PROTECTING THE PENSION PROMISE

When structuring assets, think liabilities.

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The risk management of defined benefit pension assets centres on the plan's liabilities, since those assets exist solely to fund the liabilities. What liability characteristics should we consider?

Assets and liabilities both affect three key drivers:

• The amount and timing of contributions required from the sponsor (and members in some cases);

• The pension expense that is recorded on the sponsor's income statement, and

• Security of the promised benefits or the plan's funded position.

Assets are easy to understand—liabilities are not, because there are various measures. Some measures are marked to market and respond directly to changing bond yields and inflation expectations. Some are smoothed. Some reflect current pay levels while others use future pay. Some reflect promised indexing while others do not.

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Liabilities marked to market resemble long bonds. Smoothed liabilities have no such counterpart—maybe cash but with a higher yield. Liabilities based on current pay resemble nominal long bonds. Liabilities based on projected pay resemble some combination of nominal and real-return bonds.

What Should Sponsors Do?

Recognize that the first two key drivers work off the third, the funded position. Identify which is most important to the sponsor. Appreciate that this driver will move adversely at times and determine how much bad news the sponsor can bear.

There is no silver bullet. In looking at the short term, you could match nominal bonds to the liabilities. Over the longer term, this would unduly expose the sponsor to solvency shortfalls and consequent cash calls if inflation surges beyond expectations. Mixing in real return bonds would offer a better medium- to long-term match, but there are not enough available.

There is no one answer, but there is a logical process for determining the bond-equities split and what those bonds should look like.

As a first step, design a risk-minimizing portfolio matched to the appropriate liability measure and time horizon. This will likely be some combination of nominal and real-return bonds. Appreciate that you cannot eliminate all risk. This "safe" design ensures promised benefits can be paid based on current expectations. Unforeseen demographic changes—perhaps extended longevity or too many early retirements—remain a wild card.

Consider how you might reduce the expected long-term cost by altering the mix to include riskier assets such as equities. Based on the sponsor's ability to absorb short-term shocks, what's the optimal split between risk minimizers and return generators? How easily can the sponsor handle the double-whammy of a pension solvency cash call at the same time business is down? Recall what happened to Air Canada.

Construct the riskier portion of the portfolio based on how various types of assets would enhance return or diversify risk. Instead of gauging volatility in relation to an index or peer group, focus on the projected deviation from the return required to keep the plan in balance. For example, earning 18% when the market delivers 20% matters less than losing 10% when the market falls 8%.

Ultimately, the goals of risk management are centred on liabilities. The most important is to ensure promised benefits can be paid as they come due. Additionally, the sponsor must keep the ongoing funding requirement from becoming unduly burdensome. So, when structuring assets, think liabilities. ■