Canadian Pension Risk Management

Coping with Low Interest Rates and Increasing Volatility

Sponsors

BlackRock Asset Management Canada Limited
161 Bay Street, Unit 2500
Toronto, ON, M5J 2S1
Eric Leveille
Managing Director, Head of Canadian Institutional Business
+1 (416) 643-4000
Eric.leveille@blackrock.com
www.blackrock.com

Phillips, Hager & North Investment Management
200 Burrard Street, 20th Floor
Vancouver, BC V6C 3N5
John Skeans
Vice President
+1 (604) 408-6238
jskeans@phn.com
www.phn.com

Pyramis Global Advisors (A Fidelity Investments company)
483 Bay Street North Tower, 3rd Floor
Toronto, Ontario M5G 2N7
Michael Barnett
Vice President, Institutional Distribution
1 (800) 817-5448
Michael.barnett.pyr@pyramis.com
www.pyramis.com

Sun Life Financial
225 King Street West
Toronto, Ontario M5V 3C5
Heather Wolfe
Managing Director, Client Relationships,
Defined Benefit Solutions
+1 (416) 408-7834
heather.wolfe@sunlife.com
www.sunlife.com

TD Asset Management Inc.
161 Bay Street, 34th Floor
TD Canada Trust Tower
Toronto, Ontario M5J 2T2
Mark Cestnik, CFA
Managing Director
+1 (416) 983-7088
mark.cestnik@tdam.com
www.tdam.com

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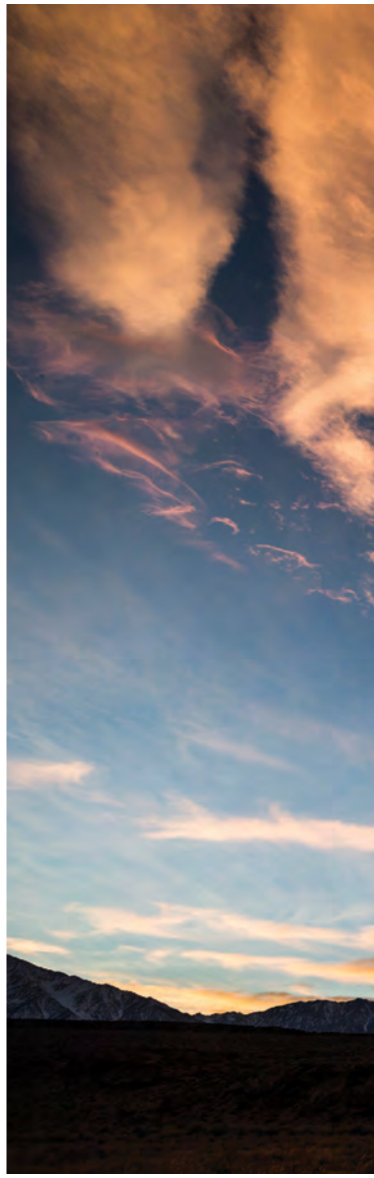
The De-Risking Challenge



In Canada, pension risk management means taking any and all steps to keep funding volatility under control — LDI, low-volatility equity strategies and even considering longer-term solutions

We all know the saying, "What a difference a year makes." For Canadian defined benefit pension plan sponsors, 2014 was not a banner year. Many gave back at least some of their hard-won funded status. "In 2013, everyone was happy with their pension plans because in Canada, we saw tremendous increases in funded ratios," says William da Silva, Senior Partner and Practice Leader, Canadian Retirement Consulting at Aon Hewitt. "We gave a chunk of that back in 2014. It shows why risk is important: it paid to take risk in 2013 and not in 2014. And even early in the year, it is pretty clear that risk continues to affect pension plans."

While the overall numbers aren't dire, it is clear that some plans gave back substantial sums in terms of funding levels. "In a survey performed by Aon Hewitt, the median solvency level of its clients' Canadian DB plans declined from 93.3% at the start of 2014 to 90.6% at Dec. 31," says Brent Simmons, Senior Managing Director of Defined Benefit Solutions at Sun Life. "As many plan sponsors are close to or fully funded, they should look for risk management solutions to crystallize their good funded positions and avoid bad news in the future."

All pension plans have been suffering from increased volatility brought on by economic uncertainties, oil price reversals and currency issues. And that's even after another good year in the equity markets.

All this unease has brought pension risk management to the forefront at Canadian defined benefit plans. It's not that plan sponsors haven't learned their lessons. "The financial crisis taught pension plans that the traditional, one-size-fits-all 60% equity/40% bond asset mix contained more risk than many of them realized," says Sun Life's Simmons.

Economic uncertainty

In the past six years, Canadian plans have considered and adopted a range of pension de-risking strategies. It's just that recently, the financial and economic environment has been particularly unwelcoming, even to those that were well on their way to full funding. "We see volatility and economic uncertainty as two clear themes within the Canadian and global capital markets landscape," says Michael Augustine, Vice President and Director of TD Asset Management. "Both themes continue to have a significant impact on defined benefit plan funded levels. Last year around this time, funding levels dramatically increased for many plans. Since then, some plans lost ground, and that trend certainly continues in 2015."

Life in the pension fast lane is not being helped by world economic conditions. "We are seeing wild swings in currency levels," says TD Asset Management's Augustine. "More topical in Canada is the dramatic drop in oil prices, which is transferring through monetary policy into even lower interest rates."

"Canada is a resource-based economy," continues Augustine. "Oil and gas extraction accounts for only about 6% of our gross domestic product, but what's more important is oil and gas sectors' contribution to broader business investment, which is more in the range of about 30%. What is clearly on the Bank of Canada's

radar is this concentration of Canada's economic prosperity as it relates to what happens in the resource sector."

It means that investment managers are spending more time discussing the impact of economic events on pension plans. "The traditional risk that gets the most attention is interest rate risk," says TD Asset Management's Augustine. "Because of the diverging central bank monetary policy between Canada and the U.S., we are seeing more movement in the shape of our yield curve. So now we are talking about more than just general interest-rate risk with clients."

Volatility unwound

That said, few investors aren't scrutinizing the rate landscape critically. "Interest rates have been punishing pension plans again," says Aon Hewitt's da Silva. "Last year, discount rates fell by anywhere from 60 basis points to 90 basis points. It was a shock when the Bank of Canada took overnight rates down by 25 basis points in January. And we've seen continued pull-down in terms of long yields."

Even though Canada may not be following the same monetary route as its southern neighbor, the changing approach to policy globally is having a noticeable effect. And it's one that won't subside soon. "As the non-conventional monetary policy that has suppressed volatility is becoming unwound, we expect to see more volatility going forward," says TD Asset Management's Augustine.

Volatility isn't the only risk that pension plans face. In fact, Canadian plan sponsors are well aware of the range of risks they face. "Risk management is of increasing importance to our clients," says Rachna de Koning, Vice President and Director of TD Asset Management. "It's on everyone's agenda and it is a high-priority item — for both public sector and corporate plans."

For pension plans, though, the range of risks they face can be understood through a critical metric. "The biggest risk that pension plans face is surplus risk — the mismatch between the liabilities and the assets," says Eric Leveille, Managing Director at BlackRock. "In surplus risk, you have the investment risk and liability risks, including both interest-rate and longevity risk. We see plans focusing on both now more than ever. Surplus risk is addressed through the strategic asset allocation over the long term."

Surplus risk, while encompassing the many risks that plans face, doesn't affect all corporate plan sponsors in the same fashion. "DB pension plans can have a significant impact on a company's business," says Sun Life's Simmons. "Managing pension risk is especially important for plans that are large compared to the size of the sponsoring employer's business."

"For most Canadian corporations, the pension plan is not a core business," says François Pellerin, LDI Strategist at Pyramis Global Advisors. "This results in a lack of appetite for pension funded status volatility. That is why we are seeing more interest in pension de-risking strategies, including hibernation — where risk is internally managed, or risk transfer — where risk is taken on by a third party."

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Canadian corporate sponsors are looking at some of these strategies because risk in the pension plan is an issue that they feel they can control. "Many DB plans are closed and aging, so their ability to make up shortfalls from contributions from new members and their ability to weather the ups and downs of markets is not as great," says Paul Martin, Vice President and Portfolio Manager at Phillips, Hager & North Investment Management. "In addition, many plans have recovered from the 2008 credit crisis and are now approaching or have achieved full funding. Closed plans that have bridged their funding gaps have less incentive to take risk than they might have had in the past. So risk management is more important than ever."

Disincentive removed

Recent accounting changes are also changing the picture for corporate sponsors. "Many Canadian plans report under the International Financial Reporting Standards, so the recent IAS changes will affect them," says Sun Life's Simmons. "The removal of the ability to take credit for future expected equity outperformance has removed an important disincentive for plan sponsors to reduce the amount of equity in their pension plan."

The accounting changes can also have effects that go beyond the pension plan. "Recent changes to IAS also require plan sponsors to record the funded status of the DB plan on the balance sheet and reflect any changes immediately," says Sun Life's Simmons. "This requirement to mark the funded status to market can create a lot of balance sheet volatility for companies with equity in their pension plans, and can negatively affect existing loan covenants and the management of capital ratios."

Again, the changes at the enterprise level are not felt equally across all sizes of corporation. "What IAS basically did was move the volatility off the P&L onto the balance sheet," says Aon Hewitt's da Silva. "For a lot of organizations, that is a better place for that volatility. For others, it is still problematic, because they may have equity issues or debt covenants that are impacted. These are usually jumbo plans."

"Most plan sponsors have been focused on managing equity and interest-rate risk, as both of these risks can create volatility in cash contribution requirements and earnings-per-share for plans that are not investing their assets to match their liabilities," says Sun Life's Simmons.

Contribution pressure removed

However, one relatively good effect is that the pressure to increase contributions has decreased. "The relaxation of the rules around solvency — the solvency test — has made a difference," says Phillips, Hager & North Investment Management's Martin. "In some jurisdictions, it's been temporary relief, and in others, it's been more long term. But it has materially reduced the need for some plans to make extraordinary contributions or fund benefits."

All these changes have increased the transparency for corporations in making pension-related decisions. "We now see different discussions when it comes to accounting vs. funding," says TD Asset Management's de Koning. "There's a clearer separation between decisions regarding the level of pension benefits a company can afford and decisions about how those benefits will be financed. In the past, accounting obscured the separation and skewed companies toward an asset mix in favor of risky assets."

The Canadian regulatory landscape has altered and continues to do so, but equally the investment environment is also changing. For both corporate and public plan sponsors, the risks associated with investing seem to be rising, but investment managers have developed solutions that mitigate these risks in novel ways.

"In the shorter term, investment risk is much more predominant," says BlackRock's Leveille. "Equity risk has always been followed, but today there's more focus on interest-rate risk, inflation (or disinflation) risk, even though there isn't any inflation, liquidity and longevity risk. It can also include idiosyncratic risk from the active managers a plan may hire."

Not the norm

One of the main trends across all asset classes is globalization, using diversification across markets as a risk management tool. This trend extends to the benchmarks used. "We see plans moving to global benchmarks," says BlackRock's Leveille. "They are simplifying their globalization. The Canadian allocation 15 years ago was probably 30% to 40%; now it's more like 20% and trending down. We have clients that have gone to a 100% global allocation. It's not the norm, but a few clients have done it."

"Global diversification in Canadian plans began 10 years ago with the elimination of the foreign property rule, and it's still ongoing," says Phillips, Hager & North Investment Management's Martin. "So today the average plan has more global equities than Canadian equities, and I think that trend will probably continue. It will also continue in other return-seeking strategies — private equity, infrastructure, liquid alternatives — because you don't have the breadth of choice in those strategies if you stick within Canada."

As pension de-risking gains an even larger foothold in Canada, plan sponsors are implementing new fixed-income strategies. By developing glidepaths and using liability driven investing, many plans are increasing or intend to increase their fixed-income allocations, particularly at the long end. (See story, page 10) But rates remain low, so this can be a difficult decision. "Some plans are looking at global or non-domestic fixed-income mandates as a way to diversify some of their Canadian credit exposure," says TD Asset Management's de Koning. "And interestingly, clients are then asking, what is that mandate going to do to my LDI strategy and how can we manage around these new mandates? It's all part of the shift from managing to market-based indices to benchmarking to the underlying liabilities."

Broadened skill-set

This development marks a change in investment philosophy, which should open up the range of strategies and instruments used by plans in their fixed-income portfolios. "The combination of likely bond market evolution and a change in the focus of pension funds to funding levels and risk management is shifting fixed-income allocations away from traditional benchmarked funds and towards fixed-income solutions," says Pyramis Global Advisors' Pellerin. "For successful delivery of these solutions, bond managers must broaden their thinking and skill-set: a flexible investment approach, deeper research capabilities and a larger tool box, including derivatives, are vital in order to add value and manage risk for pension schemes."

The rise of asset-liability focused investing pushes plan sponsors to consider new benchmarking strategies, for both hedging and return-seeking portfolios. "Going outside Canada for fixed-income exposure does mean that you are taking benchmark risk," says TD Asset Management's Augustine. "But on an absolute return basis, there is a diversification potential, so you get a better risk-adjusted outcome. But this needs to be considered within an asset-liability framework because they may have already made a commitment to LDI."

"For many smaller pension funds, the traditionally benchmarked, more rigid investment strategies that worked well in the past may not necessarily do so in the future," says Pyramis Global Advisors' Pellerin. "The major shortcoming of fixed-income benchmark-driven investing is that the benchmark often reflects the size of the largest issuers of debt — it is liability weighted. More efficient ways of capturing market risk, under the moniker of 'smart beta,' are becoming more widely adopted by institutional investors."

The need for yield — again even in the hedging portfolio — can push sponsors farther afield. "As plan sponsors increase their fixed-income allocations, we've also seen an increased interest in alternative asset classes to enhance yield," says Sun Life's Simmons. "Asset classes such as real estate, commercial mortgages and private fixed income are gaining in popularity."

Measured bets

Of course, the most progressive developments in terms of diversification are found in the return-seeking portfolio, which remains a significant portion of many asset allocations when the plan is open. "Growth in assets is still an important need for some plan sponsors," says Rachna de Koning, Vice President and Director of TD Asset Management. "Many need to close a funding gap, or for those in the public sector, make sure that they can provide the benefit promise in the long term. Some plan sponsors are thinking in terms of uncharted territory, such as alternatives, real estate, private debt and private equity. These asset classes require a level of due diligence that many never really had to think about before. Li-

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quidity risk is one of the issues. Also, there's more transparency risk here, a new kind of business risk that underlies these investments. It's a learning experience, investing in these areas."

"Virtually all plans continue to have significant allocations to return-seeking assets, and that's likely to remain key because of the need to generate returns," says Phillips, Hager & North Investment Management's Martin. "In addition to equities, Canadian plans have embraced real estate, and to a lesser extent, private equity, infrastructure and other more liquid alternatives such as credit strategies."

The move into diversifying asset classes does require more consideration and due diligence. "Clients are more mindful of what type of strategy they are in," says TD Asset Management's Augustine. "Illiquid assets can certainly be one of those strategies and harvesting illiquidity premiums can definitely contribute to a plan that is looking to offer more on a going concern basis. Some plan sponsors may have future goals that include glidepathing toward purchasing annuities, and in those instances, they may be thinking differently about the liquidity of those assets."

Alternatives aren't the only asset class that prompts liquidity concerns. "Liquidity risk needs to be considered in terms of credit — trading high-yield and corporate bonds," says BlackRock's Leveille. "The spreads are wider than they used to be. If you need to rebalance, that can be costly, so liquidity needs to be considered."

Liquidity concerns

Liquidity can also be a plan-wide, rather than simply an investment-related, risk. "What happens when a plan's benefits payments become larger than their contributions?" asks BlackRock's Leveille. "Liquidity may be a problem if you have large allocations to illiquid assets like real estate and infrastructure. It's a newer phenomenon, but it does mean that plans are becoming more aware of their liquidity needs."

Overall, most of the change in investments still occurs within the alpha-generating or return-seeking portion of the pension portfolio. "Increasing asset-class diversification is also another risk management trend," says Pyramis Global Advisors' Pellerin. "On the fixed-income front, for example, we see some plan sponsors adding asset classes such as emerging market debt, high-yield debt, floating-rate debt and global bonds. But it is important to note that we mostly see these asset classes as 'return-seeking' rather than 'hedging' assets. That's because although they are fixed-income assets, they exhibit what we call 'dirty duration,' because during tail-risk events, that duration may not result in effective liability hedging."

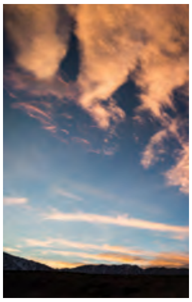
Globalization is also a feature in the selection of alternatives. "Canadian plans are moving away from the typical public equity markets into alternative asset classes," says Aon Hewitt's da Silva. "Real estate is the main one, but that is becoming less alternative and more mainstream even with smaller plans as managers scale their offers to levels that allow even smaller plans access into the asset class. We are seeing more plans look globally within their real estate allocations as they believe there are better opportunities elsewhere given how much Canadian real estate has appreciated recently."

The view across other alternative sub-asset classes is following that of real estate. "Canadian DB plans embraced domestic real estate a long time ago and now they're looking globally," says BlackRock's Leveille. "The trend is similar with infrastructure. Demand also remains strong for private equity. And we're starting to see demand for what I'd call illiquid credit. This is the outcome of regulatory change, which allows the private market to step in and provide credit in the same way that banks historically did. Plans that are looking for better returns from their fixed-income portfolios are considering this approach."

"A decade ago, 30% of Canadian DB pension assets were invested in domestic equities," says TD Asset Management's de Koning. "Now that has gone down to 15%, with the balance flowing to global alternatives. There are fewer regional mandates and more global equity new mandates, though not a huge increase in overall equity assets, as more assets are going into alternatives."

Plan purpose

Canadian plan sponsors are readjusting their approach to plan management in the wake of the economic, investment and accounting changes that have occurred and are occurring. These



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changes have significant implications for risk management. "The philosophical shift we have seen in the U.K. as to the purpose of the pension plan is gaining traction in Canada," says Sun Life's Simmons. "The old view said that the purpose of the plan was to make bets on markets and take risks. The pension plan mismatched its assets and liabilities in an attempt to generate excess returns. The new view says that the plan exists to provide promised benefits. Risk is better taken in a company's core business, where the company has a competitive advantage. The pension plan should match its assets and liabilities closely, and not be a source of surprises."

In order to match this philosophy with practice, Canadian plans are broadening their use of risk monitoring methods. "Canadian pension plans are still monitoring their plans using traditional, asset allocation-based approaches," says Paul Purcell, Managing Director at BlackRock. "But they are supplementing these with a lot of other measures. There's nothing wrong with looking at your asset mix by capital allocation and return vs. benchmarks, unless that's all that you're using. But if you're supplementing that by looking at your exposures across different risk premia, and looking at your surplus and liquidity risk, monitoring your active risk budget and monitoring your interest-rate hedges, then you are getting a broader picture. Overall, I think many pension plans have greatly improved their risk measurement and monitoring efforts."

Independent risk factors

Other managers agree, though warn of the difficulties that some of these monitoring methods raise. "I expect that setting policies based on target weights and different asset classes is likely to remain the dominant way of looking at asset allocation because it is relatively easy to understand," says Phillips, Hager & North Investment Management's Martin. "Though there is a lot of benefit to looking at different independent risk factors it's pretty complicated to measure and monitor on a regular basis. Only the biggest and best-resourced plans are currently able to do that. I should mention that this can also be a very effective tool for investment managers to use within multi-asset class investment strategies."

The shift has implications for committee behavior. "We are talking to our clients about changing the conversation at the committee level," says Aon Hewitt's da Silva. "Rather than spending most of the time discussing what happened in the last quarter, we're starting to switch the discussion to what is on the one- to three-year horizon and what strategies should we be putting in place to get you to capitalize on these views in the context of your ultimate end state. This especially supports clients with trigger strategies that want to know when those triggers might be hit so they can prepare."

Not surprisingly, for some committees, all this work is just too much. That can mean searching for a more comprehensive solution, particularly if the plan is not a core issue for the sponsors. "For those plans that are closed or frozen, we see more and more of them moving to a more delegated approach," says Aon Hewitt's da Silva. "This can be in the form of a diversified growth fund, where the manager is given, for instance, the return-seeking bucket and asked to run with it. We've seen this approach gain some traction in the U.K. As pension management evolves, the investment decisions are becoming more sophisticated and more tactical, and many committees are realizing that they just can't keep up. So they are stripping down decision making at the organizational level to be more strategic."

It's a sign that many plans are taking a fundamental look at their pension oversight methods. "Each organization is looking at their risks," says Aon Hewitt's da Silva. "Some are saying that they have the skills to manage those risks. Others are saying that they can manage some, which they will retain, but will have someone else manage the others." ■

LDI Grows Up

As plans see light at the end of the funding tunnel, sponsors know that liability driven investing is key to achieving their risk management goals

One thing that the global experience with liability driven investing tells you is that it isn't a strategy, it's a solution, a process, a prism through which plan sponsors can better see and manage the risks associated with their plan. "What LDI tells you is that the main risk you should focus on is the ability to make the payments that you have promised your investors," says Paul Martin, Vice President and Portfolio Manager at Phillips, Hager & North Investment Management. "To break that down a bit, the two biggest risks are clearly interest-rate risk and equity market risk. Interest-rate movements in the past few years have driven home people's understanding of how great a risk that can be. Inflation and longevity risk can be relevant to some, but also more difficult to target."

In Canada, defined benefit plan sponsors now have a clear view of these risks — and are using LDI to mitigate them. "Compared to five or 10 years ago, there is a substantially better awareness of asset-liability risk," says Paul Purcell, Managing Director at BlackRock. "There's been a quantum leap around understanding LDI. In terms of implementation, though, there hasn't been substantial elimination of interest-rate risk, given where long rates are at. So it's more awareness than actual implementation."

The fact that LDI is a process, not a point-in-time solution, is important to remember. One of the key steps along the way is for plan sponsors and those that oversee them to understand what risk actually means. "LDI investors are often characterized as people who don't want to take risks," says François Pellerin, LDI Strategist at Pyramis Global Advisors. "That's not true. What they don't like is risk that isn't compensated. Equity risk is compensated, so for a plan that is not well-funded, it may be right to have a significant allocation to equities, for example. But diversification is a powerful risk management tool, which may mean a tilt toward more global equities."

LDI got a shot in the arm from the accountants recently. "The adoption of IAS 19 has helped to promote the implementation of LDI," says Pyramis Global Advisors' Pellerin. "The concept of expected return on assets has historically been an impediment to LDI adoption, so the new accounting standards have helped on that front. A counter-argument, however, is that gains and losses are now not systematically recycled through the income statement."

It's also important to remember that the Canadian pension landscape differs from others that have a high takeup of LDI. "Canadian pension plans are more active, less frozen than those in the U.S.," says Pyramis Global Advisors' Pellerin. "That may be one reason why the adoption of LDI in Canada seems to somewhat lag that of the U.S. Low interest rates are another impediment to LDI adoption in both countries."

That doesn't mean that Canadian plans are eschewing the strategy. "Very few Canadian sponsors don't have an interest in LDI as a pension risk management tool," says Pyramis Global Advisors' Pellerin. "While 10 years ago, more sponsors were comfortable operating in an asset-only environment, we now see an increased focus on funded ratio risk. The concept of de-risking as you become better funded is quite alive in Canada."

Viable solution

Implementation of LDI, as opposed to identifying the need for it, often starts with a larger dollop of longer-term bonds. "I think LDI is a tool in the overall risk management toolbox, but it is not the only tool," says William da Silva, Senior Partner and Practice Leader, Canadian Retirement Consulting at Aon Hewitt. "It's prevalent in the market. But for some that just means implementing smarter fixed income strategies, needing to be longer in bonds because it will provide a better match to the liabilities. It's just that not everyone is executing because of the low interest-rate environment."

Canadian plans might usefully look at the history of the insurance industry to see how LDI can be implemented. "Some Canadian plan sponsors are recognizing that they are really running a mini-insurance company and are looking at the strategies that insurers use to manage pension risk," says Brent Simmons, Senior Managing Director of Defined Benefit Solutions at Sun Life. "Insurance companies are the original LDI adopters, with their strict regulatory requirements and risk frameworks leading to very close matching of assets and liabilities."

For many pension plans, LDI is a process of getting from here to there, with here being a more traditional asset-focused, 60/40 asset allocation to a relatively immunized, fully funded position. That process can be greatly helped by developing a glidepath or a roadmap that increases the percentage of assets that match liabilities over time. There are several ways to construct a glidepath, with the most common one relying on interest-rate triggers. When rates reach a certain point, the plan takes prearranged steps to de-risk by, for instance, purchasing additional long-duration bonds.

The problem is that few interest-rate triggers have been reached lately. "Many of our clients and prospects already have a glidepath in place," says Pyramis Global Advisors' Pellerin. "But many haven't met their funded status triggers because rates have been rallying. Most plans' funded status has gone down since last year as good equity returns have not been enough to counterbalance lower rates."

There isn't just one way to de-risk. "One size doesn't fit all — that's a phrase that gets used a lot around LDI," says Michael Augustine, Vice President and Director of TD Asset Management. "One glidepath might be right for one company but not for another. Each plan sponsor has a different risk tolerance level. Some might want a time-based plan, essentially a dollar-cost averaging strategy. Others want to be a bit more tactical and take advantage of any tailwinds they can get from movements in interest rates. The most progressive glidepaths are focused on total plan funding, and want to be nimble and ready to act when they are better funded."

Others are concerned that they may lose a first-mover advantage. "There is only so much long bond product in the market," says Aon Hewitt's da Silva. "There is a school of thought out there that believes there are lots of people on the side-lines waiting and every time yields pick up, there's buying on the long end that drives yields lower. We've seen this before, where at times the yield curve doesn't make sense; the long end of the curve trading at lower yields than mid-term bonds. Not everyone subscribes to this story, but some plans are saying we just need to get in, even though rates are low."

Time-based triggers

A broader focus can help in these low-interest-rate times. "Despite the fact that interest rates fell during the year, people were saying they couldn't sit on the sidelines any longer," says Rachna de Koning, Vice President and Director of TD Asset Management. "So if we have a glidepath, it must have time-based triggers in it. And we saw a lot more implementation in 2014 than in 2013."

As investment volatility increases, plan sponsors seem increasingly unwilling to accept the associated risks, but now they are being more specific in their demands of investment managers. "We see LDI being on the rise among Canadian plan sponsors," says TD Asset Management's Augustine. "What is changing is the demand for more customized solutions. We see people making a fundamental shift within LDI to actively managing to their liabilities."

"There's definitely a greatly increased awareness of the relevance of changes in liability values because of market movements," says Phillips, Hager & North Investment Management's Martin. "That's part of LDI, but not all of it. LDI is a process of managing assets against liabilities. Some plans have set out a glidepath to increase the duration of their assets over time, because they are unwilling or unable to put a whole lot of money in long bonds at today's interest rates. What we are seeing more of is the use of custom liability benchmarks."

It's the use of these custom benchmarks that signals most decisively the coming of age of Canadian LDI. "We're starting to see a greater use of liability benchmarking," says BlackRock's Purcell. "Instead of translating your liabilities into existing asset class benchmarks, plans are actually using their liability cash flows as their benchmark and designing a fixed-income portfolio around that. Five or 10 years ago, it would have been more challenging to do this from a technology perspective, but it's much easier today."

The request for customization reflects some of the shortcomings of asset class indexes. "A lot of the request for proposal activity we saw last year was related to customized LDI solutions," says TD Asset Management's de Koning. "So clients are demanding a lot more from us as their LDI investment manager. They want us to actively manage to a liability benchmark, which is a recognition that published benchmarks don't capture the risks they want to manage."

Customization isn't appropriate for all plans. "If you are only hedging 30% of your interest-rate risk in your liabilities, then you don't really need a liability benchmark because you're not at that level of precision," says BlackRock's Purcell. "You've got so much other risk in your portfolio, it probably isn't worth the effort. But as you get closer to hedging all of your interest-rate risk, you're definitely going to want to be more precise and therefore look at a liability benchmark approach."

Enhanced returns

There can be other reasons to hold back from too much liability matching. "Many plan sponsors would like to reduce risk, but are reluctant to give up potential future returns," says Sun Life's Simmons. "Investment strategies that combine risk management with enhanced returns are in demand. Sponsors are considering alternative fixed-income-like investments, such as private fixed income, commercial mortgages and real estate, as a better way to match assets to liabilities while still enjoying higher returns."

"More plans are beginning to introduce unconstrained fixed income strategies," says Aon Hewitt's da Silva. "Plans continue to look for ways to lengthen duration, but also giving managers some leeway in terms of enhancing yields. That can mean going global, using emerging market debt or even going private. There's definitely a greater appetite to look for more yield while still maintaining some desired level of downside protection."

Plans have sat on the fence and not adopted LDI, others that have adopted it see opportunity in today's current financial environment. "Because of the long period of low interest rates, we are starting to see some plans re-risking," says Eric Leveille, Managing Director at BlackRock. "For instance, if long bonds are giving me 2.5% yield today, and I can get more with another fixed-income product that is shorter duration, then I might choose to take that deliberate risk. Re-risking is not widespread, but we are starting to hear more on the topic."

That said, most plan sponsors that adopt LDI do so with some endgame in mind. "Some plan sponsors are using LDI as a powerful transition strategy for a future pension risk transfer transaction, by adjusting their asset portfolio to be more like an insurance portfolio, reducing their investment risk in the interim period before they buy annuities," says Sun Life's Simmons.

The endgame may be pension risk transfer — moving the pension liability off the balance sheet completely — or it may be hibernation. "Hibernation is a term associated with the retention and management of pension risk for frozen plans," says Pyramis Global Advisors' Pellerin. "It's for a plan that you'd rather not have on your balance sheet, so you 'put it to sleep' via a tight risk management program. This concept is somewhat more popular in the U.S. vs. Canada, as a greater proportion of Canadian plans are closed rather than frozen." (For more on pension risk transfer, see story, page 12.)

Others concur. "We are hearing more and more about hibernation," says TD Asset Management's Augustine. "We find that this idea is coming out of more mature pension risk management frameworks in the U.S. or the U.K. Plan sponsors are evaluating the full risk transfer approach and weighing that against taking a frozen plan and putting it into hibernation. That can be a better solution for some clients."

Even with all these choices, each plan will follow its own course. "More plan sponsors are realizing that their traditional asset mix and the various capital allocation tools they have to work with are not necessarily aligned with their unique liability profiles," says TD Asset Management's Augustine. "As more plan sponsors learn about liability benchmarking, there is more of a focus on outcome-focused investing. The largest plans take this a step further and embed their pension plan within their broader enterprise risk management framework. So they look at whether there are offsets to the pension risks within the business, or whether they may exacerbate risks that they already face." ■

The Longevity Solution

More Canadian plans are considering how best to tackle the endgame — with both pension risk transfer and hibernation on the table

For many corporate plan sponsors, in Canada as elsewhere, the defined benefit pension plan does not play a large part in their vision for the future. In fact, there is considerable appetite to find ways to de-risk the plan so corporate executives can focus on core businesses. Pension management, particularly risk management, is not often a core corporate business.

Luckily, it is now perfectly possible to de-risk a defined benefit plan, close or freeze it, put it into hibernation or even transfer the entire plan to an insurance company. The only caveat here is that to complete any of these transactions, the pension plan needs to be fully funded. And there's the rub.

Yet, thanks to some satisfying equity returns, among other trends, more and more Canadian plans, either through being fully funded, or with a little help from corporate contributions, are able to contemplate pension risk transfer or hibernation. "We're seeing an increased interest in de-risking play out in the market," says Brent Simmons, Senior Managing Director of Defined Benefit Solutions at Sun Life. "2014 was the largest Canadian group annuity market on record, and pension plans are shifting out of equities into bonds."

It's part of a global trend. "Pension de-risking is at the forefront of corporate pension decisions all around the globe," says Sun Life's Simmons. "U.S. pension risk-transfer volumes were over $8 billion in 2014, surpassing the $3 billion to $4 billion of transactions completed in 2013. In the U.K., volumes were over £30 billion in 2014, almost doubling 2013's record volumes of £16 billion."

"With the continued trend of plan sponsors closing or shrinking their DB pension plans, we expect the Canadian risk transfer market to grow in 2015," continues Simmons. "Many plan sponsors are planning for a transaction this year, by educating their stakeholders, lining up their governance processes and adjusting their asset portfolios."

Regret risk

As Simmons suggests, pension risk transfer is not a simple process. There are many stakeholders that need to be consulted and a series of fiduciary issues to be considered. But that said, it can still be an attractive proposition. "Since many plans now find themselves close to or fully funded, sponsors are also concerned with managing regret risk — the risk that they will find themselves facing another funding shortfall (and all the volatility that brings) if they don't take action now," says Sun Life's Simmons.

"We do expect that pension settlements will be implemented by a lot of organizations once their plans are fully funded," says William da Silva, Senior Partner and Practice Leader, Canadian Retirement Consulting. "But after setbacks in 2014 with funded status, there may be a pause in 2015 unless interest rates come back a bit. If a plan is 95% funded, then the delta to full funding is relatively small as compared to a plan that is now 85% or 90% funded. To fully settle their liabilities, plan sponsors are asking are the additional funds needed to settle the best deployment of cash?"

Cost is certainly an issue, with many companies having to top up plans to reach full funding. "The trend for pension settlement might continue," says François Pellerin, LDI Strategist at Pyramis Global Advisors. "Given where rates are, it is currently costly to transfer risk. But paying a premium to lighten the balance sheets through annuity purchases is a de-risking strategy worth considering."

"In our experience the pricing of pension settlements is quite volatile in Canada," says Aon Hewitt's da Silva. "But the insurance industry has come a long way over the last two years and is gearing up for a bigger play in this area."

The trend has not yet overrun the market though, with some suggesting that insurance capacity may hold back development of the business. For a Canadian plan to complete a risk transfer, they must partner with an insurer licensed in Canada. "The pension risk transfer remains a relatively small but growing part of the market," says Paul Martin, Vice President and Portfolio Manager at Phillips, Hager & North Investment Management. "It appeals primarily to closed corporate plans. The capacity of insurers to provide those buyouts in Canada is increasing, but still pretty limited as well. So though a relevant and increasingly important part of the market, I think it will remain relatively small mainly because of the limited capacity."

The issue of capacity may be more nuanced. "Insurance capacity does not seem to be a problem at this point," says Pyramis Global Advisors' Pellerin. "But capacity comes in different forms. For example, insurance companies' balance-sheet capacity needs to be looked at. As importantly, the capacity of the bond market to absorb these deals needs to be considered. High-quality bonds are the sweet spot of insurance reserve requirements, and at some point, bond supply may become an issue. So the capacity picture could change."

Annuity buy-in

Full pension risk transfer is probably the desire of many companies contemplating the process.

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After all, removing the plan completely from the balance sheet is probably the most attractive proposition. Yet few transactions are completed in one go. It is possible, and often easiest, to carve out a tranche of participants such as retirees and transfer those risks. "Plan sponsors are using annuities strategically to right-size their plans and make them sustainable, or to facilitate a full plan windup," says Sun Life's Simmons. "For the second year in a row, the 2014 pension risk transfer market is the largest on record, with estimated premiums of C$2.5 billion."

It is also possible to use annuities within the plan's asset allocation, without transferring any risk permanently. "Canadian plan sponsors have embraced the flexible annuity buy-in solution, with over 25 deals done since the solution came to the country in 2009," says Sun Life's Simmons. "In contrast, there have only been two annuity buy-ins completed in the U.S."

In a low-interest-rate environment, these structures have advantages. "Annuities are also being viewed as an alternative fixed-income strategy that can provide similar or higher returns than a typical bond portfolio, while providing investment and longevity risk for free," says Sun Life's Simmons.

The market for buyouts, buy-ins and pension de-risking of all varieties was impacted by the introduction of the first Canada-specific mortality tables by the Canadian Institute of Actuaries. "We had new mortality tables introduced in Canada last year," says Paul Purcell, Managing Director at BlackRock. "The effect on the funded ratio is nuanced because of the different types of valuations and different tables used, but for going-concern funding valuations, a 5% increase in liabilities is a rough rule of thumb that people have tended to use. It's significant."

"The new mortality tables in Canada are making pension plans more expensive in the short-term," says Pyramis Global Advisors' Pellerin. "But if you were thinking of transferring your plan to an insurance company, chances are the new tables won't have much of an impact. What the new mortality tables in Canada and the U.S. are doing is reflecting better longevity expectations. Insurance companies have already done this."

"We are seeing more play in the market around longevity risk," says Aon Hewitt's da Silva. "Pension plans have looked at their capital market risk, and developed strategies to manage equity and interest-rate risk. The next big risk is longevity. The new national mortality tables mean an increase in liabilities for most plans. We are seeing increases from 3% to 6%, 7% or even 8%."

"There are two parts to the mortality tables," da Silva continues. "There is the base table, which is saying that people are living longer than ever previously anticipated, and the projection of that base table, which shows how the increase in life expectancy is expected to increase more. Putting it in a global context Canada has had slightly better improvements in mortality than other developed nations."

"The new mortality tables may increase your accounting liability by, let's say, 5%," continues Pellerin. "So the premium you would have to pay an insurance company to take over the plan probably isn't about 10% over accounting liability anymore, but rather 5% over."

Having Canadian mortality tables will help make these costs more transparent going forward. "There's been a long, unfortunate history of actuaries and plan sponsors underestimating longevity," says BlackRock's Purcell. "Therefore, as time went by, they had to constantly reflect their experience and update their forecasts, increasing the cost of their plan. But now longevity risk, while still uncertain, is better understood and there is more allowance for future improvement, which really is the key. Longevity is a magnitude lower risk than investment risk."

"Canadian plan sponsors are recognizing that pension settlement strategies are not as expensive as they thought and that there may be a first-mover advantage for forward-thinking plan sponsors who get into the market ahead of the impending wave of demand," says Sun Life's Simmons. ■

Looking to Control Equity Volatility

The experts are all agreed. The biggest risk to any pension plan that holds stocks is equity risk. In magnitude, it far outstrips interest-rate risk. But equities have historically been key to pension funding success. So what if there was a way to get those returns, but cut the risk?

Well, it's here and it's called low volatility investing. Of course, the principles can be applied beyond equities, but it is in the stock markets that the greatest and most consistent benefits can be found.

Low volatility investing seeks to provide investors with consistent long-term equity returns with limited risk. By limiting portfolio volatility, investors should reduce the likelihood of enduring those bruising falls in value that characterized the financial crisis. And as all students of finance know, if you lose one-third of your portfolio in one period, it will take a 50% return in the next period just to get back to the starting point. Limiting volatility will also allow the benefits of compounding to shine through more consistently.

Low volatility investing is the practical application of academic ideas from 50 years ago. In recent years, more stringent testing has shown that the low volatility anomaly can be confirmed. "One strategy that we have seen a number of our clients use in the last few years is low volatility equity strategies," says Paul Martin, Vice President and Portfolio Manager at Phillips, Hager & North Investment Management. "There are different variations on these types of strategies. The key objective of these strategies is to achieve a material reduction in risk compared to a conventional equity strategy and for that reduction to be robust through different market conditions. Our LDI clients are interested in these strategies because they're already more comfortable with the idea of moving away from broad market benchmarks and mainstream products, and are more focused on their objectives."

Out the risk spectrum

Some of the interest in low volatility strategies comes from dissatisfaction with fixed income. "Bonds are supposed to be the safe asset class," says Rachna de Koning, Vice President and Director of TD Asset Management. "As investors are being forced out the risk spectrum in search of yield, they ask us, 'How can I stabilize the outcome?' That is why our low volatility strategy is a natural part of this discussion and why it has been so popular in Canada. If you can get the same return with two-thirds of the volatility, you can balance the need to take more risk with the commitment to de-risk overall."

Interestingly, though Canada often trails the U.S. in taking up new trends, this is not the case with low volatility strategies. "There's clearly been a pickup in interest in low volatility investing in Canada," says Eric Leveille, Managing Director at BlackRock. "We were ahead of the U.S. here and saw growth in the period from 2010 to 2013. Then it slowed a bit, and I would say now we're entering low-volatility 2.0, which will be driven by factor-based beta, or what is called smart beta. If a plan can achieve a cycle-market return with less volatility and some downside protection, this would be a fantastic outcome. That's one objective. The other one is to realize that it may not be necessary to pay active management fees if I can replicate the same return through smart beta at a fraction of the cost."

Alongside the increased sophistication of low volatility equities, other approaches to replicating equity returns are also gaining ground. "Diversified growth funds should increase in popularity as a broad type of asset strategy in Canada," says Phillips, Hager & North Investment Management's Martin. "The idea is an equity replacement that seeks equity-like returns over time using a variety of different strategies. It can involve using credit as well as equity strategies. They are a big part of the market in the U.K., and there are a few providers in Canada."

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