Strong disagreement on illiquidity and alternative assets
The contrasting attitudes of roundtable participants towards picking up the illiquidity premium turned out to be the biggest debate of all, with strongly held views on both sides. For this reason, we will be considering this topic at greater length in a separate report.

Foreign exchange (FX)
Canada's pension promises are paid in Canadian dollars. Assets backing the promises are inevitably globally diversified, to a greater or lesser extent. This means that changes in exchange rates relative to the Canadian dollar have an impact when returns are translated into Canadian dollars, and therefore on the funded ratio.

With the dramatic fall in the Canadian dollar in 2015 (and, more generally, with the volatility of exchange rates), exchange rate risk has climbed higher on the ladder of relevant considerations, as the ramifications are significant. Several roundtable participants said that the fact that the Canadian dollar has been falling isn't the relevant long-term consideration – because there are few long-term trends in currencies – it's volatility that matters. For the most part, it's a risk without an expected return for taking the risk, so the question is: should it be hedged?

The considerations for equities and fixed income are different.

One roundtable participant was explicit about not hedging foreign fixed income, because the cost of hedging negates the interest rate differential that they hope to pick up; and that roundtable participant is far from alone in this practice.

But for equities, there is no common position. Some roundtable participants don't hedge their foreign equities, a position defensible with the argument that over the long term, the only certainty is the hedging cost, with no obvious expected gain or loss from foreign exchange movements. So why not simply save the cost?

Another attitude appeals to psychology: whether you hedge or not, at some time you're going to regret it, so let's be 50% hedged. That way, you're never wholly right or wholly wrong, but you minimize your regret.

Roundtable participants generally agreed that it's important to have an explicit belief regarding currency, and then follow it.

"Have an explicit belief regarding currency, and then follow it"

Governance and related issues
There's no doubt that the economic and investment environment has placed an increased importance on good governance. The role of the company's board and or pension committee (referred to as the "Board" in subsequent references) is particularly important because that's where the ultimate responsibility lies. However, the role is neither hands-on nor full-time.

Two aspects came through in all the discussions. One is that the Board's responsibility is to set policy, including the setting of a statement of investment beliefs. While the Board can receive input from others, roundtable participants stressed that once the policy is set, the Board must own it. And when, as is inevitable, there is a year of negative pension plan performance, it's most important for the Board to recognize its ownership of the policy at that time.

This, in turn, emphasizes the importance of the second aspect: the need for Board education. Roundtable participants shared their approaches, which included training/education sessions on governance, investing and onboarding processes. Low turnover of Board members is particularly helpful, allowing them to gain experience through the ups and downs of multiple cycles.

With the demands of multiple pension plans and increased regulation, roundtable participants said that Boards find it difficult to deal with the many complexities they face: the issues are time consuming, often result in the need for additional meetings, and may point to the need for delegation of Board duties.

Providing investment reports to the Board should help provide clarity on issues, but often it does the opposite. Roundtable participants said the level of detail in many investment reports is appropriate for day-to-day professionals rather than a Board charged with the responsibility of oversight. This is a pervasive issue for endowments as well as pension plans.

Another important governance issue arises when there are multiple stakeholders. While stakeholders care deeply, they naturally bring different perspectives to the table. Roundtable participants say that conflicts can occur following poor market returns, when one group of stakeholders may be more at risk than another. When there is no guarantor, for example, with multi-employer target benefit plans, future active members are a group whose interests should be taken into account, via reflection on and analysis of the sustainability of current benefit levels.

This leads to considerations of inter-generational equity, if for example current active members have to shoulder the burden of a large unfunded liability. Communicating with stakeholders and members becomes extremely important.

5. Decumulation policy – a growing concern for defined contribution pension plans

> **"One suggested desirable feature was for plan members of combined DB/DC situations to be able to transfer their DC assets to the DB pension plan, and draw a lifetime income from it"**

Pension plan sponsors have long dealt with accumulation, the front end of the savings and investing challenge. Decumulation, the drawdown phase, is only just starting to assert its importance, but it will grow in importance in the future. It's becoming clearer that while members know what goes into their (DC) accounts, they don't know much about getting money out at the other end. And there are no generally accepted principles to follow.

Plan design in the decumulation phase is important, particularly to create a default option. One approach roundtable participants discussed is allowing some flexibility in the early years of retirement, with any locking-in occurring later. This has the advantage of permitting a retiree to adapt to changing or unforeseen circumstances.

In principle, the notion of deferred annuities as "longevity insurance" was comfortable to our roundtable participants, although such products are difficult, if not impossible, to find. Reference was made to Quebec's D'Amours Committee, which recommended the creation of a longevity pool to pay pensions to Quebec workers from age 75. This is a reasonable age for pooling longevity risk, because it has been demonstrated that by age 75, the financial impact arising from uncertain longevity exceeds the financial impact arising from uncertainty of returns in a 100% equity portfolio – and that much equity risk is more than most people are willing to stomach.

According to roundtable participants, roughly 50% of retiring members are taking lump sums and going into LIF/RIF arrangements rather than a pension because they see the higher initial income, which becomes important in the current regime of low interest rates. Having access to their assets is also important to members. It was ruefully agreed that brokers are doing a great job of telling prospective retirees to take a lump sum.

The fact that in Canada, unlike in other countries, plan members are not permitted to leave their assets in their workplace pension plans was regrettable, as it forces retirees into retail funds that have higher fees and therefore a large impact on the level of sustainable drawdowns.

One suggested desirable feature was for plan members of combined DB/DC situations to be able to transfer their DC assets to the DB pension plan, and draw a lifetime income from it.

6. Endowments – less constrained than defined benefit pension plans in responding to current challenges

Unlike DB pension plans, endowments don't have defined liabilities. But they do have obligations and goals.

A broad (though imprecise) generalization is that an endowment must distribute a minimum of 3.5% of its assets every year, and that the goal is to last in perpetuity – for which, then, it needs to target at least a 3.5% average long-term return, and that becomes a 3.5% average real return if the distributions are to maintain their purchasing power.

Both the real return target and the constant distribution stream mean that endowments focus on DB-like issues in formulating their investment policies, but have more flexibility because of their ability to vary their distributions according to their investment circumstances. This greater flexibility reveals itself in some of the ways in which endowments deal with current repressed conditions.

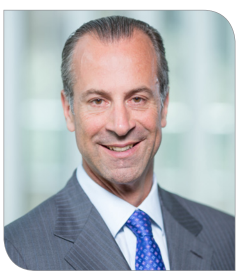
“The greater likelihood that interest rates will rise rather than fall over the long term has caused some endowments to favour equities over fixed income since the financial crisis, as they don’t have to match assets to liabilities”

Whereas DB pension plans react in the short term to their regular filings that reflect accounting rules, no such constraints exist for endowments. They can act as purely long-term investors, and short-term volatility is not their obvious risk measure. Indeed, volatility can even be an ally, enabling them to take advantage of market highs and lows to re-balance to a long-term allocation, locking in gains and buying after declines.

Two aspects of this freedom were revealed by roundtable participants. First, the greater likelihood that interest rates will rise rather than fall over the long term has caused some endowments to favour equities over fixed income since the financial crisis, as they don’t have to match assets to liabilities. Second, some endowments are building a distribution reserve out of high equity returns: they cash in after a rise, and then invest a portion of the proceeds in short-term fixed income to be available for distribution in the near future.

Environmental, social and governance factors are also important. This is particularly true for university endowments, due to their high visibility and public expectations for them to take action. The discussion about these factors revealed that divestment was not considered as effective as engagement. That’s because divestment simply changes the ownership of the shares, whereas engagement can actually make a difference, particularly if a coalition forms. Similarly, negative screening also doesn’t cause a change in the target’s behavior.

CONTACT US:



Carl S. Bang
MBA, CFA

President, Sun Life Institutional Investments (Canada) Inc.

Carl Bang is President, Sun Life Institutional Investments (Canada) Inc., a Sun Life Financial business that offers investment solutions to defined benefit pension plan clients and other institutional investors.

carl.bang@sunlife.com | 416-204-3855

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Roundtable discussions with pension plan sponsors that form the basis of this paper were conducted by Sun Life Institutional Investments (Canada) Inc. from November 9 – 19, 2015 and held in locations in Halifax, Montreal, Toronto, Calgary and Vancouver.

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