November 17, 2016

THE OSTRICH HAS ITS HEAD BURIED IN THE SAND

Is it scared or in denial?

Be it the recent U.S. election results, Brexit, changes to our own Canadian political landscape or events that have occurred in other countries around the world, there continues to be significant global social, political and economic unrest. Voters have become more cynical and distrustful of their political leaders and economic institutions, challenging traditional ways and the status quo. How does this relate to the health of your pension plans? Against the backdrop of slower global economic growth and low interest rates – some pension plan reality checks are in order.

Pension plan finance is under siege. Many pension plans continue to hold on to heroic investment assumptions regarding their investments' ability to earn outsized future returns. In some cases, aggressive investment assumptions still prevail as there is no appetite to otherwise increase contributions and/or cut pension payments to maintain current benefits. In many cases, investment committees are contemplating investing in strategies that, at the margin, are riskier than previously contemplated. A similar call to order is heard in many boardrooms – "we need more return!" At the same time, regulators are asking for pension plans to build up extra reserves/cushions, partly to safeguard pension benefits and to recognize the added risk from various investment strategies.

This centuries-old stretch for extra yield/return is not new and has always worried us more than most changes in the political landscape. At PBI, our view has always been that pension plan fiduciaries need to understand how their plan's funded status is impacted by changing investment and funding assumptions. We are sensitive to the needs of pension plan trustees and proactively discuss with them the impact of their decisions on overall additional investment and mismatch risk. However, at the very foundation, our advice is that pension plans should be funded in the least risky way possible and by making conscious decisions about the amount of investment and asset/liability mismatch risks to take on. That is just plain common sense. To those pension plan committees that have successfully managed the investment and funding risk tradeoff – we say bravo! You have helped safeguard your members' pension benefits and should be congratulated. We feel fortunate to count many of you as our clients.

There is no doubt that low interest rates make it more difficult to fund future pension promises (or past pension promises for those plans that are not fully funded). Accordingly, we are not insensitive to the need of seeking additional higher sources of investment returns in the face of very low interest rates. In fact, in our own fully funded defined benefit plan, we have added some additional but measured investment and mismatch risk to seek additional return in recent years – so far so good.

Given current economic realities, we expect that many plan fiduciaries may either have to lower pension benefits, take on more investment and asset liability mismatch risk or plan for higher contributions (or a combination of all three). Pension plan trustees are presented with a multitude of investment products that in some cases promise heroic investment returns, outsized equity risk premiums, and low risk. In all cases, investment solutions need to be evaluated not only on the additional return they may bring, but how they change your plan's funded status and asset liability matching characteristics. Our role is to help you as pension plan fiduciaries and give balanced consideration to both the investment and funding mismatch risks arising from your decisions.

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This article was never meant to be an article about the U.S. election results, which we generally consider as less important than issues with pension plan funding. Instead we wanted to get your attention to ask you – as a fiduciary, do you really understand the risks your pension plan is taking on and are you able to quantify the added mismatch risks from pushing the envelope with your investment decisions?

ABOUT PBI

PBI Actuarial Consultants Ltd. is a dynamic and growing company providing actuarial, administrative and investment consulting services for pension and benefit plans, as well as various trust funds. PBI serves clients across Canada from offices in Vancouver, Montreal and Toronto with a focus on multi-employer plans, non-profit and public sector organizations.

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