

Pension fund risk and return: should pension funds immunize?

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Bridging the Gap between Theory and
Practice



Some Preliminaries

- Private sector plans: it is time to recognize that shareholders' interests need to be considered in deciding on whether or not to immunize and target a surplus level.
- Public sector plans: have a very long horizon, generally large size and shareholders are taxpayers
 - Is there an implicit put to taxpayers when plans are in default?



Lessons

- While beneficiaries' interests are paramount, the interaction of pension risk and underlying corporate risk are important
 - Shareholder perspective needs to be considered
- The combination of corporate and pension fund risks is a risk-return trade-off choice. There is no strong reason to immunize unless there are significant costs of default on the pension plan that will force the firm into bankruptcy
- Risk to beneficiaries is related to the relative immunization position of the pension and the amount of surplus--tradeoff
- Lower contribution costs through non-immunization strategy does have an implicit cost---increased risk to shareholders
- Public sector pension plan investments and immunization strategies should not be the template for private sector plans
- Gains from the pension fund in a corporate setting rely on
 - Agency costs
 - Beneficiaries not reflecting risk of pension plan in direct compensation
 - Shareholders do not understand the risk of the pension fund



Impact on pension risk and surplus

Corporate Asset Risk	Low	Low	High	High
Correlation of pension and corporate cash flows	Low	High	Low	High
Pension fund risk profile possible	++	+	-	--
Surplus need to reduce pension risk	--	-	+	++



The Future?

- Are the problems pension funds are facing short run due to the combination of a poorly performing stock market and low interest rates—the perfect storm?
- Answer: it does not matter!

Learnings from the period

1. Movement towards market values from pension assets and liabilities and funding requirements
 - Will permit sponsors and beneficiaries to know the risk of the pension plan
 - Will permit better pricing of securities of corporation
2. Appreciation of the costs of benefits. Can not be hidden or ignored due to strongly performing equity markets
3. Pension risk through mismatching assets and liabilities and risk of the sponsor organization must be understood and their interaction taken into consideration—shareholder/corporate finance view
4. Must become active in terms of surplus ownership and limit on the amount of surplus