# EMBRACING RISK IN GLOBAL MARKETS

*Today's investment environment necessitates better decision-making tools.*



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The proposed elimination of the Foreign Property Rule will grant Canadian plan sponsors more latitude in their investment choices. The anticipated removal of the restriction is reminiscent of a teenager incessantly pestering their parents for the keys to the car: when the parents finally succumb, the teenager is handed not only a set of keys, but also the considerable responsibility that accompanies driving a car. Pension plans, with their newfound freedom from foreign content restrictions, will also be burdened with the responsibility to weigh the risk and rewards of the enhanced investment options.

Any re-examination of a plan's current asset mix should be undertaken in light of the multitude of investment vehicles with which plan sponsors are now presented. The term "global investing" is beginning to take on a much broader definition, extending beyond equities or bonds domiciled outside Canada's borders to include non-traditional asset classes. As the investment opportunity set increases in both size and complexity, plan sponsors are faced with a more elaborate landscape to navigate. To keep pace with this dynamic environment, the tools used to evaluate these investments have necessarily evolved.

## MANAGING RISK BEYOND BORDERS

Asset-liability studies and strategic benchmarks together make up the backbone of pension management, and will continue to do so. The recent bear market and the persistent low interest rate environment in which we find ourselves have shifted the focus from asset management to surplus management. Exceeding a policy index has accordingly become of secondary importance—the greater danger is that the rate of return generated by the assets will be insufficient to fund the future liability stream. Risk budgeting is a mechanism that can assist in binding the worlds of assets and liabilities together more closely. In essence, risk budgeting involves apportioning an acceptable amount of potential decrease in pension funding to the various elements of the investment process, in order to achieve returns that are able to satisfy the liability requirements.

One critical aspect of risk budgeting is establishing explicit risk tolerances—for example, identifying the reduction in funding status that is uncomfortable, and the amount considered to be intolerable. Once defined, the scarce risk resource is then allocated downstream to the specific levels within the plan: asset class, active versus passive, number and type of managers, strategic and tactical allocations, etc. More of the budget will be "spent" in those areas that are deemed most likely to be rewarded. For instance, emerging market equity is unlikely to be assigned the same proportion of the risk budget as a bond manager, on a per unit basis. Expected return for each unit of risk becomes a critical element in allocating this risk capital throughout the different risk elements of the plan.

## DISTINCT FROM ASSET ALLOCATION

Though similarities to the traditional asset allocation approach exist, risk budgeting differs in its ability to inextricably link the worlds of risk and return. It provides a more comprehensive view of the risk and rewards of each allocation decision as it relates to the overall willingness to suffer a loss in the funded status. One should also note that risk budgeting is a journey, not a destination. It is a continually evolving, dynamic process that adapts to changes in plan funding status as well as changes in risk tolerances.

Risk tools don't tell pension managers how much risk to take—only the people using these tools can derive true insight to more effectively manage the risks that pensions are faced with. Risk budgeting is a discipline that helps plan sponsors make optimal choices in light of the current health of the plan. The resulting process allows for safer navigation in the vast sea of investment strategies and products available to plan sponsors. ■