Benefits and Pensions monitor

The Canadian Magazine Of Employee Pension Fund Investment And Benefits Plan Management

2012 REPORT & DIRECTORY

NEW NORMAL FOR DC INVESTORS pg 10
DE-MYSTIFYING GM DE-RISKING pg 18
TREMENDOUS CHANGES WITH NEW B.C. ACT pg 52
AN OPEN LETTER TO CANADIAN PENSION PLAN SPONSORS, FOUNDATIONS, ENDOWMENTS
AND THEIR ADVISORS

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Yours truly,

Robin Lacey
Vice Chair, TD Asset Management
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¹Based on simulated and live returns of 21 years of Canadian equity history and 13 years of global equity history ending September 30, 2011. Actual returns may vary.

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Railroading DB Plans

By: Joe Hornyak, Executive Editor

For the last 30 years or so, we’ve been seeing rail-road lines vanish across Canada. Once, the rail-road was a source of national pride and a vital cog in making this a nation from sea to sea. The late Pierre Berton even wrote a book about the construction of the railway across Canada. At one time, ‘The Last Spike’ was required reading for anyone who considered themselves a nationalist.

So for the last few decades, with many of these rail lines no longer in use, the tracks are disappearing and they’ve been turned into, in a lot of cases, snowmobile trails.

**Making A Comeback**

However, in recent years, we’re starting to hear rumblings that rail could be making a comeback, that is if they hadn’t ripped up the tracks. Some businesses are recognizing the benefits and cost saving of shipping by rail, if they can. Among them is Canadian Tire which lists the use of rail lines for shipping in its annual sustainability report.

We thought of this in recent weeks as we started to see some murmurs that there is still life in Defined Benefit pension plans. Despite all the talk of their decline in the private sector, and with plans being frozen and closed, auto workers and airline workers agreeing to closing their DB plans to new hires, and even National Football League referees agreeing to start closing their DB, there are still some believers.

Ian Edelist, of Eckler, said, at the 2012 CPBI Atlantic regional conference, we could see a swing back to DB over the next decade. As sick and tired of dealing with DB as sponsors are right now, they may again realize that DB does in fact provide a better result, costing 46 per cent less for every retirement duration for pension investment managers – all exhibit signs of changing for the better and to the benefit of DB plans.

**Ripping Them Up**

Oh, wait, that is if there are any private sector DB plans left by then. See, it is kind of like the railway lines. Fallen into disfavour and disuse, we started ripping them up. Now, however, some are starting to regret that decision.

The same with DB. Underfunded and unpopular, we’ve been closing them, freezing them, getting rid of them. And by the time we again appreciate them and are ready to make use of them, will any still be around?
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**AIMA**

Phil Schmitt, president of Summerwood Capital Corp. and former chair of AIMA Canada, has been elected a member of AIMA’s Global Governing Council. He is the first Canadian to have been elected to this global governing council.

**Burgundy**

Ken Jesudian is chief executive officer at Burgundy Asset Management Ltd. Since joining the firm in 2005, he has held critical positions including director of research, where his primary role was the oversight of its analytical work and the hiring and development of analyst professionals. As a portfolio manager, he has been responsible for its U.S. small/mid-cap equities. He began his investment career in 1998 and has worked at Fairfax Financial Holdings Limited and Foyston, Gordon & Payne Inc.

**Medavie Blue Cross**

Ashim Khemani is president of Medavie Blue Cross. He joins the company Blue Cross with 25 years of professional experience in insurance and financial services, professional services, and retail. He has played an integral role in building and leading domestic and global teams to execute growth mandates in both publicly traded and private-sector firms.

**OTIP**

Vic Medland is CEO of the Ontario Teachers Insurance Plan. He was previously its president, group insurance services.

**ACPM**

Claude Reny, founder and president of Pensul in Montreal, QC, is the recipient of this year’s ‘ACPM Award for Exceptional Volunteerism.’ The award honours individuals for their outstanding contribution in helping ACPM to reach its goals.

**T. Rowe Price**

Robert Higginbotham is head of global institutional services at T. Rowe Price Group, Inc. He will lead the firm’s business development and relationship management activities serving institutions globally and financial intermediaries outside of the United States. Previously, he was CEO for the Europe, Middle East & Africa (EMEA), and Latin America regions at Fidelity Worldwide Investment.

**Manulife**

Greg Thompson is managing director, consultant relations, at Manulife Asset Management. Based in Montreal, QC, he will be a dedicated resource for investment consultants throughout Canada. Most recently, he was with Pyramis Global Advisors where he was a director of consultant relations. Prior to that, he spent eight years with Mercer Investment Consulting.

**Pal**

Dianne Tamburro is vice-president on the retirement and investments consulting team at Pal Benefits Inc. She has 14 years’ experience in the pension investment consulting field. Over her career at two multi-national consulting firms and a large Canadian insurance company, she has conducted investment manager research and analysis and provided a wide array of consulting services, including performance monitoring, asset mix strategy, recordkeeper and investment manager selection, and governance oversight.

**Standard Life Investments**

Blair McCreadie is head of Canadian real estate at Standard Life Investments. He is responsible for the overall operation of Standard Life Investments (Real Estate) Inc. (SLIRE) in Canada, including oversight of the Standard Life Real Estate Fund portfolio management team.

**Macor**

Claude Macorin has launched Macor Capital Management, a boutique investment consulting firm offering customized investment services to endowments, foundations, and pension plans. He was most recently managing director, investments, at the University of Guelph’s Office of Investment Management where he was responsible for all aspects of the university’s pension and endowment investments.
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Cost-cutting Threatens Wellness

Although senior leaders may know intuitively that spending on workplace wellness initiatives is an investment in the health and productivity of the labour force, programs may be cut or scaled back in an effort to improve the company’s short-term bottom line, says the Conference Board of Canada. As a result, wellness practitioners must increasingly be prepared to demonstrate the direct benefit to the business in order to protect those investments that can lead to lower costs, less absenteeism, reduced presenteeism, and higher productivity. Its research, ‘Making the Business Case for Investments in Workplace Health and Wellness,’ found that employers are still at the infancy stages when it comes to evaluating wellness programs.

Canadian Plans Above Average

Pension plans in Canada had a 1.8 per cent return in investments last year, but still came out ahead of the average for other industrialized countries, says an Organization for Economic Co-operation and Development (OECD) report. Of the countries studied, the average investment loss was 1.7 per cent. In the U.S., the loss was 2.7 per cent. “After a period of recovery over 2009-2010, OECD-area pension funds experienced negative rates of return in more than half of the OECD countries in 2011,” it says, attributing the performance to uncertainty in the world economy which hurt performance and reversed positive trends in global stock markets. Pension fund assets did hit a record $20.1 trillion, led by the U.S. with $10.6 trillion, or 53.2 per cent of total global assets. Other countries with large shares are the UK with 10.7 per cent, Japan at 7.4 per cent, and Canada at 5.6 per cent.

Pension Plans Turn To Alternatives

Pension plans have given up waiting for higher interest rates and are making structural changes to their investment approach, says a survey by RBC Investor Services Ltd. ‘Navigating Low Growth’ found 71 per cent believe the low interest rate environment is “the biggest challenge” facing them over the next year, well up from the 27 per cent who did so last year. As a result, 48 per cent expect to increase their holdings in the next year of alternatives such as real estate and infrastructure. Last year, only 21 per cent were planning to boost their alternative asset holdings. In terms of allocating these funds, 45 per cent plan to increase their real estate holdings, 34 per cent are looking at infrastructure, 14 per cent plan more private equity investments, and seven per cent will use more hedge fund investments.

Shift To DC Continues In Private Sector

In addition to a decline in registered pension plan coverage, there has been a shift from Defined Benefit to Defined Contribution plans and other plans over the past 10 years, says Office of the Chief Actuary. Overall, the proportion of active RPP members in DB plans has declined from 84 per cent to 74 per cent. However, while the reduction in DB coverage has been significant in the private sector (from 76 per cent to 52 per cent), it has not occurred in the public sector which has remained stable at 94 per cent.

Reflections

Barrie Sprawson

November 19, 1939 – September 15, 2012

By: Patrick Longhurst

When I arrived in Canada in October 1973 and joined the benefits consulting group at KPMG, I had a huge learning curve ahead of me. I just qualified as an actuary, I had no consulting experience, and Canadian tax and pension legislation were a mystery to me.

For the next four years, Barrie Sprawson took me under his wing, and showed me, by example, the nuances of consulting. I could not have had a better tutor. The Sprawsons were also extremely sociable and I remember, with pleasure, the parties that were held at their home in Oakville, ON.

Barrie and I were to work together later in our careers and I was always struck by his enthusiasm for helping his clients and his passion for embodying innovative solutions to pension and benefits issues. He approached his non-work life with an equal amount of energy and it seemed that he always had a new cause that he was championing.

I am not alone in feeling this way about Barrie, and I know that many of my past colleagues are proud to think of him as their mentor. As one individual said to me, “Three words come to mind when I think of Barrie Sprawson – Professionalism, Integrity, and Kindness. That pretty much says it all.”

I felt lucky that I was able to have lunch with Barrie recently and tell him how I felt about the influence he had had on my career. We do not always have such opportunities.

In the meantime, I would like to express my condolences to Barrie’s wife, Gillian, and to his family.
Tail-risk Event Likely
About three-quarters of executives from a mixed universe of institutional investors think a significant tail-risk event is likely to very likely within the next 12 months, says a survey from State Street Global Advisors. It surveyed money managers, family offices, consultants, and private banks on the five most likely causes of a tail-risk event in the next year. A global economic recession (36 per cent) and a recession in Europe (35 per cent) topped the list, followed closely by the breakup of the eurozone (33 per cent). Greece dropping the euro (29 per cent) and a recession in the U.S. (21 per cent) rounded out the top five. It also found about 80 per cent believe that tail-risk management should be an integral part of portfolio management and 73 per cent said they are better prepared to weather a severe market downturn since making strategic asset allocation changes after the 2008 market crash.

Invesco Using Eagle In Europe
Invesco has fully implemented Eagle Investment Systems LLC’s performance measurement solution to manage its retail and institutional business in Continental Europe, leveraging the existing production instance of the Eagle platform in North America. It selected Eagle’s performance measurement solution to help consolidate its global portfolio management operations onto one platform and create more efficiency. As a result of this deployment, Invesco now has a consolidated view of its business across North America and Continental Europe. Streamlining these processes has helped it realize cost savings and establish a baseline for consolidating additional European funds in the future. It is also utilizing Eagle’s data mart for enhanced reporting across performance, holdings, transactions, fund rankings/ratings, and risk metrics.

Road To Stability Littered With Obstacles
Global economic and financial issues remain sizable and the road to greater stability is littered with obstacles, says the Desjardins Group economic studies team. China is raising concerns, the United States fears a fiscal cliff, the eurozone is in recession, and Canada’s growth drivers are weakening, it says. In Canada, the pillars for growth are dwindling. Consumer spending on goods is being slowed by the rebalancing of household budgets, while exports are being hurt by the lethargy of trade partners. As well, government expenditures are declining due to the budget cuts by the federal and provincial governments. The key event of the summer was the promise from the president of the European Central Bank (ECB) to do everything necessary to preserve the euro. It is in this context that the ECB can now make unlimited purchases of bonds from countries that have asked for help from the bailout fund so as to ease the financial pressures on these countries. On the other hand, there is still a lot to do in this region to stabilize the situation. China’s economy is of increasing concern and other stimulus measures are on the menu. All of this, it says, suggests that the central banks will hesitate to raise their key rates for several more quarters, with most still trying to stimulate growth with increasingly bold measures.

Difficult Road Ahead For Euro
The Euro will not break, but the road ahead will remain difficult, says Anton Brender, chief economist at Dexia Asset Management and co-author of ‘The Sovereign Debt Crisis – Placing a Curb on Growth.’ Speaking at its ‘The Global Sovereign Debt Crisis: A European Perspective’ luncheon, he said as soon as it gets close to a breaking point, something will be done and the Euro will still be here in 10 years. Part of the challenge is that growth has decelerated everywhere in the world, not just China and Asia. And while the U.S. has kept up some pace of slow steady growth, it has done so by gambling that markets will buy its decision to hold off on rebalancing its budget. Its view, he said, is that it is only going to rebalance as much as it must to stimulate the economy. Europe had a different strategy and decided to get its public accounts in order. However, with growth stumbling, he said it is clear that the country that made less effort – the U.S. – managed to reduce its deficit more by doing less than the European countries.

California Changes Public Pensions
California will make sweeping changes to public service pensions. Its governor, Jerry Brown, has signed into law new rules that will increase the retirement age for new employees depending on their job, cap the annual payout at $132,120, eliminate numerous abuses of the system, and require workers who are not contributing half of their retirement costs to pay more. Starting in January 2013, new employees will automatically have to contribute 50 per cent of their pension costs. The changes affect the state and most local governments, many of which participate in the state’s pension programs. CalPERS estimates the fund will save between $42 billion and $55 billion over 30 years while CalSTRS pegged its savings at $22.7 billion over 30 years as a result of the changes.

Bentall Kennedy Ranks On Top For ESG
Bentall Kennedy has ranked first in its class in the Americas for environmental, social, and governance (ESG) performance by the Global Real Estate Sustainability Benchmark (GRESB) for the second year in a row. The GRESB Foundation measures the ESG performance of listed and private property funds. This year, there were 450 property companies and funds. The published list ranks the number one entity for each asset class (retail, industrial, commercial, and diversified) in the Americas, Asia, Oceania, and Europe. Bentall Kennedy was rated the top performer in the diversified category, which GRESB defines as no one asset class representing more than 60 per cent of assets. The survey gathers information on areas including sustainable management practices and policies and employee training programs and remuneration policies.

In addition, the report highlights the top performers in each asset class. Bentall Kennedy ranked number one in retail, commercial, industrial, and diversified categories. The report also provides insights into the drivers of performance, such as the importance of effective governance and responsible investment strategies. It also highlights the growing trend of green building practices and the role they play in improving energy efficiency and reducing carbon emissions.
We have seen some serious shocks to the global economic environment that have significantly impacted the financial positions of Defined Benefit pension plans. Somewhat lost in the shuffle is the impact that those shocks have had on Defined Contribution pension plan members. DC members fund their own retirement and the impact of poor investment returns is often not fully understood until the investor reaches retirement age and begins to self-fund their retirement.

The DC Model
The primary focus of a DC plan is to facilitate savings to support the retirement needs of each member.

*Chart A* illustrates the basic DC retirement savings model. Retirement income levels are impacted by contribution levels and the investment performance of the fund. Investment performance is, in turn, impacted by key factors including:

- the time that the balances are invested
- the asset mix employed
- the performance of the investments employed

These create a number of challenges starting with achieving retirement savings goals in a low growth economic environment.

The stock market has experienced three significant corrections since 2000 – the tech bubble in 2000, the U.S. credit crisis in 2008, and the European debt crisis in 2011. When coupled with a fall in bond yields over this period, an environment has been created where bonds have outperformed lacklustre stock market returns. Given the tendency for DC members to lean on equities to support long-term investment growth needs, this period has caused many members’ plans to underperform expectations.

Provided members maintain their discipline, some of this should correct as markets normalize. However, some of these economic shocks may have negatively impacted our economies and changed future long-term investment performance expectations.

There are compelling reasons to believe that GDP growth will remain slower over the new several years, in line with GDP growth levels in the early part of the 2000s. These include:

- the continued impact of the European debt crisis and the deleveraging of European governments and banks
- slower growth in China
- the removal of some of the growth stimuli which aided growth in the ’80s and ’90s
- the aging of workforces in key economies
- the potential for higher tax rates to improve current runaway government deficit levels

This slower growth is expected, in turn, to lead to lower investment returns over the next several years. Corporate profits are lower in low growth environments, leading to lower stock valuations. This may be compounded by an aging global population that tends to decrease demand for equities.

Monetary Policy
At the same time, monetary policy measures such as the Fed’s quantitative easing programs will maintain bond yields at their current low levels in the near term, limiting bond returns in the short run. As economies stabilize, rising interest rates will then result in capital losses for bonds, further hurting bond returns. Accordingly, it is reasonable to expect a prolonged period of lower DC plan returns.

The impact of poor investment performance can be devastating to a DC participant. Consider a 25-year-old investor who joins the working world and contributes 10 per cent of pay annually to a DC plan for 40 years. A reduction of the average annual investment return by one per cent (from 6.5 per cent to 5.5 per cent) would result in a reduction from 47 per cent to 38 per cent of the pre-retirement income that the member could replace.
DC plans are far lower than those in their DB counterparts. These differences can act to constrain DC plans and investors in the following ways:

- They may not have the scale to meet the minimum investment requirements necessary for some alternative asset classes.
- The small asset sizes may drive plan sponsors to simpler investment structures to reduce cost structure for these plans.
- Certain investments may have liquidity constraints that may pose challenges for DC plans that offer investment choice to members.

The opportunity presents itself to the institutional investment industry to build better investment vehicles tailored to the needs of DC members and sponsors by incorporating some of the same structures and asset classes that allow large DB pension funds to better manage risks and enhance returns over the long run.

The most significant innovation in DC investment structures over the last 20 years is the development of target date funds (TDFs). TDFs consist of a series of balanced funds that use a dynamic asset mix path (a glide path) designed to provide members with an optimal asset mix at each stage of their career. The proportion of each fund that is invested in equities reduces as the target retirement date approaches. TDFs make it simple for DC members to implement and maintain a prudent asset mix over the course of their working careers. For this reason, we have seen significant flows to TDFs in DC plans in Canada and around the world.

As TDFs continue to gain popularity in DC plans, these funds will evolve to better meet the lifetime needs of DC investors in the following ways:

- Inclusion of Alternative Asset Classes
- By incorporating some of the structures and asset classes employed by more complex DB investment funds, a TDF can help DC investors to enhance portfolio returns and better manage volatility. A TDF can enhance returns through allocations to small cap and emerging markets equities and high yield bonds.

At the same time, a TDF can reduce volatility through better geographic diversification, and employing style offsets in key asset classes. Volatility on its own is not necessarily a problem for DC investors, provided that they have a reasonably long time horizon and the discipline not to overreact to short-term market fluctuations. However, the ability to reduce volatility is beneficial to all DC investors.

- Extended glide paths

TDFs that focus primarily on maximizing accumulations over the employment years use an asset mix glide path that ends at the fund’s targeted retirement date or soon thereafter. These types of glide paths are known as retirement glide paths.

Most DC members live well beyond their retirement date and will continue to invest their DC assets and draw income after that date. The truncated time horizon of these TDFs leaves DC investors with an asset mix strategy that is considerably more conservative than what might be optimal, given that their actual investment time horizon could extend more than 30 years beyond the retirement date.

More sophisticated target date products now recognize the importance of an asset mix glide path that optimizes the asset mix over the course of the investor’s expected lifetime. These TDFs are referred to as through retirement funds.

This lifetime focus does not lock the DC member into the TDF investment options. As with other funds offered by DC plans, investors may withdraw their plan assets upon retirement or termination and invest them in a similar strategy outside of the program. However, the objectives and time horizon of the investor should remain consistent both within and outside of the plan.

- More Focus on Decumulation

The final stage in the evolution of DC plans is to combine TDFs with optional payout vehicles that enable members to customize an income stream in retirement to meet their own specific requirements. Currently, DC members are forced to manage their withdrawals on an ad hoc basis to support their income needs in retirement. If they are too aggressive with their withdrawals, they may run out of money.

The following income features could be offered in conjunction with a TDF to accommodate cash flows in the accumulation period. They could be embedded as options within the TDF or offered outside the TDF as a complement to the TDF by the recordkeeper.
A systematic withdrawal plan (SWP) will allow the TDF glide path to continue to manage the asset mix while enabling the DC member to elect to withdraw income on a regular monthly basis. The SWP can be structured as a fixed-dollar withdrawal from the TDF or as a fixed percentage of the member’s invested assets.

Immediate annuities will allow DC members to achieve income certainty. An annuity purchase allows a plan member to take all or a portion of the balance accumulated in the TDF and convert it to a guaranteed regular lifetime income. Annuity pricing is tied to long bond yields. In low interest rate environments, such as the present, annuities can be expensive. However, the ability to use a portion of the TDF balance at retirement to provide an income floor could be attractive to risk-averse DC members. Annuities would be particularly appealing in conjunction with a TDF in a DC plan if they could leverage preferred group annuity pricing.

A guaranteed minimum withdrawal benefit (GMWB), also referred to as a variable annuity, is an insurance contract that provides a guaranteed minimum income stream from an underlying investment fund. The income stream is a percentage of the underlying investment balance (referred to as the ‘benefit base’) at the time of retirement. The benefit base at the retirement date grows with strong investment experience in the underlying investments. At the same time, the GMWB wrapper ensures that the benefit base will not fall, regardless of poor market performance.

Deferred annuities are lifetime annuities purchased prior to their commencement (or during the accumulation phase of a TDF). A TDF investment manager could incorporate deferred annuities into the glide path during the accumulation phase. Instead of shifting assets from equities into a fixed income portfolio, the TDF could actually pre-purchase retirement income for the DC member using deferred annuities.

Maximizing DC plan accumulation will become increasingly challenging to DC members in a low growth environment. Attaining benefit adequacy will be further impaired by longer retirement periods and the limited resources available to DC members and plan sponsors. Better designed TDFs – incorporating alternative asset classes, through retirement glide paths, and more formal and flexible decumulation options – can better equip members to make long-term decisions that will better maximize their income in retirement.
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MODERATOR: Is this low volatility premise just a function of the current economic conditions?

YUSUKE KHAN: The premise of lower volatility higher returns holds most true in down markets as lower beta strategies are expected to perform better than the broad market in declining periods. While there appears to be some evidence that, on a risk adjusted basis, lower beta stocks have provided better alpha than the higher beta alternatives, even in up markets, the jury is still out as to whether the lower volatility/higher returns trend can hold true in any markets. It is, after all, a basic premise of investing that higher risk should be rewarded with higher returns.

PAUL FAHEY: Certainly, it’s contrary to everything we’ve learned as investment professionals. But if you look at the literature, and I’ve seen some studies going back to the ’50s, over virtually all periods and all markets, with a few notable exceptions, low volatility stocks have outperformed, if not absolutely, definitely on a risk adjusted basis. I’m not saying this is something that we can expect for many years to come, but it does seem to be an enduring phenomenon.

BILL HOYT: To bridge these two arguments, I would emphasize that the low volatility effect does not work in all markets; but then, of course, nothing works in all markets. One thing that our in-house studies going back to the 1920s seem to suggest is that over the long term, even accounting for strong bull markets during which low volatility strategies typically underperform, the benefits from low volatility equity investing appeared to more than make up the difference of temporary underperformance. Over a very long period of time, the low volatility effect seems sustainable.

MARC-ANDRÉ LEWIS: Also with interest rates being so low right now, there is a very favourable context for interest in those strategies. That being said, if you look at every decade since the ’60s and ’70s, the outperformance is there; most of the time in absolute, but always in terms of risk adjusted return.

MODERATOR: What sort of impact does it have on volatility?

FAHEY: What we focus on at the NAV Canada pension fund is the mismatch between our assets and our liabilities. So, anything we can do to dampen down that mismatched risk is obviously very helpful. This strategy allows us to address the equity risk which dominates all other risks in traditionally weighted portfolios. In a typical, 60/40 weighted asset mix, more than 90 per cent of the volatility is coming from the equity component. If you can identify a strategy that allows you to remove about one-third of the volatility – and that’s been our experience in the time that we’ve been using it – that’s a huge contribution towards dampening down the mismatch risk. On that basis alone, it was extremely attractive to us and that’s why we decided to investigate it further when we became aware of it a couple of years ago.
**The Mythical Risk Premium**

**LEWIS:** At the Caisse, we’ve been actively managing equity portfolios against benchmarks, which didn’t discourage managers who prefer low volatility. However, the way performance and risk were measured wasn’t really favourable to this kind of view. But in the last two years, we’ve been doing a lot of work on these strategies. From our standpoint, the main attraction is getting something to complement our risk return profile because the Caisse, per se, is not a pension fund. We offer specialized portfolios to our depositors, mostly public pension plans and government agencies. So, it fills a nice spot in the products we can offer, sitting somewhere between bonds, regulated infrastructure, and liquid normal indexed or actively managed equities.

**MODERATOR:** Turning the risk/return belief on its head, is this a hard thing for people to get their heads around?

**HOYT:** That is the part to grasp. The foundation of investment theory is that higher risk asset classes are required to generate higher returns. That’s why we can say, with fair confidence, that stocks over the long term have outperformed bonds and bonds have outperformed cash. Stocks were riskier than bonds and bonds were riskier than cash. And, as logical as it may seem to assume that the same dynamic exists within the equity asset class, research has suggested that when you’re talking about stocks relative to other stocks, the reverse may be true.

Researchers that have utilized a capital asset pricing model (CAPM) framework, have discovered it’s not very robust. Their work suggests that if one takes the market and divides it into high beta and low beta stocks, one ends up with a situation where the high beta stocks do, in fact, have a greater slope (higher beta) in a CAPM framework, but they have a significantly negative alpha. The opposite is true for low volatility stocks. The slope is not as steep so the beta is lower, but it has a positive intercept, so it has positive alpha.

It’s a bit confusing to grasp the idea that something that works at the asset class level may not work within the equity asset class, but research seems to suggest the effect exists.

**LEWIS:** It also comes to the definition of what risk is for different investors. If you look at it on an absolute basis and on a long enough horizon, you get these higher risk adjusted returns, but you must take into account that you have so many people whose performance is measured against a given benchmark. Even though many people say they’re long-term investors, the fact they’re monitored quarterly and even daily means the patience of investors is also different. So, there’s also internal dynamics inside markets, inside the way managers are measured and monitored, if you want, that creates inefficiencies and might prevent investors from taking full advantage of low vol strategies.

**MODERATOR:** What sort of returns are you getting?

**FAHEY:** We went into this starting at the beginning of 2011 and the returns have been spectacular, to the point where we’re almost concerned because they have outperformed so much over the last two years. This is something we’re looking at more lately because we may have addressed our volatility dilemma somewhat by going into low volatility equities, but now we’re starting to look at the valuation of those equities that we’re investing in. Some of the work that we’re looking at right now would indicate that those stocks are somewhat expensive compared to the rest of the market right now. That is, however, not surprising given the low level of interest rates and the higher income associated with these types of equities. As well, maybe they deserve to have a higher premium PE associated with them, but given that most are not really growth stocks, to assign them a higher PE than the rest of the market may start to raise some red flags. So, as highly invested in them as we are, over three-quarters of our equity exposure is in low volatility equities, we’re beginning the process of evaluating whether we want to modify that exposure somewhat.

**MODERATOR:** What are some of the characteristics of the companies in these portfolios?

**HOYT:** These tend to be the same sorts of companies that often find themselves in a yield oriented portfolio. You have a lot of consumer staples and utilities companies. Healthcare companies, in particular, pharmaceutical companies, are often highly represented in low volatility portfolios. What we are discovering is that pharmaceutical companies often have significant cash generating capability from their patent portfolios. These companies are managed by mature managers that know how to maximize cash flow generation off a particular asset, patents in this case.

So, you end up with a portfolio which behaves at the portfolio level in a low volatility manner, but it is also comprised of individual companies which, when you look at them, you would say ‘yes, this is the type of company which has underlying business drivers which themselves are not highly volatile.’
MODERATOR: Are these portfolios somewhat immune to economic cycles?

HOYT: What I would say is that the cash flow generating ability of the companies in these types of portfolios tends to be more resilient than the economy on average, which, in turn, tends to be more resilient than some more speculative or cyclical sectors. Technology, by its very nature, tends to be growth oriented and risk taking.

Companies in other sectors, such as energy or materials, are not necessarily more risk taking, but they are cyclical in nature and they are levered to the economic cycle. So, they do better than the economy on average while the economy is strong and they do weaker than the economy on average while the economy is weak. Those types of companies are underweighted in low volatility portfolios.

LEWIS: But you still have an equity portfolio which means that if it has 70 per cent beta or something like that, if markets go down 30 per cent, you’re most likely going to end up losing more than 15 per cent of your money. Severe market movements won’t end up causing as negative a return in low vol portfolios; but you are not shielded from corrections.

FAHEY: Absolutely, in a down market these portfolios will almost certainly also lose money. It’s just a matter of the impact. The way that the math works is if you can protect your downside, you don’t need to make as much in the upside. If your portfolio goes down 50 per cent, it needs to double before you’re back to your high water mark. Whereas, if you just went down only 10 per cent, then a subsequent 10 per cent rebound leaves you in much better shape.

HOYT: Just one point that I sometimes have to emphasize is that resilient to down markets is not the same thing as immune to down markets. Investors must expect that in a big downward move in the general stock market, you will see a negative return on a low volatility portfolio. It’s just that the negative return may be less.

MODERATOR: What sort of allocations are you seeing for low vol strategies?

KHAN: Clients have typically targeted lower volatility strategies in a more indirect way, looking at managers with lower standard deviation, looking at managers with better down market capture and perhaps paying less attention to matters such as information ratio and tracking error that were more popular prior to the financial crisis. In the search work we have done, there’s a shift towards those types of managers.

What’s the optimal figure? This depends very much on the beliefs that reside with the investment committee, whether this is deemed as a replacement for more traditional cap weighted or index type strategies or whether this is complementary to that.

LEWIS: As we speak, it’s probably just a few percentage points over our overall equity exposure, but the plan is to make it a more significant portion over the next years. But we want to be patient; we want to build that over time.

FAHEY: Our objective was to stem the volatility from our equities. When we became aware of this particular strategy and after we completed our research, we moved expeditiously to the point where now we have three-quarters of our equity exposure in low volatility mandates. We are re-examining that and trying to figure out whether or not we want to be as heavily weighted from this point going forward given that low volatility strategies have performed so strongly on a relative basis over the last year or so. We think as a long-term strategy, it makes sense, but in the shorter run, we may want to modify that exposure.

HOYT: We’re seeing interest from some of our clients who have liability driven investing needs. They are searching for a better means by which to maintain an equity exposure while mitigating downside risk. Low volatility equity portfolios have the potential to deliver equity-like returns with lower risk and with downside protection being a particular characteristic. That’s really resonating with a lot of our clients.

MODERATOR: Can any size pension fund use this strategy?

LEWIS: Given the size of our fund, it’s something we thought a lot about and I’d say there’s no capacity problem as long as you are willing to widen the market you want to focus on. Obviously, given our size, if we wanted really to focus just on Canada, it’s something we could do up to a given amount. But if you are willing to go global on these types of strategies, we don’t see capacity problems.

KHAN: I wouldn’t see why it would be less appropriate for a smaller plan than for a larger plan. I think the merits of these types of strategies would be suitable for both.

MODERATOR: Are there enough skilled managers out there to provide these strategies?

HOYT: There are two aspects of capturing the low volatility
effect in an equity portfolio. One aspect is capturing the low volatility effect itself, and it's fairly well understood how to assemble portfolios that minimize volatility. There are common tools available to help managers capture that part of the process.

The real differentiating value amongst managers is the other part of the process, that is, stock selection. There are a number of ways that one can address that. One could choose passive low vol and not utilize alpha at the individual stock level, at all. However, selecting stocks utilizing quantitative stock selection models is a common choice. Quantitative managers are frequently low volatility managers because of the need for sophisticated portfolio construction. Selecting stocks with traditional fundamental analysis is also an option.

KHAN: You're getting to the question of whether this is alpha or beta. To the extent that the pricing anomaly is well understood and can be systematically captured, one could be tempted to call it beta. But even if that were so, it doesn't preclude active managers from developing better portfolio construction methodologies and smarter ways to further improve the risk adjusted return patterns of these portfolios, and that certainly would qualify as alpha.

MODERATOR: Are there entry points for DC plans that are interested in providing this as an option for their members?

HOYT: Absolutely, there are a number of ways that one can take advantage of the low volatility effect. One can do it just passively through an ETF, for example, or, to the extent that it is desired, one can add value on top of that with alpha (stock selection), either quantitative or fundamental.

FAHEY: There are also managers starting to offer pooled funds that you can invest in both as an institution and as a retail investor. They're small and not that widespread, but they are starting to become more available.

MODERATOR: What kind of fees are institutional investors facing?

FAHEY: We've found that the fees, to the extent that you're asking for a strict quantitative solution and not looking for a value added mandate, can be quite small, depending on whether it's a domestic or foreign portfolio. They are a fraction of actively managed portfolio fees.

If you want a value added product, then, you're starting to move out on the spectrum towards a fully actively managed product so the fees will be somewhat higher. But generally, for someone moving from active management to a low vol strategy, they will be substantially cutting their manager fees.

KHAN: In the low volatility space, there exists a whole range of strategies from the more systematic very low cost strategies to other more highly engineered or alpha driven strategies with higher fees attached to them.

MODERATOR: How would you summarize low vol strategies?

KHAN: I would say that it is clear that investors generally have been very mindful of protecting and managing risk, particularly on the downside following the events of 2008, and are looking at better ways of capturing a more efficient risk return trade-off for their portfolios. Low volatility strategies seem to present some very attractive characteristics by exploiting what have been described as pervasive and long-standing behavioural biases. They can, therefore, act as an interesting complement to other types of strategies within the context of a larger portfolio. Investors, however, need to fully explore and understand the arguments that support the continued effectiveness of the low volatility anomaly in order to gain a good appreciation of this type of strategy.

FAHEY: Low volatility is a very interesting strategy and a very useful strategy, but it's just one of any number of approaches that a portfolio manager can take to meet their goals. We're continuing to explore alternative approaches and this has been a good one, very fortuitous for us in the short term. But, we're continuing to look at other methods to de-risk our portfolios. We are also looking at risk allocation type strategies as opposed to asset allocation strategies. So, there are continual challenges and you can't sit back and be satisfied that you've found the answer to the equation. The dynamic nature of markets will result in some strategies working for periods of time, but no strategies will work reliably in all market conditions.

So, it behooves all of us to become familiar with many different types of equity portfolio management strategies and to continue to explore for better ways to manage our portfolios.

HOYT: A significant quantitative capability is required in order to capture the low volatility effect, but one point that I would emphasize is that it actually is possible to select individual assets on a fundamental basis and still incorporate them into a low volatility equity strategy, which is what we are developing here.
In June, General Motors (GM) announced that it was de-risking its salaried pension plan and reducing its pension obligations by US$26 billion through a combination of lump sums and annuities. This is the largest pension de-risking transaction ever announced and it signals a shift in the way that organizations think about their pension obligations. Rather than being deferred compensation arrangements administered by human resources, pension plans are now subject to the same risk management process and cash flow evaluations that finance applies to other corporate assets.

Analysts have applauded the GM transaction and, as a result, other U.S. corporations will likely follow GM’s footsteps. Within Canada, serious interest in de-risking is growing and next year it’s expected that the country will see its first $1 billion pension de-risking transaction.

The article below provides the background on the GM transaction. It also discusses the steps that Canadian Defined Benefit plan sponsors can take to evaluate whether a similar transaction is right for them.

Pension Headache

When breaking down the mechanics of the GM transaction, it is important to understand that GM is essentially a pension plan that makes cars on the side. At the end of 2011, GM’s pension obligations were about US$134 billion while its stock market value was only about US$32 billion. Put another way, GM’s pension investment unit manages assets that are four times larger than the value of GM’s manufacturing business. This means that the value of GM’s stock has largely been determined by GM’s pension investment skills, as opposed to GM’s manufacturing skills.

GM’s pension plans have also been a huge drain on cash. Over a 15-year period ended December 2006, it put US$55 billion into its workers’ pension plans, compared with US$13 billion it paid out in dividends, says the Roger Lowenstein book ‘While America Aged.’

Despite these large contributions, GM’s pension plans are still not well funded. At the end of March 2012, its U.S. pension plans were US$12.9 billion short of its obligations, and its non-U.S. pension plans were US$11.6 billion short of obligations.

In June, GM announced that it was de-risking its U.S. salaried plan through a combination of lump sum cash settlements and an annuity buy-out.

As a part of the transaction, GM will purchase a group annuity from Prudential Financial Inc. (Prudential) for 76,000 retirees and spouses who retired before October 1, 1997. The remaining 42,000 retirees, who retired after that date and before December 1, 2011, will be able to choose between a group annuity and a lump sum cash settlement. Salaried plan members not impacted by the transaction will be moved to a new plan and the current plan will be terminated.

This de-risking will reduce GM’s pension obligations in its U.S. salaried plan by about US$26 billion to US$10 billion from the US$36 billion reported at the end of 2011. It will require a cash contribution of between US$3.5 and US$4.5 billion.
from GM. GM will pay US$29 billion to Prudential and the retirees who elect lump sums.

Prudential will hold the assets related to the GM annuity buy-out in a separate account. If this account is insufficient, then Prudential will make up the difference from its general account. According to a GM filing, both it and Prudential could pull out of the deal before it is set to close at the end of the year if markets deteriorate and increase the total cash required to close the transaction.

If the deal goes through, it will eclipse anything seen previously in the group annuity market.

**New Corporate Finance**

One unique feature of the GM transaction compared to prior U.S. pension risk transfer transactions was the evaluation of the transaction from a corporate finance perspective. GM approached the transaction strategically by investigating the relative merits of the transaction versus other potential uses of cash (share repurchases, dividends, acquisitions, capital improvements, etc.).

The US$3.5 to $4.5 billion of cash that GM contributes is the difference between the cost of the annuity/lump sums and the pension obligations that GM holds on its books, and represents a 10 per cent premium. GM’s actual cost is lower than the 10 per cent premium as it no longer has to pay administration expenses and Pension Benefit Guarantee Corporation assessments for 118,000 retirees. From a risk management perspective, this premium provides future certainty by reducing cash and accounting volatility.

Its CEO, Dan Akerson, has said that the company would consider offering a similar choice for its 400,000 union plan retirees and spouses, so this transaction could just be the first step. Transferring the union plan obligations would further transform GM’s business footprint from pension investment manager to manufacturer, allowing it to get back to focusing on its core business.

**Can It Happen Here?**

Since the GM deal was announced, Sun Life has been receiving regular inquiries about whether a similar transaction can happen in Canada. We believe that many boards and management teams are asking the question, ‘If pension de-risking makes sense for GM, then is this something our company should do?’

Capacity in the Canadian market is large enough that pension risk transfer transactions in excess of $1 billion are possible now. It may take time for the market to digest large transactions, so there may be a first mover advantage for plan sponsors who are considering risk transfer transactions.

Though much of the discussion around the GM transaction has focused on jumbo deals, it’s important to remember that pension plans of all sizes are causing considerable headaches for their employers. We expect that the overall number of pension risk transfer transactions will increase as employers of all sizes begin de-risking their plans.

Each plan sponsor should evaluate their de-risking options based on their own situation and priorities. It’s not a one-size-fits-all solution. Here are some steps that plan sponsors should be considering in light of the GM transaction:

- Contact your pension consultant – De-risking best practices are evolving quickly and a consultant can assist in evaluating the wide range of solutions available.
- Contact your investment banker – One of the insights from the GM transactions is that pension plans should be evaluated within the broader corporate finance framework.
- Understand the longevity particulars of your plan – Each pension plan has its own characteristics that will impact the life expectancy of its members.

The GM transaction has changed the pension risk transfer playing field and is generating global discussion about plan sponsors evaluate their pension plans within a broader corporate finance framework.

**Market Reaction**

Analyst reaction to the GM transaction has been very positive, despite the fact that GM’s annual earnings will decrease by US$200 million because of smaller pension income. In the past, analysts routinely mentioned GM’s pension challenges as being one of several factors restraining its stock price.

“As GM continues to fund and de-risk its pension, investors should develop increased confidence that incremental cash flows will accrue to them, and not the pension. As this happens, GM’s multiple should expand.”

Source: Credit Suisse, Equity Research. June 4, 2012

**“Although there could be some negative perception in the market associated with the premium paid, as well as the one time EPS charge from settling the liability, investors and rating agencies recognize the reduction in volatility achieved. Longer term, settling a material portion of the liability could lead to improved valuation and enhance the firm’s flexibility for additional capital allocation investments outside the pension plan.”**


Investors also had a positive view, seeing the longer term benefits. GM shares rose six cents, or 0.3 per cent, to $22.26 on a day when the rest of the stock market was down more than two per cent.

The GM deal could be the tip of the iceberg in the U.S. With S&P500 companies facing combined pension obligations of US$1.7 trillion, and U.S. state and municipal governments also exposed to DB schemes, that tipping point may have been reached.
We cannot pick up a paper these days without seeing articles about pension underfunding, its impact on the financial viability of some corporations, rising costs of public sector pensions, or concerns about long-term sustainability of programs such as the Old Age Security.

So, it is time to engage in serious discussions about strategies to reduce the growing costs and risks of the pension promise. These challenges are real and are, unfortunately, not going away easily.

The concept of liability driven investing (LDI) was initially raised many years ago, mostly by bond managers looking to wrestle mandates from equity titans. Historically, however, it has been a challenge to shift the dialogue away from an asset-only discussion, based on expected returns and risk measured as standard deviation of absolute returns, to a more holistic decision-making process that truly looks at the impact of financial markets on both plan assets and liabilities.

**Asset-only Context**

In an asset-only context, with expected returns on equities always assumed to include some premium over expected bond returns, it is tempting to keep significant equity exposure, despite the resulting mismatch with the plan liabilities. The hope of ultimately reaping the rewards is too tempting.

On the other hand, when insurance companies make a promise to pay a certain benefit, they generally try to make sure that they back that promise up with a prudent investment approach that immunizes that promise. Practitioners understand this, shareholders expect this, and regulators demand it. But still, the conceptual framework that a Defined Benefit pension plan is a similar animal with a promise made to pay a future benefit has taken a longer time to permeate into the consciousness of those that are making these promises to their employees.

Consultants have found it challenging to explain the notion that a pension plan needs to be managed from a liability framework and that governance models need to adapt to a more integrated, holistic way of managing risk. In a world where both bonds and stocks generated double digit returns, it essentially didn’t really matter what the asset mix was.

But, we aren’t in Kansas anymore and the reality is that we may not be there for a while, as governments financially repress asset owners (stealth taxation) in order to bail out the debtors.

We are still seeing too many discussions where pension plan trustees are saying they understand their liabilities and are managing to them, but are then surprised when they learn how much interest risk exposure they truly have. A good example of some of the freakonomics out there is worrying whether your active fixed income manager is taking too much risk by moving off the duration target by one year. In reality, the typical pension plan is a much bigger risk taker. Consider a typical pension plan that is 70 per cent funded, invested 60 per cent in equities and 40 per cent in universe bonds (a common approach in Canada), and with liabilities with a duration of 14 years. For this pension plan, interest rate exposure is less than 15 per cent hedged. Putting it another way, the mismatch between the duration of this plan’s assets and liabilities is 12 years. How can we be uncomfortable with a fixed income manager who presumably has a deep understanding of the bond market, moving off the duration target by one year when the pension plan, which is often managed by a committee which may meet quarterly, is mismatching the duration of its assets and liabilities by 12 years?
When the idea of immunizing a larger portion of interest rate risk is raised, there is a reluctance to do so because of a view that interest rates are at record lows, that they ‘can only go up from here,’ and that bond returns are expected to be very low going forward. This discussion has been the same since the mid-1990s and interest rates (which ‘could only go up’) have declined significantly since then. In effect, pension plans are making an interest rate call based not on LDI concepts of hedging risks, but on return-only assumptions on bonds. This delay tactic has cost many pension plans dearly.

We know that economists and most market participants are notoriously bad at making predictions (given the dearth of active bond managers focusing solely on interest rate anticipation strategies) so I will not attempt to do this. However, I will say that there has been a high correlation between the direction in interest rates from the peak to the mirror image (the red line). While this is by no means scientific, it nonetheless is an interesting look at history unwinding and you can see that we might just as easily be in a low interest rate environment for many years to come. After the great depression, interest rates (not floating at the time – and one could debate whether we have truly floating rates now given all the quantitative easing and non-market participants buying in the market) – were low for decades. The certainty with which we hear many in the industry calling for higher interest rates is not a given even if it is consensus. Reinhart’s article ‘Financial Repression Back to Stay’ noted that:

“One of the main goals of financial repression is to keep nominal interest rates lower than would otherwise prevail. This effect, other things being equal, reduces governments’ interest expenses for a given stock of debt and contributes to deficit reduction. However, when financial repression produces negative real interest rates and reduces or liquidates existing debts, it is a transfer from creditors (savers) to borrowers and, in some cases, governments.”

She also noted that one of the keys to financial repression is the ability of non-market players to influence the yield curve. Does this sound familiar?

As some of these discussions are being played out in the board rooms and investment committee meetings around the country, it is important to keep in mind that LDI can mean different things to different people. In its strictest form, structuring a fully hedged bond portfolio is likely unpalatable given most plans’ severely underfunded positions and lack of free cash to immediately fund the deficits.

Fulsome Discussion

However, there are many other approaches to ‘taking DB risk off the table’ beyond conventional LDI with a structured bond portfolio. It is also important to keep in mind that without a more fulsome discussion about all types of strategic risk management approaches, doing nothing is an explicit active decision to keep the mismatch risk on and pray to the equity and interest rate gods to bail you out. With Ben Bernanke’s announcement of QE3 and the ECB actions of late, we can rely less in the short run that rates will rise (and maybe even longer if Reinhart’s view of financial repression holds true). My bet is on real rates staying low or negative for a while as stealth taxes are more appealing to politicians than real taxes.

So what can pension plans do with all this doom and gloom talk? As we have seen in Europe and, more recently, in North America, discussions and actions are starting to shift. Our Financial Strategy Group is seeing some trends that we believe Canadian plan sponsors of DB pension plans should consider:

- Engage in more meaningful discussions around broader, holistic risk management strategies that go beyond asset-only discussions.
- Open their minds to liability driven investment solutions such as dynamic derisking which at least helps formulate a journey plan for moving towards a more hedged investment strategy when funded status improves.
- Monitor funded status more frequently to obtain a better understanding of what is happening with the pension plan and to be in a position to act more nimbly when markets provide opportunities.

- Explore and seek education about risk transfer strategies such as annuity buy-ins, buy-outs, and longevity risk transfers from other countries (such as what GM entered into in the U.S.) to see whether they make sense in Canada.
- Restructure the governance budget away from manager research and monitoring managers to focus on the bigger strategic challenges.
- Seek advice on funding policy strategies or plan design changes.
- Learn about longevity risk.

One example is the recent GM annuity buy-out. What stands out is that it was the largest deal by more than $20 billion in U.S. history. Because of the size of the transaction, they used an independent fiduciary which was a precedent for large plan sponsors. They also used a separate account structure to enhance participant security. Doing this in a low rate environment with no immediate backlash from the analyst community implies that analysts are likely seeing through accounting liability and pension expense smoothing. Advising on such deals also provides insights into how insurers value pension buy-outs.

Exploring Options

While the pension world is grappling with the most recent ‘perfect storm,’ there are people who are spending their days (and sometimes nights) exploring options to assist pension plans in managing their risks. By focusing on a more integrated, holistic approach to governance with a joined up focus on assets and liabilities, DB pension plans can plan and explore ways to help mitigate and manage these risks better. Let’s call this liability driven governance as LDI is often viewed too simplistically. We cannot manage what returns Mr. Market will provide, but our jobs are to manage all the risks as best we can.

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AGF Investments expands Global Equity team

Stephen Way, Senior Vice-President at AGF Investments Inc. is delighted to welcome the following new members to the AGF investment management team.

Tim Codrington joins AGF Investments Inc. as an Associate Portfolio Manager on the global equity team. Tim brings with him more than 14 years of investment management expertise. He was most recently with Putnam Investments where he co-managed the firm’s Global Consumer Fund to a top quartile three-year track record as rated by Morningstar. Tim holds an MBA and BA from Harvard University.

Sanjay Luthra comes to AGF as a Global Equity Analyst, with over five years in the financial services industry. Sanjay joins AGF from Ontario Municipal Employees Retirement System (OMERS) Capital Markets, where he specialized in Asia and Europe, covering the Technology, Media and Telecom sectors. Sanjay received his B.Eng. from the Birla Institute of Technology, Ranchi, India, and his MBA from the Rotman School of Management, University of Toronto.

Vinod Dasaratha joins AGF as a Global Equity Analyst, bringing more than seven years of experience in asset management on both the buy and sell sides. Vinod comes to us from Heckman Global Advisors, a division of The Roosevelt Investment Group Inc. He was part of the team that helped develop the country allocation framework that has been used by AGF’s global equity mandate for a number of years. Vinod holds an MS and BE in Mechanical Engineering from Columbia University and the University of Mysore, India, respectively. He is a CFA charterholder.

Maksim (Maks) Piskunov joins AGF as a Global Equity Analyst. Prior to obtaining his MBA, Maks worked at Canada Pension Plan Investment Board (CPPiB) for more than three years and was a business analyst at McKinsey & Company in Chicago and Toronto, where he developed plans and strategies for a variety of companies. Maks holds an MBA from the University of Chicago Booth School of Business and has dual degrees (a BA in International Relations and a BS in Economics) from the Wharton School and College of Arts and Sciences at the University of Pennsylvania.

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Risk Management Solutions: Finding Commonality Across DB and CAPs

The Move From DB To CAP

A recent report from OSFI’s chief actuary shows that as the private sector closes and freezes Defined Benefit pension plans, many are adding a Capital Accumulation Plan (CAP) component to replace it. It shows that in 2004 there were 18,000 members in dual DB/CAPs. By 2010, this had grown to 477,000. Not surprisingly, the vast number were from the private sector as only two per cent were public sector employees.

Recent contract settlements at Air Canada and the Big Three automakers in Canada saw this trend continue. Even National Football League referees agreed to end their labour dispute by closing their DB plan and adding a CAP for future hires.

For sponsors of these plans, the focus must shift from risk management of DB plans to managing risk for both DB and CAP. However, rather than seeking different solutions to manage the risk in each, are there common approaches and practices that can be applied to both? BMO Group Retirement Services has brought together a panel of industry experts to examine this situation. The roundtable participants are:

✦ Joan Johannson – President, BMO Group Retirement Services Inc.
✦ Larry Ketchebaw – Manager, Pension and Benefits at Unisource Canada, Inc.
✦ Anita Lieberman – Vice-president, Business Development, Ontario, BMO Group Retirement Services Inc.
✦ Paul Litner – Chair of the Pensions & Benefits Department, Osler, Hoskin & Harcourt LLP
✦ Anne Meloche – Partner at Mercer Investment Consulting.
✦ Robin Pond – Senior Investment & CAP Consultant, Buck Consultants
✦ Blair Richards – Chief Executive Officer of the Halifax Port ILA/HEA Pension Plan and Trust Funds

The moderator is Joe Hornyak, executive editor, Benefits and Pensions Monitor.

Moderator: What are some of the common risks between DB plans and CAPs?

Robin Pond: Whenever you’re trying to define risk, for each plan type, you have to look at a variety of factors. It is not a simple task. One common aspect is investment risk, largely in terms of volatility, albeit the effects may somewhat differ. On the DB side, you have to consider the funding level and the risk tolerance of the plan sponsors, amongst other factors. On the DC side, perhaps the age of the participant is the key factor, together with, again, risk tolerance as to how much volatility the individual can withstand.

In hybrid plans, we are seeing a change in risk management. The interesting thing here is that the closed DB plan is almost treated as a DC in that there is a funding horizon – or a finite life span. Originally, DB plans were thought to be eternal and were funded on this basis given an assumption that we will always have enough young members coming in for funding purposes. Suddenly, when closing private sector DB plans, you create a finite life for the plan. This triggers a possible move to something similar to the glide path that you would see in a target date fund – which is an investment vehicle from the CAP space. This becomes the basis for dynamic asset allocation because the closed DB plan now has similar risks to manage as an individual CAP account. Another risk involves defining risks in
terms of objectives which will differ depending upon the parties.

**Paul Litner:** First, let me say that ‘risk’ is a deceptively simple word. Risk can (and should) actually be divided into many different categories (e.g., investment risk, interest rate risk, currency risk, legal risk, etc). What we are seeing more often, in relation to both DB and DC plans, are fiduciaries trying to specifically identify the different categories of risk, break them down, and take steps to manage each type of risk individually as opposed to simply managing risk at a high level, which was more common in the past. As the private sector moves away from Defined Benefit plans into Defined Contribution plans, in the legal/regulatory context, many sponsors/administrators are now starting to apply the more robust governance practices that have traditionally applied to DB plans to their DC plans. Meanwhile, at the other end of the spectrum, some other plan sponsors are now just coming to grips with the fact that they have fiduciary obligations and legal duties and legal risks, in relation to the DC plans. What is common to both DB and DC plans, from a legal perspective, is that persons who manage those plans will have duties of prudence as a fiduciary and will also have fiduciary duties in relation to the communication of information to plan members. These two core elements of fiduciary duties are common to both types of plans and, although they’re applied slightly differently in the context of DB and DC plans, the risk management techniques that are used to ensure that these legal duties are met are common to both DB and DC arrangements.

**Larry Ketchabaw:** We have had a hybrid plan going back for 20 plus years. When you wear both hats, on the DB side, you’re trying to get a return on investment to move from a solvency deficiency to fully funded. On the CAP side, you have your plan member, say Mr. Ketchabaw, 59 years old, who ‘might like to retire some time,’ but his funds haven’t gone anywhere in the last five years. His situation is not that different from an underfunded DB. So really, both plan types are trying to get to the same end game and struggling with the same issue – a way to get a return.

**Joan Johannson:** As Robin mentioned, volatility is definitely a common aspect of risk and we’re more attuned to it now in the CAP environment than we were before 2008. Diversification can help handle specific market risk both in the CAP space and for DB plans. Since the economic downturn, however, we have seen marked interest in Liability Driven Investing (LDI). This makes a lot of sense. However, an exclusive focus on LDI can leave behind the growth component needed for the longer term. This has resulted in a building demand for Liability Sensitive Equity Strategies – as these strategies are designed to protect on the downside while providing increased growth opportunities. Robin referred to a glide path strategy working in the DB world, especially for closed plans. This form of risk management seems to allow for the growth aspects of the path and also an LDI solution to operate in tandem. Again, this is a means of managing volatility while also meeting the needs of active or closed plans. And, there certainly seem to be parallels with managing an individual DC member’s needs, as Larry has pointed out.

**Anne Meloche:** I definitely believe that we can use ideas from DB plans with DC plans. In mid to large DB plans, many plan sponsors have added specific funds designed to work together to meet specific needs for the plan (inflation protection, volatility reduction, etc.). But this doesn’t mean that in the DC world we have to offer each of these ingredients separately in the a la carte menu. Some can be combined into one fund to become what I call an ‘asset class fund’ which is professionally managed while others can only be used as one of the ingredients of the automated solution. This allows you to be more creative. The fact that average plan members don’t necessarily fully understand each ingredient is less of an issue – since it is professionally managed, they do not need to. I think we can do things which are creative by taking some of the best DB ideas and responsibly applying them to DC.

**Pond:** The reason I think we’re going towards DB concepts in the DC world can be really well illustrated in this scenario: You’re sitting on a pension committee, you’re responsible for a closed DB plan and you also have a CAP plan for your members. You’re sitting down with Robin Pond, your investment expert, who tells you that in your DB, you have to seek out returns and that you need to consider alternative investments such as private equity and real estate and all kinds of other alternative investment strategies. And you have decided to do that for your DB plan.

Now for your DC plan, your lawyer advises you of your fiduciary duty to act in the best interest of the members. And
that prompts the question, ‘If I’m adopting this strategy for the DB plan to meet our objectives, why am I not considering this for the DC members to enable them to get the returns they need as well?’ It might be because the particular strategy is too complex or it may not meet your objectives. However, given your lawyer’s advice, you better have an answer. That is part of the liability risk that you have to manage.

Blair Richards: But I believe to define risk we need to see if we agree on what a good pension is so that we can manage to that expectation. If you ask a regulator, he’ll tell you it’s a plan that’s always being paid and funded. Having said that, the amount paid may not be sufficient to look after an increase in the cost of living for the beneficiary – the plan member. They can be doomed to a cost of living shortfall, although the plan is deemed a good one as it is funded.

If you ask a plan sponsor, a good plan is one that doesn’t cost them much.

If you ask a member, a good plan is one that allows them to keep up with inflation and provides for a retirement, perhaps with some dignity.

I’m suggesting there’s a middle ground there. We need to agree on that definition. Then we could set objectives and we could address the elements of the problem of risk management around the objective. This becomes, first and foremost, affordability. Then we could set objectives and we could address the elements of the problem of risk management around the objective. This becomes, first and foremost, affordability. Then we could set objectives and we could address the elements of the problem of risk management around the objective. This becomes, first and foremost, affordability.

Pond: Blair makes an excellent point. Whenever you’re trying to define risk, you have to look at whose risk is it? And the other big factor, and I think Larry also touched on this, is defining risks in terms of objectives. The objectives will differ depending on the parties, but, from the plan sponsor’s point of view, in a DB plan a big part of the objective is affordability.

Johannson: I believe that plan sponsors are not always motivated simply by cost management – or risk management – to move to DC, although it can certainly help with their bottom line and ability to access credit. Many also have noted that employees rarely stay with one firm for their entire career. For an average Canadian employee who may change jobs at least five times in their career, a DB plan offering may be less effective and less appreciated until the employee nears retirement.

The sponsor’s motivation for a move to DC can be to offer a more appropriate plan for their employees. Once committed to creating CAPs, I have seen much time and effort spent by HR teams to create educational programs and encourage the use of tools to help employees better define their personal goals. A key element of risk to manage in these instances would speak to your point, Blair, on setting appropriate objectives and expectations. I believe many plan sponsors offering CAP programs are concerned with helping employees manage these risks.

Richards: Well, I would suggest, Joan, that you give employers a lot of credit that I don’t. It’s true that CAPs were largely a response to new and differing careers. No more are employees 35 years with the same company and then out to retirement.

Although this is important, performance is only one of many ingredients for success. I think that the most important ingredients for success are making sure employees define their objectives and work to meet their retirement goals. But there seems to be a disengagement from this by too many plan sponsors in the CAP environment and they have to understand that this is an area of risk for them as well, in addition to their overall duty to help support the growing retirement community.

Anita Lieberman: It appears this group is suggesting that the approach needed is that CAPs should adopt DB rigour, particularly when it comes to duties of prudence as well as the need for education. However, I am curious to know if there is a different duty to educate within a hybrid plan?
Moderator: Are tools to manage the volatility in CAPs keeping pace with those in the DB world?

Meloche: The CAP investment environment has been lagging the DB environment by about five years. Still, some of the existing DB tools can be used in the CAP world. What complicates this is, however, the lack of sophistication of the average member. The plan member cannot match the level of knowledge and expertise of the plan sponsor’s finance people or the experts that they may rely upon for their DB plan. Yet, we’re asking them to act as their personal CFO with their own assets. They must rely on the communication and education programs of the plan sponsor. At the end of the day, the sponsor’s fiduciary liability relies on ‘how can I communicate and then explain these solutions to plan members.’

Moderator: Is the lack of member knowledge one of the reasons we don’t see CAPs moving to alternative investments?

Ketchabaw: As a DB plan sponsor, we’ve had all kinds of discussions lately about alternative forms of investments because we’re trying to figure out ways of getting returns. We’ve always been very, very vanilla, both on our DB and CAP investments. But, we are looking at those now on the DB side because we’re worried that we’re not going to be able to close that solvency gap. As Robin indicated earlier, that begs the question for me, if we’re doing that on the DB side and we’re comparing DB to CAP, should we be looking at this for the CAP as well?

Lieberman: With the economic downturn, returns are lower than in the past and the cost stands out as a bigger part of the equation. To offset this, we have seen a marked increase in the use of ETF products. These can be found in managed portfolios or, for those preferring a target date solution, we have seen ETFs employed effectively as a way to acquire market exposure, with a glide path, but at a lower rate. It’s a strategy for both limiting the risk through diversification and an increasingly conservative glide path and reducing the fees by using a passive product.

Moderator: Are there effective ways to handle other forms of risk in CAPs?

Johannson: One risk that has long faced CAPs, that does not apply in the DB world, is engagement. Automatic enrolment, following in the path first established in the U.S., has reduced the risk of employees never participating in their retirement savings plan. This initially led to further challenges if the plan member did not select an investment. Plans have evolved to address this.

Meloche: Yes. We have been giving plan members an array of investment options to select from and, before placing them into a default fund, we have been following up with them with numerous reminders that they need to make a selection. In the U.S., the Pension Protection Act of 2006 (Act) reversed this entire process. They now auto-enroll employees, apply a set contribution rate which escalates, and place them automatically into the default investment. With amendments to their Act, they have now defined what qualifies as a default to provide a safe harbour and, as a result, most default options are target date funds, which meet the ‘well diversified’ qualification. The plan member has a choice. If they don’t like this process, they can opt out of the plan or change the contribution rate or the investment option. In Canada, though, we have experienced some reluctance with certain plan sponsors to follow the U.S. approach as we do not have a ‘safe harbour’ available for plan sponsors and some fear that this could increase their liabilities.

However, with the U.S. approach, members are automatically invested in a well-diversified solution which usually also takes care of the typical lack of rebalancing and risk reduction as they draw closer to retirement. Hence, the U.S. approach addresses the risk of plan members making poor investment decisions. Those who feel comfortable with making a decision, probably at most 10 to 30 per cent of plan members, have the option to
If 70 per cent of your assets flow into the automated solution, this is where your fiduciary risk is. So perhaps you should spend 70 per cent of your time on this.

**Ketchabaw:** Why aren’t we catering to the 100 per cent?

**Meloche:** If 70 per cent of your assets select their own investments from a variety of investment options.

**Ketchabaw:** Why aren’t we catering to the 100 per cent?

**Meloche:** And then for larger plans where you have DB and CAP, your CAP solution can leverage the DB investment structure by using the same managers to gain economies of scale in terms of fees and access to best-of-class managers.

**Ketchabaw:** And I’m on that committee for DB and CAP and I’m sitting there listening to all the presentations on the DB side as to how we’re going to get back to 100 per cent funded. Yet, on the CAP side, we’re just not doing the same kind of work needed to be able to introduce those kinds of things to reap these benefits for plan members.

**Meloche:** Yes, I agree. By offering an a la carte menu from which to construct a portfolio, we address the other 30 per cent who feel able to do this. In fact, an automated default solution can be built using the same investment options offered in the a la carte menu by people with the appropriate expertise. In this way, the full 100 per cent of the population, that is the less knowledgeable and the knowledgeable appropriate expertise. In this way, the full 100 per cent of the population, that is the less knowledgeable and the knowledgeable members, have access to the same type of investments and returns.

**Johannson:** So you would have, if I understand it, a line-up of various funds from which the engaged investor could choose to create a portfolio. And from these, you create one or more automated solutions which could act as a default. More than one solution might work if you wish to see if target date funds. We’re seeing an interest in exactly that kind of combination under the banner of Managed Portfolios. It also helps with oversight. You have the same funds in both, but you are providing the expertise and the exposure in the automated solution that’s also available to the more sophisticated investor individually. Of course, you need the right expertise to create the managed portfolios.

**Lieberman:** I believe for DB and for CAP this would usually be a consultant driven solution to leverage their expertise in this area.

**Moderator:** With DB plans, there is a lot of talk now about de-risking. Can you de-risk a CAP plan the same way you can a DB plan?

**Lieberman:** I believe that goes back to Joan’s point concerning pairing a liability driven strategy, such as LDI, with one that uses equities selected as part of a Liability Sensitive Equity Strategy to provide the needed growth component. The idea is to provide that growth with the sort of equities that control the downside exposure. But this would tend to be a DB solution.

**Pond:** Can you de-risk CAPs in the same way? Target-date funds take you from more stocks to fewer stocks over time. However, what people found is that in 2008 the retirement option of those in target-date funds went down 10 per cent, ruining their chances to retire in the short term. We now have a lot of people working today who thought they were going to retire in 2008. I think de-risking in the CAP context has to go into building more certainty in terms of the life income you will receive after you retire. In fact, to go back to Blair’s point of what defines a good pension plan, whether it’s DB or CAP, a good pension provides a certain level of certainty about your life income on retirement. What really needs to be built into CAPs is greater certainty and that means products that are affordable and likely are annuitized a little bit each...
year along the way. This would build into a life income and provide some protection creating a certain certainty.

**Meloche:** The Ambachtsheer Letter in August has an article called ‘Turning a CAP Frog into Pension Prince Charming.’ It asserts that the current CAP model mainly focuses on the accumulation of financial capital with no particular objective in mind. It suggests ‘DB-ization’ as a solution. This proposes that the risk underlying the CAP investments would somehow be automatically reduced when a member’s account balance is truly expected to meet their retirement goals. However, the risk would be increased to create greater returns when the balance is expected to be below their retirement goals. I think it is an interesting proposal, but I do not know how easy it would be for record keepers to implement in a CAP plan.

**Pond:** Yes, the DB-ization concept is intriguing, but it’s something like ‘gambler’s ruin.’ It works like this: I’m going to the track and I’m putting two bucks on the first horse. If I lose, I’m putting four bucks on a horse in the next race and so on in the hopes of an eventual win. That’s kind of what you’re doing with a pension plan when the balance goes down and you increase the risk. Now, it’s great if you don’t run out of money and still have the time to place another bet. The problem with the ‘gambler’s ruin’ scenario is at a certain point you won’t have enough money or time left to make back what you lost.

**Lieberman:** It does appear to run counter to the prevailing theory to protect the aging investor from losses by reducing risk as they approach retirement.

**Ketchabaw:** And I’m sitting here listening to this and I’m thinking it’s almost like rebalancing. That strategy has proven to be successful over many, many years.

**Lightner:** To me, de-risking in a CAP context is really just emerging. Sponsors haven’t spent a lot of time considering how to de-risk the plan for their members. Certainly, target-date/lifecycle funds are steps in that direction, but they’re not perfect solutions. What I do think, however, is that traditionally, whether it’s CAP or DB, the only real option for members to de-risk once they get to retirement age is the annuity market. And the annuity market right now is not an attractive option, so there’s a real need for alternatives to the annuity market.

**Pond:** You have to take a gradualist approach too. The idea of, well, ‘I’ll manage it in a CAP until I’m ready to retire and then look for something like an annuity’ is wrong if the market drops a month or two before retirement. Obviously, they would have been better to somehow incrementally go into something annuity-like all along.

**Johannson:** I believe that there is a role for annuities and the idea of a staggered entry into the annuity market can offer interest rate risk protection if started early enough. However, a staggered bond or GIC portfolio or any guaranteed investment plan that starts with a Current Pay solution and then can be laddered out five, 10, 15 years, would offer interest rate protection and a guaranteed income stream. There are such products on the market available at transition into retirement. Possibly some might be suitable for a TFSA plan prior to retirement and this would be worth investigating. Recent articles have indicated that there is a decided uptick in interest in TFSA plans including amongst younger members. This likely be a developing trend given that this is a new product in the market.

**Richards:** I’ve had this discussion about the risks in our CAP. We long ago not only concluded but articulated that we could not escape the fiduciary duties or the liabilities associated with these plans regardless of the vehicle. And we launched on a course of action that has always been a step ahead of regulation and has been prudent. We didn’t need somebody to tell us that you have to communicate, that you have to inform and educate and advise and all of the issues that go around that. But I have never made any commitment to anybody in our CAP about what the balance would be when they retire. That is up to them. I simply said, ‘Here’s the plan,’ and we explained it.

So beyond that, my comments really are about the DB plan. And what I’m seeing around de-risking comes, unfortunately, in the shadow of a severe event – the economic downturn. And like a lot of responses, the pendulum has swung a bit too far. So you’re seeing people pushing low volatility and some form of LDI and absolute return funds. And now I need to be concerned about tail risk management. That’s a term I never heard of in the first 20 years.

**Johannson:** Well that’s certainly true. For a long period of time there was much discussion around how to manage surplus situations. This was the major focus during the economic hay-day before the fall.
It’s true that the pendulum of interest in different strategies, be they conservative or more aggressive, seems to follow after economic performance and today it is all about de-risking through annuities and long/short equities and so on. Perhaps this all should have been considered much earlier when the boom times were still with us and currently we should be careful to not ignore growth in controlling other forms of risk. It’s a thought.

Richards: Well, yes, and our process has changed. It struck me one day that 25 years ago, we had a single balanced manager and over time we added further managers to provide diversification. We gave them the money, but we defined the ranges and made all the decisions. Now we have specialty managers with more dynamic strategies. When it comes to moving into real estate and infrastructure and corporate bonds, these decisions may be entirely relevant to what we’re trying to do with our DB but, at least in our plans, may not make sense as an option for the CAP.

Moderator: In terms of risk management, where does the elimination of mandatory retirement fit into all of this?

Pond: The elimination of mandatory retirement is an important feature of a CAP world. After all DB and CAP plans each have different safety valves when funding is too low. When you think of the safety valves for a DB plan, it’s either change the benefits, change the contribution, or somehow change the investment return. On the CAP side, the safety valve is lifestyle and how much money do I need when I cease working and when do I cease working? Whether we think it’s good or bad, the ability to work until you’re 70 or longer actually becomes a part of the overall retirement planning. You can now adjust your plans based on whether you need to work longer to meet your retirement income goals. If you want a better lifestyle, perhaps you work longer. That is the reality everyone faces in a CAP world and, therefore, you had to eliminate mandatory retirement to give people the flexibility to properly plan for their retirement.

Ketchabaw: I’m thankful we no longer have mandatory retirement given the economic environment of the last four years because there are a lot of people that have had to work longer because their balances dipped so badly. They would never recover from that loss if they had started drawing on those plans immediately. But they could work a little bit longer and, hopefully, gain those dollars back to be able to have the retirement they expected.

Moderator: What are the next steps?

Litner: In the legal world, we have largely operated in a vacuum when it comes to law and regulations applicable to CAPs over the past decade or so. We’re starting to see signs of that changing and I expect that to be the trend going forward. As next steps, I would say, expect more regulation, expect more intervention by regulators, and more oversight. You’re seeing CAPSA sending out new policy upon new policy directed at how you should manage a CAP. You’re seeing the federal government enacting legislation directed at what a CAP portfolio should look like. You’re starting to see cases dealing with the duty to communicate and with the legal duty to invest prudently which can be easily applied to CAP plans. So expect the legal obligations of sponsors to become more of a focal point than it has been in the past. Will this require a similar level of rigour in risk management as sponsors and administrators have traditionally applied to DB plans? That remains to be seen, but applying similar risk management concepts and processes may be a good next step for those who manage CAP plans.

Lieberman: From a risk management perspective, many of the ideas discussed today provide inspiration to create and distribute products for CAPs that address these issues. This discussion also reaffirms our need to continue with programs to deal with such behavioural challenges as lack of engagement and overall lack of financial literacy amongst plan members. To the extent that we have conversations like this, we can start to generate further creative ideas that can create new solutions to help people save and control risk in their CAPs by leveraging some of the experience, products, and processes from the DB world.

Pond: I worry a lot about expectations amongst Canadians. They are still very unrealistic. Back in the ’80s, I was at a major pension fund. I would have people asking if they could get out of a healthy DB plan as they were lured by advertisements promising early retirement – Freedom 45 became Freedom 55, though still with a yacht. Now, it must be Freedom 65 or beyond. Perhaps the yacht is now a kayak. So, the expectations are adjusting, but there’s still a widespread expectation that we’re all going to retire at a reasonable age and we’re all going to travel and stay in five-star hotels. Realistic lifestyle objectives for retirement have to become a part of our focus when defining the level of life income that’s needed and also the appropriate level of certainty to build into that life income expectation. As usual, there are no magic fixes, it is all matter of trade off. But this is the next challenge facing our industry.

Ketchabaw: In the early ’90s, people were trying to get out of their DB plan to get into CAPs because they were all living in such high-return worlds. Here we are,
years later, and the CAPs are not giving us the returns we expected and we hate that. We’re talking about trying to make our CAP plans more DB-like. To me, it’s a frustrating world because it still continues to evolve and what is the right answer?

Richards: As you know, I’m federally regulated and as a federal plan, on the DB side, I am now forced to do annual valuations. Like everybody else who is federally regulated, there are prescribed rates that I have to plug into my solvency calculations. The cumulative effect of these is having a spillover effect that is not necessarily for the good of the plan’s returns. As a result, while the times are historically abnormal in terms of low performance, the Feds have chosen at this time to tie my hands behind my back when I am looking for the most prudent solutions. In my mind, it’s totally unnecessary, but this is the next step I have to deal with and it impacts our DB plan investment decisions. And this is a new reason, in this specific case, why DB and CAP risk management decisions may be very different.

Meloche: For me, the next steps are to pre-package DB-like solutions that will help CAP members during their accumulation as well as during the phase where they transition into decumulation or their spend down. To have this, we’ll need the greater engagement of all plan sponsors, including those who see their responsibility as only levying and paying contributions. We also need to continually work to engage plan members. For the CAP environment to work, we need all parties at the table (DC experts, record keepers, and plan sponsors) to find solutions and embed these solutions in CAPs to support plan members so that we can increase their chances to meet their retirement goals. In short, we need all people in the CAP world to care.

Johannson: We started today’s dialogue by looking at risk in DB and CAP plans to determine if there is commonality in the types of risk and in risk management solutions. What a great dialogue with a range of perspectives. I believe the answer is clearly that there is some degree of commonality and some opportunity of borrowing CAP ideas, such as target date glide paths, and applying these in the DB world. There also is an opportunity to consider the investment alternatives available in DB plans and how they might be applied in CAP plans.

We have heard of a number of these ideas such as using staggered annuities phased in over time or employing other laddered and guaranteed fixed income products or perhaps introducing Managed Portfolios, professionally created from the same funds or fund managers as for a DB plan and offered additionally on an individual basis, where appropriate, for a full member solution.

We have also heard of some significant differences in terms of liability, looking at Blair’s situation on the DB side which has a whole level of challenge and risk management not shared by his CAP plans. However, listening to Paul, we learn of the increasing degrees of regulation which, while offering clear direction of the right path, can also mean a more DB level of fiduciary governance. And, of course, we need to keep all stakeholders engaged and attuned to the needs of the members and beneficiaries relative to a stable and sustainable retirement.

As stated today, the swinging pendulum of the economy has clearly dictated gaps in strategy and risk management over time which are usually addressed after a significant economic event. Currently, this has dictated a liability driven mind-set on the DB side which might also benefit from recalling that we will need growth as well, albeit introduced with caution to control the downside. This prudence perhaps could also apply to CAPs.

Our next steps may well be to consider the expert experience offered here and see how best these strategies might cross-apply within our own plans. Clearly, one next step is the cross-pollination of ideas and the new strategies, procedures, and products that we can develop to meet these needs within both the DB and CAP worlds.

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40 Benefits and Pensions Monitor | October 2012
Beyond Stocks & Bonds: The Real Asset Solution

With many Canadian pension plans facing funding challenges, they are seeking new sources of returns and one of the areas they are investigating is real assets. Greystone Managed Investments Inc. assembled an expert panel to examine this asset class:

The panelists included:

- **Jason Campbell** — Investment Consultant, Eckler Consultants & Actuaries
- **Kevin Fahey** — Director, Investments, CAAT Pension Plan
- **Jeff Mouland** — Executive Director and Head of Infrastructure, Greystone Managed Investments Inc.
- **Jeff Norton** — President and CEO, Teachers’ Retirement Allowance Fund (TRAF)
- **Janet Rabovsky** — Senior Consultant, Towers Watson Canada
- **David Vickerman** — Executive Director, Infrastructure, Greystone Managed Investments Inc.
- **Ted Welter** — Managing Director, Real Estate and Mortgages, Greystone Managed Investments Inc.

Their discussion will look at what real assets are and how they generate return. They also examine the impact of size when it comes to investing in this area as well as approaches for investors to realize the benefits of real assets.

The moderator is Joe Hornyak, executive editor of *Benefits and Pensions Monitor.*
MODERATOR: What investments do you consider to be real assets?

JEFF NORTON: What TRAF would consider real assets in our portfolio would be anything that has a tangible quality to it, which has a utility just by virtue of the nature of the asset.

JASON CAMPBELL: These would be assets with tangible value linked to running society or the economy. Commercial real estate and infrastructure are the two areas we focus most on because society requires them for essential functions. However, you could probably put commodities and farmland in the real assets bucket as well.

TED WELTER: I would add that in the infrastructure space, it’s relatively early days in that it’s really only been designated as an asset class in the last five to seven years – compare that with real estate which has been around as an asset class for a long period of time. While we’re still at the early stages of infrastructure development as a stand-alone asset class, it is one that pension funds are increasingly attracted to.

KEVIN FAHEY: Canada is somewhat unique in that we’re probably ahead of the curve, perhaps with the exception of the Australians, relative to the rest of the world when it comes to infrastructure. That said, it’s still early days which means there’s a lot of room for asset class growth.

RABOVSKY: Until recently, one of the reasons that the small- to mid-size plans have not been able to access real estate and infrastructure broadly is that solutions have not been available. We are now starting to see viable cost effective products for investors who can meet the minimum investment thresholds. We are also starting to see greater diversity of products. Not all clients want to go into closed-end products and we are now starting to see open-end products.

MODERATOR: Why are Canadians and Australians ahead of the curve?

FAHEY: Canadians are looking to alternatives, particularly with infrastructure, for inflation protection, diversification, and a steady income stream.

RABOVSKY: In Australia and Canada, as well as the UK, there’s a concept of the social contract. As a result, public-private partnership models are easier to accept. However, you’re also starting to see big U.S. public plans becoming interested because they can’t really get an equity risk premium anymore. They need to find ways to achieve the higher required rates of return that are still built into their actuarial assumptions.

MOULAND: If you look at the Australians, there’s also the question of the opportunity set and available capital. The forced savings concept from their superannuation plans created a significant appetite to deploy capital in the infrastructure space. As Australian infrastructure opportunities began to diminish, the necessity to deploy capital facilitated

JANET RABOVSKY: It would be real estate, infrastructure, precious metals, commodities, timberland, and agriculture. We actually split out timberland and agriculture because they have different properties. And building on what everyone else said, these assets provide definite inflation protection, diversification, and downside protection for a portfolio.

MODERATOR: How far along the curve are we in terms of pension funds buying real assets such as real estate and infrastructure?

JEFF MOULAND: The larger Canadian pension plans have been relatively early adopters in establishing in-house investment teams for infrastructure. However, the smaller to mid-size plans typically do not have the scale or size to invest on a direct basis, thus there are opportunities for infrastructure managers to provide the sourcing and execution capabilities to those plans motivated to allocate funds. We are definitely seeing a lot of interest in this alternative asset class from the various Canadian pension plans.

RABOVSKY: It’s overhear.

“Your expected returns are higher than with fixed income, there is long-term visibility to cash flows and there is less volatility relative to public equities.”

– Jeff Mouland
expansion into global infrastructure assets. They were really the first-movers into North American infrastructure. In Canada, the larger pension plans are also well capitalized. Out of necessity, Canadians have built in-house capacity and have been very active on a global basis.

WELTER: In Canada, the very large plans have internal resources to manage real estate assets. When you move into the smaller plans, they have been late adopters. They’re turning to it and often are seeking the advice of consultants to help build allocations.

A big consideration is finding managers that can execute to the governance and fiduciary standards that are required and expected when managing institutional capital.

MODERATOR: Are sponsors looking to real assets because of portfolio volatility or are they looking for return?

DAVID VICKERMAN: Both, but there is an additional reason. In the case of real estate and infrastructure, pension plans experience better matching to their long-term liabilities. Both asset classes exhibit lower relative volatility compared to public markets, with the potential for return premiums.

MOULAND: Why wouldn’t you invest in infrastructure? Your expected returns are higher than with fixed income. There is long-term visibility to cash flows and there is less volatility relative to public equities. Granted, infrastructure typically doesn’t have the same liquidity as public equities, but as a private investor, you typically have significant shareholder control. Given the strategic, regulated, and/or monopolistic nature of many assets, you can take a long-term ownership view where returns are uncorrelated with the public markets.

FAHEY: Certainly over the last 20 years, there has been more of a movement away from investment-only viewpoints to asset liability matching. Real estate and infrastructure play into liability relative thinking more than, perhaps, traditional asset classes.

WELTER: I really like that statement.

I always think that if there’s a chart that shows the international property index from 1985 to today, 85 per cent of the productivity of the asset class comes from income. So, you get ebbs and flows of capital appreciation and depreciation.

Why is this relevant? Long-term investment strategies are highly appropriate for pension plans. So, if you tilt away from a relative performance discussion of real estate or infrastructure relative to stocks and bonds and you tilt the discussion more towards the liability obligations of a pension plan and the absolute return rate that a physical asset class can provide, it’s compelling. There’s less volatility and high predictability of income and it matches well to the liability side.

CAMPBELL: The objectives of plan sponsors have changed a lot from the mid-’80s as well. If you were a publicly traded company, you’d look to your pension plan as a profit centre. If you invested in good stocks, it was going to make money for the sponsor. Today, the focus has turned much more to the contribution, stability, and cash flow visibility that everybody wants.

NORTON: You’re probably getting that now without giving up a lot of return either. Historically, we looked at alternatives as returning the mid-point of stocks and bonds. Now, it’s ‘I don’t know what your long-term capital market assumptions are, but real estate probably isn’t much below equities.’

MODERATOR: How much should be allocated to real assets? What effect does cash flow play on overall allocations?

NORTON: It’s somewhat subjective. In an optimizer, you’ll want to add some constraints due to liquidity; for example a maximum of 10 per cent to infrastructure. The ultimate allocation can, therefore, be partly subjective. Infrastructure, in our case, is a five per cent target. It’s sort of a walk before we run, so these numbers will probably increase before they decrease.

“On balance, I probably would come down on the side of the open-end funds”  
– Jeff Norton
RABOVSKY: Liquidity is a large factor, but it should be examined in detail. If you are cash negative and are paying pensions, you still have the option to take your rental payments and your yield on your real assets and actually use those to pay your pensions. That’s something we’re going to see more of to control the actual level of the allocations. We’re increasingly talking to clients about the balance between liquidity and illiquidity and, if they’re still making contributions, how that all plays out.

CAMPBELL: There’s the strategic allocation to the plan as a whole, but, given the illiquidity of the asset class, there is also the management of short-term deviations in portfolio exposure. If your long-term target allocation is 7½ per cent and you’re only at five, re-investing dividend cash flows is a good way to increase your allocation. If you’re overweight relative to your target allocation, you might change that approach and start to take the dividends as a way of just managing your overall allocations.

RABOVSKY: What we’re trying to do is get clients to get away from, ‘okay, five per cent this, five per cent that.’ Let’s just have a range because what you really are doing is finding risk and exposures to create certain types of return patterns in the portfolio. If you do it that way, it actually becomes much easier to adjust as the needs of the client change.

NORTON: When you say you’re trying to get clients away from labelling, do you do a ‘real asset’ search? Do you have an infrastructure manager and a real estate manager in the same search?

RABOVSKY: The way we would think about it is slightly different. We’d say, ‘okay, let’s say your allocation is 10 per cent. You might want to have somewhere between four and six per cent in each.’ And then we would look at the best opportunities within each category based on what’s open and the best manager. We’d say, ‘okay, here’s our best idea for core infrastructure, here’s our best idea for real estate...’

CAMPBELL: We’ve put both forward in front of clients. Most clients today are working on a real asset search which could be say a 10 per cent allocation – it could be all real estate, all infrastructure, or both. We’re looking at that spectrum and working with clients to decide where they want to be.

MOULDAN: We obviously believe that investors should take a long, hard look at gaining exposure to real assets for many of the reasons we have already discussed, including long-term cash yield. However, we also recognize that different plans are at different stages of the learning curve as it pertains to understanding the risks and return characteristics of real assets and, in particular, infrastructure. In conducting infrastructure roundtable discussions across the country for the past few months, we have seen tremendous interest and appetite to gain exposure. That said, there are significant differences between various plans on the timeline for adoption. However, there is a general consensus that plans will be increasing their allocation to infrastructure going forward.

MAGISTRATE: Is communication more important with real assets?

WELTER: The issue is the liquidity. Real estate is not illiquid, it’s just the time to create liquidity is very different. A bond can be done in hours. In stocks, it can be done in days and weeks. In real estate, it can take weeks and months. The plan has to take the responsibility of knowing that. The manager has to create products that serve the client’s needs as their needs change. That’s the communication link you must have.

CAMPBELL: We emphasize that, not only in terms of the asset class itself, but from a manager selection perspective. You’re really married to your manager
for an extended period of time. If you make a mistake with an equity firm, you can probably get out pretty quickly. These asset classes require that a greater amount of due diligence and governance be done upfront, as well as increased communication throughout the process because you won’t be able to move managers quickly if you don’t like what’s happening.

MODERATOR: How do you determine whether or not exposure to real assets should be domestic or global?

NORTON: That’s a good question. From a real estate perspective, we’ve looked at it several times in the last six years. We’ve looked at it asking if we should diversify globally, but we just can’t get there when we look at the increased cost. In addition to the manager fees, there’s a little bit of tax inefficiency depending on the jurisdiction as well as further costs on the governance and if you’re going to hedge the currency. We think the Canadian market is still fundamentally better than most places in the world and we just haven’t felt the risk/reward from a global real estate perspective made sense.

FAHEY: Our real estate is also all in Canada so far and I think from the outset that was formed by the fact it was a new allocation.

MOULAND: The reality of our domestic infrastructure market is that the ability to deploy significant capital on a timely basis is often limited. Having the mandate and network to source transactions on a global basis provides a better opportunity to get investor money working earlier, as well as providing diversification to the overall portfolio. Economic cycles and fundamental infrastructure needs vary on a global basis, thus the ability to identify, compare, and execute transactions across a multi-sector and multi-geographical opportunity set, in our opinion, is in the best interest of investors.

MODERATOR: Are there differences in the returns between real estate and infrastructure?

RABOVSKY: It’s how the money is earned. From a real estate perspective, you have a building, you have tenants, and you have rental income. You may have some sort of capital appreciation, but basically it’s bricks, mortar, and tenants.

With infrastructure, you have an asset that could be contracted or regulated, in which case, you would have a regular income. You may have a greater degree of economic sensitivity as well. If you have a contracted and regulated infrastructure portfolio, it doesn’t really matter where you are in the economic cycle. Whereas even the best real estate is going to be subject to interest rate and economic cycles, maybe not in the short term, but certainly if you entered a 10-year recession, so you’d have a problem. If you have a water contract for 10 years; you don’t care what’s happening. So, you need to understand how you’re actually earning your money and the degree of GDP sensitivity you’d like to have in your portfolio.

VICKERMAN: Infrastructure, as an asset class, is very broad compared to real estate. Assets, within the infrastructure asset class, range in characteristic from those where revenue is based completely on demand by the users to those where the revenue is based on long-term contractual agreements. These varying types of revenue stream result in a broad range of risk/return characteristics.

I would say for small or mid-size pension plans to not think they are too small to participate in these investments.

— Jason Campbell

FAHEY: When examining the GDP exposure and relationship with returns, history does demonstrate that through the latter part of the decade some infrastructure funds did have a lot of economic sensitivity imbedded in them.

CAMPBELL: In addition to the asset class, investors need to understand how their managers will use leverage. The economic sensitivity that you think you’re getting with a certain type of asset can be far greater than expected if you don’t understand your manager’s use of leverage and how much debt he’s using.

MODERATOR: We touched on this briefly in the beginning, how do...
these real assets fit into a liability-driven investing framework?

CAMPBELL: From my perspective, LDI is such a broad term now. Years ago, I would have thought of it as just immunization. Now it can include anything from inflation hedging to generating cash flow to pay your liabilities – both the long term and the short term. So, there are all sorts of ways to define LDI.

There is no doubt that falling bond yields are a driving part of the allure of real estate and infrastructure. You can't make the returns on bonds that you could five years ago or, especially, 15 years ago. Real assets can fit as a bond replacement for some clients.

VICKERMAN: Well, the infrastructure asset class has very limited options in the public sector. The options that exist are so-called ‘listed infrastructure funds,’ whereby the public entity is investing in the public equity of businesses exposed to infrastructure, such as SNC Lavalin or Alantia. From a correlation, volatility, and risk/return perspective, this option is very different from investing in direct global infrastructure assets.

FAHEY: Public markets may be a better avenue for small plans, but in terms of what most people are looking to infrastructure for, I don't think that the publicly traded instruments are going to provide the desired diversification. They tend to follow the risk of public markets.

RABOFSKY: Our view is that public is sub-par because it’s so highly correlated to the equity market. It’s just a different type of equity. So, while you may want to use it to build exposure, we just don't think it actually helps investors. You’re not getting that diversification.

CAMPBELL: We’ve used it very similarly as part of the appeal is reducing exposure to market volatility from listed equities. If you just look at 2008 and 2009, the experience was drastically different between the private and public investments. So, even if over 15 or 20 years public and private investments come out with similar performance, that doesn’t mean plan sponsors can handle the short-term volatility.

MODERATOR: How do smaller funds get into private investments in real assets?

CAMPBELL: The available product is a bit of a challenge, but on Canadian real estate and infrastructure, you can make the returns on bonds that you could five years ago or, especially, 15 years ago. Real assets can fit as a bond replacement for some clients.

RABOFSKY: Even in infrastructure, let’s say you take a 10 per cent allocation on a $100 million plan, you still get your $10 million minimum. They can get in it, it’s just more difficult.

MODERATOR: What are some of the differences between using open-end and closed-end funds?

MOULAND: As the infrastructure asset class matures and investors become more knowledgeable of the asset class, we feel the open-end model will become more common. To date, most infrastructure funds are closed-end funds, largely due to the direct application of the private equity model. Investors currently do not have a lot of open-end options. However, if you
are an investor who is looking to gain exposure to core infrastructure assets that provide long-term cash-flow generation and sustainable capital appreciation, we feel that a typical 10+ year closed-end model creates an unnecessary exit requirement. Why should a long-term pension plan investor have to sell a strong performing asset simply because the fund has a fixed expiration date? Another aspect of the closed-end fund is that it has a defined investment period, whereas the open-end model does not. In an open-end structure, this ensures transaction selection and execution is not driven by a fund’s internal time restrictions. We also feel that the long-term nature of the open-end model provides greater partnering and deal sourcing opportunities with larger pension plans and strategic corporates given the alignment of interest as it pertains to long-term ownership of infrastructure assets.

CAMPBELL: One caution of open-end funds is that truly long-term investors are somewhat at the whim of other short-term investors in the fund. While this hasn’t been an issue with a lot of funds flowing into real estate and infrastructure, if for some reason you have significantly negative returns for two or three years, is everyone going to stick in the fund or are they going to start pulling capital out? It’s hard to predict.

FAHEY: But, you referenced the valuation point, Jeff, and to me, you really do have to get very comfortable with the methodology that the open-end fund is using and the people who are running the fund and how they’re getting paid relative to what the valuations are at any given time.

In a closed-end model, you know they’re going to be accountable and they do have to sell that asset.

NORTON: On balance, I probably would come down on the side of the open-end funds. We were in on some of the earliest closed-end funds and we spent a lot of time and incurring a lot of fees to have the manager build a portfolio that then had to be liquidated.

I do agree with the valuation considerations, but if you’re not paying a performance based fee, this risk is mitigated.

The other thing that Jason touched on is we like to control our destiny so, if you have an open-end fund, we like the ability to transfer our fund interest and not have the only exit be redemption to the manager. We like the open-end model because there is re-investment risk from closed-end funds. With an open structure, we do not always have to recycle the money and re-deploy investment. If you build a solid investment portfolio, you’ll hold it forever.

WELTER: To my mind, closed-end funds, as a very general statement, are manager-centric. You have an expert and are aligned more to people who are experts in a specific field or strategies. They want a disproportionate share for the expertise they bring to the table and they’ll have an end date to realize that amount.

The challenge I have with closed-end strategies is that you not only have the asset class volatility, but you have an event risk that shocks the portfolio when your fund winds up. You have to reload and recalibrate the product. All the time and cost to do that is a drag on an institutional investor’s portfolio.

You could have a great market timing exit strategy where you realize great profits and a great end product, now you have to get back in at that same pricing.

MODERATOR: Is it the right time to get into real assets?

WELTER: I always find that a fascinating question. Is it the right time to get into real estate or infrastructure, is it the right time in the cycle? History would suggest that these assets are highly appropriate for a pension plan.

If you look at where income streams are with real estate, I feel fairly passionate that we’ve had flat income lines and an inability to grow income because there’s so much pressure from the tenant base that isn’t willing to pay for it.

But the other component of it is all these tenants have shown real constraint discipline and are managing their balance

“History would suggest that these assets are highly appropriate for a pension plan”

– Ted Welter
sheets very well. So, from security of capital, preservation of capital, and the ability to grow, we actually have great tenancies that are paying the rent every month. I would suggest that although the purchase may be fully priced, we’re under appreciating the income growth line.

**RABOVSKY:** If core infrastructure is only going to deliver net seven or eight per cent, it should actually attract a much lower fee than something that is more value added and opportunistic. If infrastructure assets generate a higher return, they can support higher fees. That was the missing link in the past. We’ve had that in real estate: you know what the patterns rights are increasingly associated with their fund investments.

**RABOVSKY:** Absolutely, we do that for clients. But our experience shows, because we use an external manager, people don’t like giving up their control.

**NORTON:** We did our first strategy on investing in infrastructure in ’04, created a separate asset allocation in ’07, and then we did an updated strategy at that time. We didn’t think we’d be able to do co-investments. We’re only a $4 billion plan. However, things have changed as we have done two co-investments since then. This year, our average cost on infrastructure is low because the scale comes down with our co-investments.

**MODERATOR:** Any final thoughts.

**VICKERMAN:** I would like to go back to the macro-economic environment that is creating investor interest in real assets, like real estate and infrastructure. We have a low interest rate environment that seems likely to continue, plus we have high equity market volatility and a lack of investment returns. Combined with inflation concerns and pension funding requirements, this macro environment is driving significant investment interest into infrastructure and looks to be a long-term secular dynamic.

**MOULAND:** It is clear from our interactions that Canadian investors are increasingly becoming more sophisticated in their understanding of the infrastructure asset class. Investors are demanding quick deployment of their committed capital to generate long-term real returns that are stable and predictable. We believe open-end global platforms allow investors to gain real infrastructure exposure on a timely basis through a diversified infrastructure portfolio.

**WELTER:** In the case of infrastructure and real estate, we have long-dated assets that relate to the long-term needs of pension plans. It’s very important for pension plans to know who the managers are and to investigate, challenge, solve, and get products that are very well-governed and managed with people and processes that are long-term in nature.

**CAMPBELL:** The last thing I would say for small or mid-size pension plans is not to think they are too small to participate in these investments. The greater the willingness to do some upfront heavy lifting and due diligence, the greater the chance of making successful investments.

**NORTON:** From our perspective, we see our allocation on a strategic basis probably increasing over time. At the same time, there’s more product and competitiveness that’s focusing the managers and driving down fees. Infrastructure, in particular, will continue to evolve and real estate has been there a long time and that probably won’t change.
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### MONEY MANAGERS

#### STATISTICAL REPORT

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50  Benefits and Pensions Monitor  | October 2012
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1 Includes $1,895M of sub-advised DB Pension assets
2 Includes $703.6M of Money Market Funds
3 Direct client recordkeeping relationships
4 Direct clients and more than 500 clients through insurance company relationships
5 Some assets are in a hybrid plan, hence are included in both DB and DC totals
6 Relationships through omnibus DC providers

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The Pension Benefits Standards Act of B.C. has remained largely unchanged since it was introduced in 1993. However, we will see tremendous changes to how pensions are structured and administered in B.C. with the passage of Bill 38 this May which replaces the existing act. While the new act introduced a number of changes to the pension landscape in B.C., the most important changes can be summarized as follows:

- Increased flexibility in terms of plan structure and design
- Increased rules in respect of governance and oversight
- Increased powers of the superintendent of pensions
- Changes to the minimum standards that apply to all registered pension plans

The new act comes on the heels of the Joint Expert Panel of B.C. and Alberta and co-operation between the two provinces to harmonize the legislation between them. Therefore, while draft legislation has not yet been released in Alberta, it is expected to mirror the new act in all material respects.

**Flexibility**

The most significant change that will follow from the new act is the enhanced flexibility in terms of how pension plans can be established. Under the current act, there are rigid plan classifications. Pension plans are either Defined Benefit or Defined Contribution. There is some modest flexibility available currently if the pension plan is the result of a collective agreement which limits the obligations of the employer in respect of contributions. However, generally speaking the historical classifications for pension plans left little ability for an employer to create a plan that worked for its financial situation and the demographics of its workforce, without transferring the whole of the risk of poor investment returns to the employees.

One example of this added flexibility will be the availability of a ‘target benefit provision’ which can be added to any type of pension plan. A target benefit provision promises a benefit upon retirement (and, in that way, resembles the classic DB pension promise that can be such a useful tool in attracting and retaining employees). However, that benefit can be amended if required by funding concerns that arise for the plan. As is the case under most existing pension standards legislation, classic DB provisions cannot be amended (for service already provided), which imposes a heavy onus on the employer to fund that promise, even when poor investment returns make it difficult to do so. The target benefit provision creates a ‘safety valve’ of sorts that can help the employer ride-out a period of poor investment returns.

The new act will also allow a sponsor to create a ‘solvency reserve account’ in a classic DB pension plan. Historically, when special payments were needed to address a deficiency in the plan, those payments and funds were inaccessible after being paid into the plan. If the plan’s funded position improved, the employer might be able to take contribution holidays (depending on the terms of the plan), but rarely would an employer...
be permitted to take actuarial or ongoing surplus from the plan. The new act will allow sponsors to have a separate account in the plan into which those special payments can be paid and from which excess can be withdrawn if appropriate. Much of the detail about how the solvency reserve accounts can be established and how an employer can access funds in that account will be found in the regulations to the new act, a draft of which has yet to be released.

**Governance**

The new act will introduce a number of new requirements for the administration and governance of registered pension plans. Every pension plan will need to prepare a ‘governance policy’ and every administrator will be required to ensure that the plan complies with that policy. While the details of the governance policy will be found in the yet-unreleased regulations, a review of the CAPSA Guideline No. 4 suggests that it will have to discuss:

- fiduciary responsibilities
- governance objectives
- roles and responsibilities
- performance measures
- risk management
- oversight and compliance
- code of conduct
- conflicts of interest
- conducting reviews of the policy

For those pension plans that do not yet have a formal governance structure in place, they will need to determine what the new requirements mean for them.

The new act will also impose requirements in respect of how the governance of the plan is monitored and assessed. The act provides that the administrator will have to assess the plan’s governance as required by the regulations. While the detail of those requirements is not yet known (because the regulations are not yet released), it is likely that the regulations will specify the form of such compliance, whether it must be in writing, how frequently it must be conducted, and whether it must be filed with, or just available to, the superintendent of pensions.

**Superintendent’s New Powers**

One of the most significant new powers given to the superintendent of pensions with the new act is the power to designate a new actuary for a pension plan if the superintendent is of the opinion that the assumptions or methods used by the existing actuary were inappropriate, even if those assumptions or methods were consistent with actuarial practice. Exercise of this broad power would mean giving the designated actuary access to all relevant information and would lead to that actuary preparing the actuarial report that would bind the administrator and sponsor as if it was prepared by the plan actuary.

The superintendent will also have the ability to impose an ‘administrative penalty’ for breaches of certain, prescribed provisions of the act. This penalty is in addition to the fines that the superintendent has always been able to impose, suggesting that the penalties will be
ordered more liberally.

**Changes To Minimum Standards**

There are a number of changes to the minimum standard rules with the new act, the most important of which is the move to immediate vesting, something we have seen in many jurisdictions recently. Pension plans will still be allowed to have a waiting period, but vesting will be immediate upon an individual becoming a member.

The spousal waiver will remain in place. However, under the new act, in order for a spouse to waive his or her entitlements, he/she will have to complete the waiver familiar to those of us in B.C. (which waives the right to a 60 per cent joint and survivor pension) and a second waiver to waive his or her entitlement as the member’s deemed designated beneficiary.

All administrators and sponsors of existing pension plans in B.C. should be aware of the changes coming with the new act and should monitor the draft regulations carefully to understand the impact of those changes. Employers that do not currently sponsor a pension plan should also monitor these developments as they are designed to encourage employers to offer pension plans and to give those employers options in terms of developing plans that reflect their human resource needs and their financial abilities.

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Lisa Chamzuk is a partner at Lawson Lundell LLP practicing exclusively in the area of pension and employee benefits. 

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Workplace Wellness – Alive And Well?

By: Karen E. Treml

Workplace wellness is an oft-used term that seems to lack inherent definition. For example, Denise Balch, president of Connex Health Consulting, doesn’t like the term. “I find [it] too limiting and not relevant enough to senior executives and the challenges they face.”

The Luxembourg Declaration on Workplace Health Promotion (2007) uses the term ‘workplace health promotion’ in place of workplace wellness and defines it as the combined efforts of employers, employees, and society to improve the health and well-being of people at work. It posits that well-being can be achieved through a combination of improving work organization and the working environment, promoting active participation, and encouraging personal development. Chris Bonnett, president of H3 Consulting, says this definition demonstrates that it is not the sole responsibility of any one party to create and sustain a healthier workplace. As well, it reinforces the important role employers can play in strengthening the organization of work and the conditions under which work is done.

Call To Action

In 2011, the Buffett National Wellness Survey indicated that Canadian employers consider work-related stress to be the most important health risk facing employees in their organizations, followed closely by smoking, mental health issues, and high blood pressure.

The seriousness of these concerns appears to be prompting Canadian organizations to take action to assess and improve their employees’ health. Although only 26 per cent of the organizations responding to the survey indicated that they took a strategic approach to improving employee wellness, 72 per cent said they offered some initiatives intended to improve employee health or well-being.

Sue Pridham, president of Tri Fit Inc., feels that employers are indeed embracing workplace wellness. “Workplace wellness programs are an attractive benefit to employers and employees alike.” In her experience, progressive employers are looking for more robust, continuous, and strategic approaches to workplace wellness that are aligned with corporate objectives and move beyond ad hoc, sporadic programs. “Comprehensive wellness programs focus on both employee and employer needs and interests to reduce health risks and support healthy lifestyle choices.

Similarly, Darren Harris, vice-president of marketing at Organizational Health Inc. (OHI), says employers see the value of offering workplace wellness programs for increased productivity and for the potential savings in benefits costs, but also for the positive bounce they can achieve in employee engagement and retention. In an economy with a scarcity of talented resources, employers are recognizing that workplace wellness programs speak to the kind of corporate culture that is now expected by prospective employees.

However, some employers remain reluctant to embrace workplace wellness solutions. Balch feels while most employers are interested, they are reluctant to take a strategic approach that includes careful planning and measurement. In her experience, this is because they are concerned about the time, effort, and cost of doing so, as well as the competing priorities, and just not knowing how.

Bonnett sees three reasons for employer reluctance. “Firstly, employers often see workplace health promotion as an ‘extra’ – something to do if they have the resources available. That attitude may be driven by generally poor evaluation of these programs. Results are hit-and-miss and are highly dependent on the context of a particular workplace. And, unless programs are comprehensive with adequate duration, intensity, and scope, the desired outcomes are extremely elusive.

As well, wellness programs are unlikely to work if the underlying organizational foundation is weak. Layering a weight loss, smoking cessation, or a flu shot program on top of a toxic, highly confrontational, or chronically stressed work environment can’t work.

Finally, employers often don’t see the linkage between a healthy workforce and a productive organization. Those on-and-off programs need to be tied to strategic markers of organizational progress.”

Moved Beyond

It seems that workplace wellness initiatives have moved beyond the simplicity of earlier programs. At Tri-Fit, Pridham says her clients include things like biometric screening, flu clinics, walking challenges, sport and fitness team fund-raising, on-site massage services, group exercise classes, and wellness intranet sites.

Harris finds that their clients see the value in implementing comprehensive health and wellness strategies with program elements including individual and team health challenges, onsite health fairs, biometric screening clinics, training programs, and individual and group behaviour management health coaching. Balch says the programs that she has found popular are blood pressure screening, biggest loser weight loss challenges, pedometer programs, and nutritional programs.

Despite the popularity of wellness-focused initiatives, the results of the Buffett survey suggest that few organizations are taking an evidence-based approach to assessing the impact of their initiatives or keeping track of how well the eventual results match up with the anticipated benefits. Only 21 per cent of respondents indicated that they had measured the health of their organization’s full-time employees, with this proportion being somewhat higher in Atlantic Canada and in public sector organizations. As well, only a small proportion of organizations con-
lishing the baseline costs from which to measure future savings and the resultant ROI. Many firms do not have credible data on all their costs. Most can secure numbers for benefit expenditures on short- and long-term disability, workers’ compensation, EAP, and prescription drugs, but many have little to no access to other costs such as presenteeism, casual absenteeism, lost productivity, replacement worker costs, and staff turnover. However, he says it’s important to monitor progress and every effort should be made to establish a baseline. He adds that employers’ expectations need to be managed such that they are aware some costs may actually increase in the short term.

For example, a wellness program implemented correctly can drive up EAP utilization as employees seek assistance or can increase drug claims for those who learn through a biometric screening program that they are at risk for, or have, a medical condition where pharmaceutical treatment is warranted. It’s important in the initial design of the program to set reasonable intervals at which to measure outcomes, with many programs needing three to five years to see positive results. When measuring changes to expenses, the wellness program cannot always claim a one-to-one relationship for savings. Success shouldn’t be measured in dollars alone and markers such as staff retention and employee satisfaction should also be attributed to the value of a well-run program.

Breaching Confidentiality
Another consideration, says Balch, is the difficulty in convincing some employers that they can measure results without breaching confidentiality. She finds employers tend to implement programs and talk about measurement, but don’t follow through. She does, however, see this starting to change. And she believes this is the key to creating a value proposition for employee health initiatives which could change how the ‘C’ suite views HR and occupational health. Rather than just an ‘expense’ item, these initiatives could ultimately be perceived as being real contributors to overall corporate performance.

Indeed, the Buffett survey indicates that a majority of organizations report significant non-financial benefits from their programs. Most organizations (60 per cent) report that they have received positive feedback from participants and many also report that their initiatives have resulted in improved morale (45 per cent) and reduced absenteeism (24 per cent). Almost all of the respondents felt that the health of their employees influenced their organization’s overall performance (97 per cent).

Given the popularity and integration of workplace wellness initiatives, what does the future hold? Bonnett hopes that future programs will be comprehensive and directly linked to the success markers noted in the organization’s strategic plan and that the programs will be more formally and professionally evaluated. He believes the most interesting programs are those that draw statistical linkage between personal health risks, organizational factors, and biometric measures, particularly those that measure stress. This type of research has been conducted in Sweden for a few years, but hasn’t been widely implemented elsewhere because of cost and complexity. ‘The ‘U.S. Patient Protection and Affordable Care Act’ gives resources to employers in the U.S. to measure and improve their workplace health promotion strategies, including regular national surveying and training of employer staff by the Centers for Disease Control and Prevention. While Health Canada took an important early lead in supporting workplace health promotion, it has disappeared from this field. Perhaps the competitive interests of Canadian employers could help secure new support from governments and public health, says Bonnett.

Harris thinks that future program elements will focus more on electronic delivery methods to respond to user preference and ease of accessibility, while social media applications will play a larger role in motivating employee participation. Biometric clinics are likely to include a wider array of screens with more sophisticated markers. Incentive programs will continue to shift from providing rewards for mere participation to tying incentives to the healthy outcomes that employees achieve. Recognizing health and wellness extends beyond the workplace and programs, it...
will look for more ways to include the families of employees so that the pursuit of a healthy lifestyle is a 24/7 endeavour.

**Healthy Outcomes**

Harris adds that programs using smartphone technology have already started to migrate to Canada and offer the prospect of messages of encouragement to, for example, those seeking to stop smoking. His company offers ‘Beating the Blues’ – an online cognitive behavioural therapy program that has been clinically tested with strong positive results in other countries. These kinds of online applications will increase in number, providing timely and effective coaching/counselling. The U.S. has moved a good distance along the spectrum to linking incentives and benefits coverage to healthy outcomes and, as such, screening programs have become more important in providing regular readings on an employee’s health status.

Balch sees upcoming wellness programs trending toward more cost effective, do-it-yourself, proven programs with low cost and high impact. As well, she says, programs will work for some organizations when they are focused on behaviour change.

With rising healthcare costs, an aging workforce, and a war for talent, companies are looking for strategies to manage costs, keep their workforce healthy, and attract and retain top talent, says Pridham. Workplace wellness programs are an attractive benefit to employers and employees alike, she says. Harris agrees and says that workplace wellness requires that organizations embed into their culture the value of providing employees the knowledge and tools to keep themselves and their colleagues physically and emotionally healthy. Workplace wellness must be practiced at all levels of an organization and organizations must promise long-term commitments to maintaining the health of their employees.

Karen E. Treml is Benefits and Pensions Monitor’s staff writer

**ADDENDA**

The following was not available for the Managers of Socially Responsible Investments for Canadian pension funds directory in the September issue of Benefits and Pensions Monitor.

**LETKO BROSSEAU & ASSOCIATES INC.** Lisa Caswell MBA CFA, Client Services; Ste. 2510, 1800 McGill College, Montreal, QC H3A 3J6 PH: 647-426-1780 eMail: lisa.caswell@lba.ca Web: www.lba.ca SRI Products/Services: ESG Balanced Fund Managed Since: 2010 SRI Philosophy/Style: Offer non-taxable entities the opportunity to invest according to standards of corporate governance, social rights, and environmental issues. Fundamental long-term approach applies original in-house research to analysis of companies, industries, and economies with careful attention to valuations and international diversification.
Two out of three employees will suffer from some type of foot problem in their lifetime. One in five occupational injuries affects a lower limb. The hazards might differ by workplace and the foot injury might differ by worker, but this statistic is too high to be ignored. Foot care is often seen as a less important safety issue and this often leads to a lack of attention to preventative foot care.

Main Categories
Categories of work-related foot damage include wounds from lacerations, sprains, crushing, and punctures which account for 10 per cent of all disabling injuries, and injuries from tripping, falling, or slipping which account for 15 per cent.

Some common occupational injuries to the feet are caused by such things as long periods of standing, unyielding floors, poorly fitted footwear, not wearing personal protective footwear, feet becoming trapped between objects, explosions, and chemical splashes. Furthermore, slippery floors, littered walkways, poor lighting, and bad footwear can cause sprained ankles or fractured bones.

A flexible work area that can be switched around during a shift is best for those required to stand. Consider installing an adjustable platform or pedestal for the worker or workstation. Foot rests also help the worker to reduce foot stress and a chair should always be provided for rest.

The lack of mobility associated with inside sitting jobs, driving, or airline travel can also be problematic. The legs and feet need regular exercise to be healthy. Range of motion exercises while sitting on a plane or at a desk can help. Providing a foot stool to elevate the feet throughout the day, or getting away from the computer screen for a stretch break, can also help with circulation and swelling.

The type of flooring in your workplace can seriously influence employee comfort and safety. Flooring that provides flexibility is best. Shock-absorbing and insulated insoles could be provided to workers who must walk on unyielding floors.

Designing Jobs
Varied tasks that require changing positions, using different muscles, and keeping the lower limbs more flexible are healthier.

To avoid more serious foot injuries, ensure that mobile equipment is separate from pedestrian traffic and that warning signs and safety mirrors are installed. Proper machine guarding is imperative. Housekeeping and strategic clean-ups can reduce accidents. Tripping and falling can also be prevented by adding colour contrast and angular lighting to increase depth perception in areas such as stairs, ramps, and passageways.

Some jobs require protective equipment. Choosing the right boots can be an effective preventative strategy. Those who work in hazardous areas need steel-toe caps. Employees who work outdoors need insulated temperature protection. Insulated overshoes or muffs as well as leg warmers can also benefit the lower limbs.

Higher Risk
Because feet contain a total of 66 joints, arthritic workers are at a higher risk of suffering from painful and swollen feet. The best shoes to consider are those with plenty of space at the toes, rocker soles designed to reduce pain at the ball of the foot, and laces that can be loosened if swelling occurs.

Healthy feet equal healthy business. Consider foot care posters, workshops hosted by foot care specialists such as podiatrists, and remind workers to ‘be good to their feet’ so that they can be active, focused, and balanced while lowering their risk of falls and injury. After all, keeping feet healthy may just reduce absenteeism and insurance costs while increasing productivity and morale.
Actuary Criticism A Little Unfair

Re: Letter in August 2012 issue of Benefits and Pensions Monitor, ‘Actuaries To Blame For DB Woes’

Gord Tulk, of State Insurance Inc., wishes to put 100 per cent of the blame for the current difficulty faced by Defined Benefit plans on the shoulders of actuaries. While I don’t want to sound defensive, I think his criticism is at least a little unfair.

While it might be fair to say that actuaries did not well predict 20 years ago the investment environment in which we currently live, the last 40 years are marked with cautionary reports by actuaries to governments and plan sponsors on the risks associated with defined benefit promises funded by equity investments or worse, not funded at all. Many actuaries failed to see the maturing of industries such as steel and automobile production. But, in fairness to them, so did the owners of these businesses as well as our governments that maintained policies of allowing underfunded plans to be funded ‘later.’ Hindsight is 20-20 – but where is Tulk’s letter to the editor from 30 years ago declaring the impending doom of DB plans?

Tulk touts the Defined Contribution plan and PRPPs as the more effective way to provide for retirement savings. While we can endlessly debate the cost effectiveness of DB versus DC the truth remains that large DB plans will be more cost effective than large DC plans. I predict that PRPPs will not work any better than the current RRSP/DC plan regime since, if you study the details, you still have the conundrum of developing a customized investment strategy for each and every plan member ... this will take time and money.

Lost in the discussion of cost-effectiveness is the reality that DC plans are failing badly at providing retirement income. When a DB plan goes out of business there is outrage if the plan only provides benefits at 90 cents on the dollar. But, when the market crashes and a DC plan member has his income cut by one-third, it is accepted as the necessary outcome of the system.

Finally, for every insolvent employer that defaults on its many obligations including pension contributions, there are dozens of plan sponsors that continue to run their businesses wisely, following the rules and funding the deficits that have arisen in the DB plans they sponsor. This self-correcting mechanism of increased contributions in down markets will ultimately be the success of many DB plans while the next door neighbor lucky enough to have one of Tulk’s DC plans will enjoy the self -correcting mechanism of postponing retirement for five years – maybe 10.

Joe Nunes
President
Actuarial Solutions Inc.

PRPP Article Misses Mark

Re: Sponsor’s Desk in August 2012 issue of Benefits and Pensions Monitor, ‘PRPP: Balancing the Gap’

I read your article but it appears you have overlooked the fundamental and real issue related to PRPPs: once in place, all companies will basically switch to PRPPs simply because of the reduction of fiduciary and legal liability.

The debate and range of opinions to which you refer is basically a long way from the real underlying issue of the switching of current DB and DC plans to PRPPs.

The ‘big money’ issue is the financial institutions capturing, forever, a huge ongoing – unregulated – cash cow. They will effectively become the pension providers for all Canadians.

There is no benefit to members of existing DB and DC plans in PRPPs. If you really believe there is a benefit, I would be grateful to hear what it is.

Gerry Wahl
Scott Sweatman, a lawyer and founding partner of Spectrum HR Law LLP, will provide an overview of recent developments in case law related to pensions and benefits and take a look at what’s on the legislative horizon that may have a pension and benefits impact at the CPBI Pacific’s ‘Legal Update.’ It takes place October 30 in Vancouver, BC. For more information, visit http://intranet.cpbi-icra.ca

Mark P. Kritzman, senior lecturer in finance at the MIT Sloan School of Management, will examine ‘Is illiquidity worth the risk?’ at an AIMA Canada Education and Research Committee session. It takes place November 6 in Toronto, ON. For more information, visit http://aima-canada.org

CPBI Saskatchewan is offering a two-day in-depth look at group benefits plans. ‘Benefits Beyond the Basics’ will examine areas such as claims administration, flexible benefits and flexible spending accounts, and funding. It takes place November 6 and 7 in Saskatoon, SK. For more information, visit http://www.cpbi-icra.ca

Martin Reeves, senior partner and managing director at BCG; Prof. Keyong Dong, dean and professor at the Renmin University School of Public Administration in Beijing; and Heinz Rudolph, chief economist at the Worldbank; will be among the featured speakers at the ‘WorldPensionSummit 2012.’ It takes place November 14 to 16 in Amsterdam, The Netherlands. For more information, visit www.worldpensionsummit.com

The Conference Board of Canada’s ‘Benefits Summit 2012’ features original benefits benchmarking research which can be used to help make critical benefits decisions and balance cost and value. Sessions will look at the move to flexible benefits, and integrating a wellness strategy into a benefits plan. It takes place November 16 in Calgary, AB.

Readers of Benefits and Pensions Monitor can save $300 on registration by using the rebate code PRM3. For more information, visit www.conference-board.ca

Increasing portfolio yield and stability amidst uncertainty and reinventing endowment models to meet obligations will be among the sessions at the ‘10th Annual Foundation, Endowment & Not For Profit Investment Summit.’ Other sessions will examine weathering volatility with diversification and risk management; implementing responsible and impact investing; and addressing inadequate returns using global tactical asset allocation. It takes place January 16 and 17 in Toronto, ON. For more information, visit http://www.foundationendowment.ca/
The Search For Market Anomalies

By: Jim Helik

As we continue to worry about countries going bankrupt, global pension underfunding, and equity markets that are only now beginning to recover, academics and other researchers continue their search for market anomalies in the efficient market hypothesis. In other words, they ask how can we make money in the markets.

Here are some items of interest from the front lines.

Follow The Masters

The activities of market insiders, especially insider buying of company stock, has long been used as an indicator of likely future positive price movement. Despite the long history of politicians profiting from advance knowledge of changes to regulations, less well studied has been the activities of government officials and the policies they promote to predict stock behaviour. For example, after the ratification of the U.S constitution, Treasury Secretary Alexander Hamilton persuaded Congress to redeem securities issued earlier by the federal government at face value. At the time, these securities were trading at as little as 10 per cent of their initial value. Many members of Congress proceeded to buy as many of these securities in the market as they could, before the information became public, despite their actions angering Thomas Jefferson and others.

More recently and more rigorously, a 2004 study by Alan Ziobrowski looked at the publicly disclosed stock holdings of U.S. senators over a six-year period. Portfolios mirroring their purchases outperformed the market by 85 basis points a month. Portfolios mirroring the stock sales of senators underperformed the market by 12 basis points a month.

A current working paper from Feng Chi, at the University of Toronto, notes that while, taking the U.S. Congress as a whole, the average member’s stock portfolio underperforms the market by four per cent annually, the results are different for members that have a potential “informational advantage” for specific industries or sectors based on the member’s sponsoring of bills or membership on certain legislative committees. These “informed trades” outperformed the market by 8.25 per cent in the following month. The gains were also accrued over a short time horizon, which is consistent with the notion of the participants having time-sensitive insider information.

The window on the use of the disclosed stock holdings of public officials may be closing. In April of this year, the wonderfully named ‘Stop Trading on Congressional Knowledge (STOCK) Act’ was signed into law in the United States. Its purpose is to prevent members of Congress from using non-public information for their personal benefit by requiring faster disclosure of financial transactions.

Other new research notes that some actions of retail investors can be indicative of future stock market behaviour. It has long been known that the supply of financial information, from earning announcements and news headlines to analyst upgrades/downgrades has an impact on stock volatility (which can be traded) and on stock price. However, what about the demand for information by investors?

Predictive Nature

A paper from Nikolaos Vlastakis and Raphael Markellos, of the Cranfield School of Management in England, looks at the predictive nature of investor demand for information. For ‘Information Demand and Stock Market Volatility,’ the researchers used a dataset of Google search frequencies for keywords related to 30 of the largest stocks traded on the NYSE and NASDAQ. They found a direct effect between the demand for information on the internet and measures of market activity (volatility and volume). This was true for both individual stocks and for the market as a whole. And, not surprisingly, this relationship between information demand and market activity becomes stronger during periods of high market uncertainty and volatility (such as the recent financial crisis) as investors seek to reduce their own uncertainty by searching for information online.

Jim Helik is a contributing author to the ‘Managing High Net Worth’ course and the ‘Commodities As Investments’ course published by CSI Global Education. He is also one of the first holders in Canada of the Human Resource Management Professional designation from the Society for Human Resource Management.
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1. Standard Life Investments Limited, 06/12/06 to 12/31/11. Fund performance based on institutional pooled pension fund, gross of fees. 2. Source: Standard Life Investments Limited, 07/01/06 to 12/31/11. Volatility of Absolute Return is the annualised standard deviation of monthly absolute returns. 3. MSCI World (£) volatility, 07/01/06 to 12/31/11 16.5%. Volatility of Benchmark Return is the annualised standard deviation of monthly MSCI World (£) returns. 4. As at 12/31/11. Source: Standard Life Investments Limited. 5. Units of the Canadian GARS Funds will be offered on a private placement basis (i.e. pursuant to exemptions from prospectus and registration requirements under applicable securities legislation) only to those persons where and to whom they may be lawfully sold and only by persons lawfully permitted to sell such units. This communication is not, and under no circumstances is to be construed as, a public offering to sell, or a solicitation of an offer to buy securities.

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