CATALYST FOR CHANGE

Plan sponsors need to move away from the status quo.

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The removal of foreign content restrictions has been a highly visible change in the Canadian pension environment. Less visible, yet no less significant, have been the increased numbers of plans facing a shortfall. Given such changes, plan sponsors have had good reason to consider the ways in which their pensions are managed. And that includes looking at the multitude of investment options now available to them.

The last 10 years have seen very little deviation away from the typical equity/fixed income allocations in Canadian pension funds. Indeed, for funds with assets greater than $1 billion, the average asset mix still follows a traditional 60/40 allocation between equities and bonds. At the same time, the split between foreign and domestic equities is roughly even,[1] with equities as the key driver behind pension returns. Recent history has seen Canadian plan sponsors benefit from their relatively high allocations to outperforming domestic equities. And, due to the red-hot performance of Canadian equities, there is little appetite among plan sponsors to lower their allocations. Indeed, any increases to foreign equity are typically performed through new contributions or at the expense of domestic fixed income allocations.

Is this recent outperformance in Canadian markets a carryover from the days of foreign content restrictions? Perhaps. In some ways, the foreign property rule acted as a form of legislated home country bias. At the same time, Canadian equity markets are decidedly slanted toward resource-based industries and we currently find ourselves in the midst of a cyclical resource boom. But how long can this resource-fuelled outperformance last?

Whatever the case, such recent improvements in asset returns have not been enough to reverse the steady decline in pension health. Generally speaking, plan liabilities have grown at a faster rate than assets, largely because of persistently low interest rates. The Office of the Superintendent of Financial Institutions (OSFI), estimates as many as three-quarters of defined benefit pension plans have a solvency ratio of less than one. Indeed, the Ontario Teachers' Pension Plan consistently exceeds their benchmark (as of December 31, 2005, four-year return = 11.6% vs. benchmark = 7.7%), yet the funding ratio is only 84%, and President and CEO Claude Lamoureux is calling for benefit cuts and contribution hikes.

Alternative approach

Plan sponsors today are faced with many issues beyond their realm of control, such as low interest rates, diminished equity risk premiums, increased life expectancies and anticipated regulatory changes. However, waiting for these elements to align into more favourable circumstances is not a prudent strategy. One alternative approach to pension management that attempts to better manage plan funding status has been put forth by M. Barton Waring. Called "Liability-Relative Strategic Asset Allocation Policies," one of its main tenets suggests doing away with the traditional asset-centric method of investing and adopting a more liability-relative approach. If the ultimate goal of plan sponsors is to manage the health of the pension plan, then the objective should be to either maximize surplus or minimize deficits while controlling for the volatility of that surplus or deficit. Waring's paper suggests plan sponsors employing this method will have greater success in controlling the funding risk of pensions.

No matter how pension management evolves, it is evident that the status quo has not served plan sponsors as well in recent years. By evolving to a more fully integrated asset/liability process, pensions should be able to improve the health of their plans regardless of the conditions found in the marketplace. ■

1. Source: RBC Dexia Investor Services—Plans Over $1 Billion Universe.