Canadian Pension Risk Management

Setting the Derisking Pace

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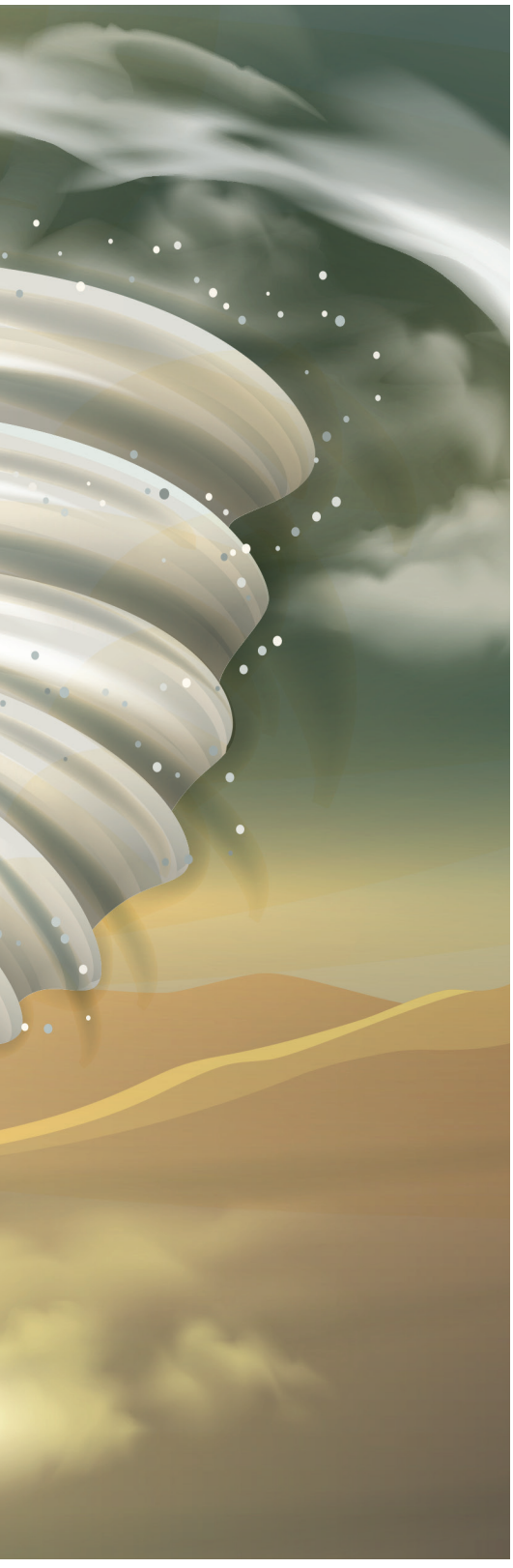
A Torrid Year Ahead



With rising rates, increased solvency and more favorable regulation, Canadian pension plans are likely to speed up derisking activities in the year ahead

Canadian defined benefit pension plans entered 2017 on a high. Domestic interest rates are rising, following the pattern seen in the U.S. since the election, and solvency rates have jumped up. Aon Hewitt estimates that the average funded ratio for its clients is about 95%, with some 35% more than 100% funded.

"Compared to the last few years," said Brent Simmons, senior managing director of defined benefit solutions at Sun Life Financial, "This is a significant improvement."

The effect is to push plan sponsors to reconsider their pension risk management and specifically whether now is the time to derisk.

Liability driven investing (LDI) is the risk management technique of choice in Canada. By matching their assets with their liabilities, pension plans seek to limit the volatility of their funded ratio. Nevertheless, implementation of the strategy — or philosophy as some call it — is not universal. "We see many plans self-identify as being LDI-focused," said Bruce MacKinnon, vice president and director of TD Asset Management. "But within that definition, there are several different strategies that plans are using."

Using triggers

What is clear is that Canadian plan sponsors aren't arguing about whether to derisk, but about when and how. In moving from a weaker form of LDI that simply involves buying long bonds, plan sponsors are working through the process of understanding what LDI means for their plan.

"A more sophisticated version of LDI uses glidepaths to plot a derisking route that involves triggers, usually when certain funded ratio marks are reached," said Francois Pellerin, LDI strategist at Fidelity Institutional Asset Management (FIAM).

Because of the recent rise in funded ratios across Canadian plans, managers expect more of these glidepath triggers to be reached in 2017. When that trigger is pulled, plans generally move assets from a return-seeking portfolio to the liability hedging portfolio, on a path to fully matching assets and liabilities. At least that's the theory.

In recent years, plans have been reluctant to follow through even when triggers are reached because of the low level of interest rates. "Some plan sponsors are looking for a better way to manage their interest-rate risk," said William da Silva, senior partner and national retirement practice leader at Aon Hewitt. "Maybe we can relax the asset-liability mismatch a little bit because there are some opportunities outside the core bond offering for LDI to pick up yield. At these low interest rates, any material yield pick-up can go a long way on the fixed-income side."

Da Silva doesn't suggest that plans are leaving LDI, merely detouring a bit off the glidepath. Adds FIAM's Pellerin: "We see plan sponsors adding plus sectors in their LDI mandates. They want duration, but they also want yield, so they will consider adding U.S. high-yield bonds, leveraged loans and emerging market debt into their hedging portfolios."

Tail risk

This type of re-risking can incur tail risk, so sponsors need to assess the risk properly. Because some of the core-plus sectors aren't perfectly correlated with core Canadian bonds, Pellerin said, this strategy can be effective, but plan sponsors need to make sure that tail risk is well-understood.

Canadian pension plans have followed in the footsteps of their U.S. neighbors in using derivatives to provide duration extension. It's common in early-stage LDI to adopt a long Canadian bond index as a hedging benchmark. "As a next step, we commonly see plans using futures to extend their asset duration to target a desired hedge ratio," said Richard R. Ratkowski, director of investment strategies at NISA Investment Advisors.

Gregory W. Johnson, director of client services at NISA Investment Advisors, points to an interim step that some sponsors take, particularly if they are looking down the

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road to a more customized benchmark or an end-state portfolio. "They may choose a customized zero coupon government (strips) and long corporate blended benchmark, which has a similar risk profile to the long Canadian government bond index, but is a little more efficient from a hedging perspective," he said. "These are important steps to get additional years of duration than are possible from physical fixed income."

The LDI path is not straightforward in any country, but Canada poses some specific problems for plan sponsors. "Plan sponsors are rightly focused on funding," Ratkowski said. "But they are also focused on accounting. So they are in a world where they are trying to serve two masters. It's not as clear-cut as it is in the U.S. where funding and accounting are more closely aligned."

Aon Hewitt's da Silva said, "We continue to debate how to construct the yield curve in terms of pegging liabilities to it." It has always been a challenge for investors to minimize tracking error against underlying yield curves that are not only volatile but often not investable.

One of the elements of Ontario's review of pension regulation is a potential loosening of the solvency requirements. This would serve to address some of the current dichotomies between accounting and solvency valuations by allowing smoothing in funding calculations. But this change would not alter the accounting situation, or indeed the economic impact, which is of most interest to those companies seeking pension settlement.

In the U.S., the accounting liability valuation and the funding liability valuation techniques are both based on corporate bond yields and are essentially the same. In Canada, plans rely on spreads published by the Canadian Institute of Actuaries to value a liability for solvency valuation. "That method has quirks that introduce investment challenges," said NISA's Johnson. So managers and consultants alike are working to develop investible, real-time market-based discount curves that can be used to value liabilities.

More precise liability matching is a focus for plans that are closer to full funding. "If you sponsor an open plan that is only 80% funded, it is likely that 60% to 70% of your assets are rightfully in equities or other risk assets," FIAM's Pellerin said. "Customization of liability benchmarks only makes sense when you are much closer to full funding. As Canadian plans are improving their funding position, we are getting significantly more requests for more sophisticated asset-liability matching programs."

Another indication of growing sophistication among Canadian plan sponsors is the rise in requests for completion portfolios. As the name implies, these are portfolios that take into account other fixed-income managers with the specific objective of keeping the plan on its LDI glidepath.

"It's a way for plans to employ active fixed-income managers for alpha generation, with the appropriate restrictions, and then use a physical fixed income and/or derivative overlay to manage the tracking error of the LDI portfolio," NISA's Ratkowski said. "This style fits very neatly alongside other managers that have bigger alpha targets and tracking error budgets, but may not be as liability focused."

Appetite for risk

In Canada, pension risk management is increasingly viewed as part of a larger picture, particularly for corporate plan sponsors. "Plans are beginning to look beyond the narrow definitions of solvency and accounting measures to consider the broad obligations within the context of their corporate objectives and more importantly, their appetite for risk," TDAM's MacKinnon said.

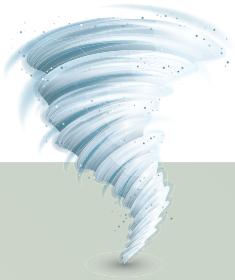
"For many companies, the pension plan is one of the largest 'divisions' within the firm," FIAM's Pellerin said. This can be a catalyst for considering whether the effort expended on managing the plan is appropriate. Certainly some sponsors come to the conclusion that they need to partner with pension risk management experts in order to run their plans effectively.

"If I'm a private-sector employer, the right question is not should I be taking the risk, but where should I be taking risk," Sun Life Financial's Simmons said. "For many private sector employers, the best place to take risk is in their core business - not their pension plan."

"If your plan is 75% or 80% funded, then it is ill-advised to hope for markets to bail you out," Pellerin said. "Rates could go up 200 basis points and markets could return 8% a year for the next five years and you'd still be short. One thing we talk to sponsors about is the inevitability of contributions. Also important is the need to protect those contributions with dynamic pension risk management."

For those Canadian plans that are in the enviable position of being close to or at full funding, managers point to one risk that can be hard to quantify. "Four times in the last 20 years, the average plan has been 100% funded," Sun Life Financial's Simmons said. "Many pension plan sponsors regret not having acted when they had a chance. The question is whether this latest roller coaster 'dip and climb' will spur them to act and take risk off the table." ⌫

Changes Afoot at CPP



For once, the changes are significant. The Canadian Pension Plan (CPP) is the contributory, earnings-related portion of the country's state retirement income system. Thanks to legislation passed last November, the federal government and all provinces except Quebec have agreed to enhancements that will, among other changes, increase income replacement from a quarter to a third of pensionable earnings for Canadian workers.

"The significant change in the CPP will impact the whole balance of benefits that workplaces provide," said William da Silva, a senior partner and national retirement practice leader at Aon Hewitt. "We expect many organizations to be looking at their pension programs, whether they are defined benefit, defined contribution or something in between. It's going to have ramifications for all employers that could lead to plan design changes. And with changes to plan design come potential changes to funding and investment strategies."

The changes are set to be phased in from 2019, with contribution rates increased as well as providing for a higher earnings limit. The costs are borne equally by employers and employees, so will impact employer benefit contributions. Many workplace plans integrate their pension benefit formula with the CPP, so this will be an area that will need to be revisited.

"We expect that some employers are going to look at the cost and the rise in the overall benefit bill and will have to make some hard decisions on how best to bear these new costs," da Silva said.

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The Growing Focus on the Endgame

Canadian plans are exploring all the options — hibernation, annuitization or a combination — to conquer their pension dilemmas

Canadian defined benefit plans are an endangered species, as are plans elsewhere. But it is far too early to write off this approach to providing retirement income for employees. First, Canada has a significant proportion of public pension plans, which to date have shown little appetite for freezing, closing or terminating. More importantly, though, the private-sector plans are also taking a measured approach to future pension provision.

What is abundantly clear is that plan sponsors do not want the worry of potential future pension costs. The good news is that there are a range of derisking options that can solve the problem in a meaningful way.

It's hard to find a plan that isn't mulling over its choices. One is clearly pension settlement, in which a pension plan seeks to transfer part or all of their pension liabilities to an insurance company. Annuitization is a growing part of the pension picture in Canada, with an estimated $2.7 billion in annuity contracts bought in 2016 and predictions that some $4 billion in deals will be completed this year.

Equally popular are strategies that many call "hibernation," in which a plan sponsor seeks to match its assets and liabilities as precisely as possible in order to maintain the plan in-house, but minimize any future unknown costs. This is obviously harder to accomplish with an open plan, but not impossible. These approaches represent two ends of a rather long spectrum of options. Most plans are using a combination of strategies to address the issues around pension risk management. For instance, many plans will identify a group of beneficiaries — retirees or terminated, vested employees — as a group to annuitize, while retaining the other participants.

Combination of strategies

Every plan sponsor is likely to come up with a different solution, though it usually starts with the realization that the strategy needs to change.

"We've migrated from explaining liability driven investing to discussing how it is properly deployed," said Francois Pellerin, LDI strategist at Fidelity Institutional Asset Management (FIAM). "Should you customize the LDI program to your plan? And should you prepare for risk transfer? These are frequent questions that are now emerging."

"A key objective of an LDI journey is that it helps companies ensure that they are controlling the risk so that it does not affect their broader enterprise," said Bruce MacKinnon, a vice president and director at TD Asset Management. "Once a plan has closed, and many have, companies need to consider to transfer this risk away to a third party, to annuitize, or simply develop a plan to ensure that risk continues to be controlled."

The choice depends on the sponsor's objective – and often on cost. "From our perspective, it becomes a question of the cost of keeping participants in the plan," said Richard R. Ratkowski, director of investment strategies at NISA Investment Advisors. "You can maintain a plan indefinitely, which has some cost associated with it. You could facilitate a pension buyout and that has some different costs. But ultimately which one is cheaper? It's our belief that in many of those cases, keeping the plan in-house is going to have less cost over the long run."

Not surprisingly, that view is not shared by those in the insurance industry.

Investigate buyouts

Many look to the U.S. for indications of how the pension settlement business might develop. As in the U.S., more Canadian insurers are offering capacity across the size range. But there are some significant differences. The solvency rules in Canada, though undergoing some changes, mean that the current value of pensions on company balance sheets are closer to the economic value — or the fund-

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ing required for a buyout — than in the U.S. "For funding purposes, the liability valuation technique is the so-called solvency liability value, which is more aligned with a valuation that looks like an annuity buyout valuation," said Gregory W. Johnson, director of client services at NISA Investment Advisors. "Our view is that valuation may contain what amounts to an insurance profit margin, which a plan sponsor would not have to pay if they keep the plan in-house."

It must be understood that annuitization and hibernation are not either/or decisions. Many — in fact, most — pension settlements take place over a number of years and occur through a series of different transactions involving different groups of beneficiaries. Even if a plan is closed and frozen, it is unlikely that the entire plan will be settled in one go.

This piecemeal approach to settlement can raise its own issues. "It can be easy and cheap to annuitize retirees with an insurance company," FIAM's Pellerin said. "But if you sell everything that is easy to hedge, then you are stuck with the dicier segments of the population as those may be prohibitive to sell to an insurance company. For those plans contemplating hibernation, a more diverse population can be easier to manage and hedge."

Primary reason

Others disagree. "It can be challenging setting an investment policy that covers a wide range of members," said Brent Simmons, senior managing director of defined benefit solutions at Sun Life Financial. "Purchasing annuities for some members can actually clean up the plan and allow for a more transparent investment policy discussion for those that remain in the plan."

Cost may not always be the primary reason that sponsors think about buyouts. There is evidence that a pension settlement can occur because a corporate plan sponsor simply wants to streamline and simplify pension provision. For some companies, the sheer size of the pension plan may feel like a deadweight that draws focus away from the core business.

One feature of the Canadian pension landscape is the pension buy-in, where annuities are used as an investment strategy within an ongoing plan. Buy-ins can offer attractive rates relative to the low level of Canadian interest rates. The attractiveness of this strategy in Canada (as well as annuity buy-outs) is expected to grow due to regulatory changes, in contrast to the U.S. where it is used infrequently, may have more to do with regulation. Historically, pension plans have been subjected to annuity boomerang risk: Should the insurer fail, the pension risk would revert back to the sponsor. Now however, several provinces have removed this risk entirely, and Ontario and others are considering removal as part of their funding reviews.

Another aspect of the Canadian pension market is prevalence of those plans with some exposure to inflation — up to half of all DB plans, according to industry estimates. Until recently, insurance companies were reluctant to offer annuities for CPI-linked pensions. But in 2015 and 2016, five deals totaling more than $1 billion were completed for inflation-linked pension plans.

Safe investment policy

"If you are a pensioner at a company that is struggling, or in a pension plan that is carrying a significant amount of risk, maybe you might say, 'Who do I want to pay my pension?'" said Sun Life Financial's Simmons. The answer, he suggests, might be that the pensioner is happier with the safer investment approach and regulations of an insurance company.

"The market for pension settlements in Canada continues to grow and evolve," said William da Silva, a senior partner and national retirement practice leader at Aon Hewitt. "We not only have the traditional life insurance companies that have been bringing capacity to the annuity market, but we are now seeing other financial institutions and nontraditional players joining the marketplace."

Canadian pension plans still have plenty of choice, though, on how to move into and across the pension derisking spectrum. Managers are happy to help prepare for pension settlement or hibernation, or indeed even to make that final push to full funding that the now more solvent funds may need. ⌫

The Allure of the Target-Benefit Plan

When defined benefit plans close, defined contribution plans are often lined up to take their place. This common pattern is seen in Canada as well as in other developed countries. But here, there's a twist. Understanding the attractions of DB plans for beneficiaries, as well as the challenges for plan sponsors, there is a move in Canada to support a hybrid model, called target-benefit, defined ambition or shared risk plans.

The idea is that both employers and employees contribute, investment management is handled on a pooled, professional basis, but the benefit will not be defined absolutely.

"There are some core benefits that will be delivered with greater certainty," said William da Silva, senior partner and national retirement practice leader at Aon Hewitt. "The word promise will not enter into the conversation. The employer will contribute X% into the plan for each employee, and actuarially speaking that X% should deliver this base benefit. All other benefits may be delivered on a contingent basis."

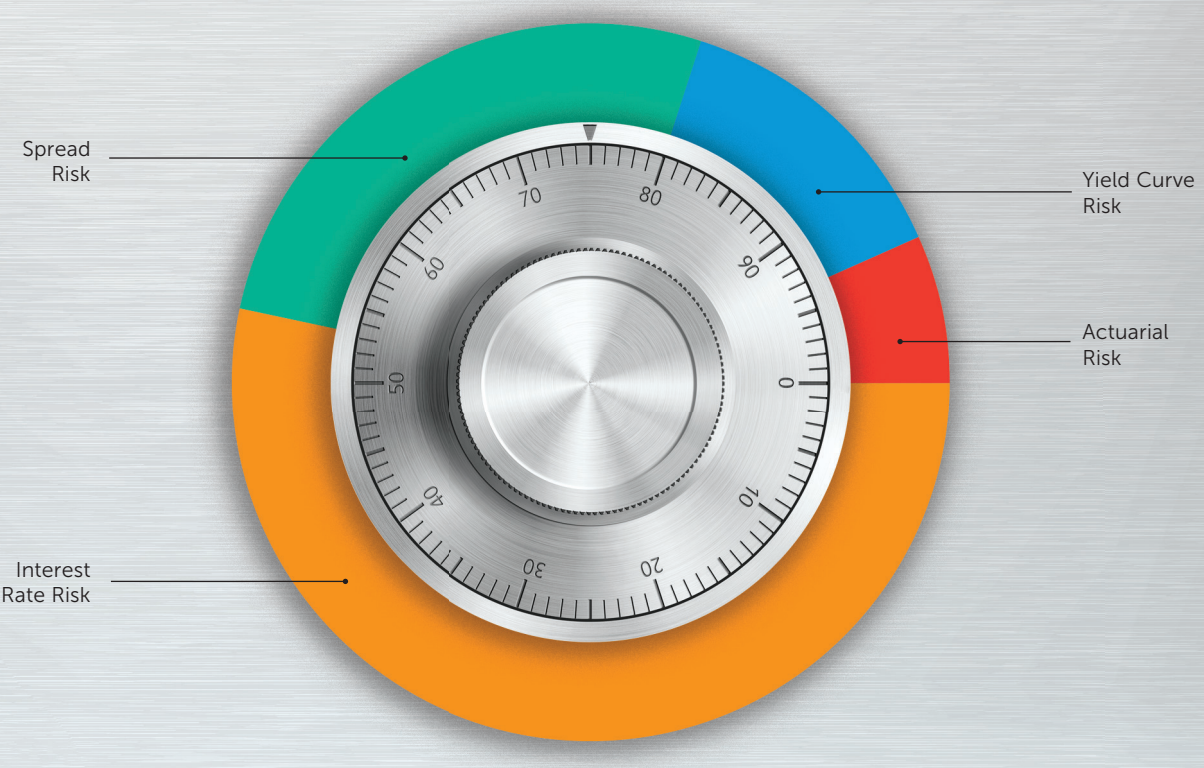
"The growth of these plans should help employees and sponsors work together to design strategies that are resilient enough to provide benefits to retirees, but doing so with a variety of financial conditions," said Bruce MacKinnon, vice president and director of TD Asset Management.

This approach has not yet met with widespread adoption. Many provinces and the federal regulator allow for target-benefit plans, but the province with the largest number of pension plans — Ontario — doesn't. And that's held back the process. "I don't really believe that there is a political environment supporting a move to target-benefit plans as of yet," MacKinnon said.

For instance, in the past year, General Motors, Ford and Chrysler — all Ontario-based — negotiated with the auto worker unions to have new hires join a pure DC plan. However, many other public-sector plans in Canada remain DB-only though, so it's an area to watch.

"The end of DB plans isn't coming as fast in Canada as one might think it is in the U.S.," said Francois Pellerin, LDI strategist at Fidelity Institutional Asset Management.

Aon Hewitt's da Silva points to an about-face. "We helped design a plan in British Columbia that was DC and then swung the pendulum back to a target-benefit plan," he said. There are many different ways to transition out of DB.



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Canadian Plans Embrace Innovation

Now inured to low-for-long interest rates, plan sponsors are implementing more sophisticated expositions of LDI and looking to risk-reducing and yield-enhancing investment strategies

Although the roller coaster of pension fund solvency in Canada appears to be on an upward trajectory, plan sponsors aren't just relying on derisking to keep their plans on an even keel. More and more they are beginning to use investment strategies in innovative ways both to enhance yield and reduce risk.

Canadian plans find themselves in a challenging market environment. "We're at the end of a 30-year bull market in bonds; we are entering the ninth year of an equity run, and we finished a commodity super-cycle over the last couple of years—though relative value commodities are looking pretty interesting at the moment," said Daniel Elsberry, senior managing director at K2 Advisors, Franklin Templeton. "So today, asset allocation is a challenge."

The investment management industry loves a vacuum though. In this case, managers have been devising products that meet the needs of Canadian pension plans. From higher-yielding bond strategies and smart beta equity strategies that limit downside risk to hedge fund platforms that offer both lower fees and more liquidity, investors are now spoilt for choice.

Alternatives and less well-known fixed income sectors such as investment grade private debt are a growth area for Canadian investors. "We've seen very large allocations to private debt from both LDI clients and others," said Bruce MacKinnon, vice president and director of TD Asset Management. "That said, unlike the spread compression and the occasional bidding frenzy for comparable new issues that we're seeing in the public bond markets, investment grade private debt is a very attractive asset class that seeks to provide higher yield without increasing the risk of an investment grade public bond portfolio, but we need to remain very discerning."

Yield opportunity

Hedge funds and other alternatives often offer Canadian investors an additional inducement in the form of global diversification. "Canadian investors tend to have a home bias," K2 Franklin Templeton's Elsberry said. "Hedge funds can provide investors a way to diversify their portfolio and mitigate risk, while being used as an equity replacement, fixed income substitute or an opportunistic mandate. Combine that with lower fees, robust risk management and transparency, and you can see why we are having success in the market."

Liquid alternatives have particular attraction for those plans that are on a glidepath to pension settlement. These plans can't afford to tie up assets for long periods, yet still require the higher returns of alternatives.

Other newer strategies that plans are using include Canadian investment-grade private debt. "We see plans using these illiquid assets in their risk-reducing portfolios," TDAM's MacKinnon said. "It's a creative way to harvest more yield out of the conservative part of the portfolio in a low-interest-rate environment."

Smart beta or risk premia strategies can have a place in the return-seeking portfolio. "There's some evidence that risk premia strategies can help the return-seeking portfolio produce better risk-adjusted returns," said Richard R. Ratkowski, director of investment strategies at NISA Investment Advisors."The challenge, of course, is finding a persistent premia and determining effective ways of capturing them."

Low vol

There are a number of strategies that can play a role in reducing portfolio risk."Being able to combine hedge fund managers with some of the liquid risk premia products can also provide the left-tail protection that investors seek in more volatile markets," said K2 Franklin Templeton's Elsberry.

As many of the more innovative investment strategies Canadian investors are choosing involve global assets, one of the final questions they face is whether to hedge the currency risk.

"It might make sense to hedge less in Canada than say, in the U.S.," said Francois Pellerin, LDI strategist at Fidelity Institutional Asset Management. "Some empirical studies suggest that when foreign equity markets do poorly, the Canadian dollar tends to depreciate. That, in part, is because Canada is more of a commodity based market than the U.S." ⌫

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A Renewed Focus on Longevity

As solvency rises, plan sponsors consider the impact of risks other than interest rates and volatility. Today that means thinking about ways to mitigate demographic risks

Canada is no different than other developed nations. Its workers are living longer than expected. And that's an issue for those tasked with providing income for them in retirement. Enter concerns about longevity.

Brent Simmons, senior managing director of defined benefit solutions at Sun Life Financial, suggested looking back 40 years. "If you compare the assumptions used by pension actuaries in the 1970s and those used today, they are 20% to 25% higher today," he said. What happens, he asks, if today's assumptions are equally off base?

So perhaps it's no surprise that products to help mitigate this risk are proliferating. Longevity insurance is gaining more acceptance in Canada. "What that means is that pension funds are swapping their expected mortality with the realized mortality rates, using an insurance company as counterparty," said Bruce MacKinnon, vice president and director of TD Asset Management.

In 2015, BCE Inc. executed the first longevity insurance transaction in North America for $5 billion with Sun Life. This was followed by a smaller, $35 million transaction executed by Canadian Bank Note Co. with Canada Life Assurance last year. In these deals, the plan sponsor retains responsibility for payment of the pensions, but is insured against any unexpected longevity increases. Observers expect more of these transactions in Canada as they have become more affordable for a range of pension plans.

Mitigating risk

Two sorts of plan sponsors are particularly interested in longevity risk. "One group is looking to get out of the pension business and wants to make sure that longevity is properly priced into any transaction they enter into," said William da Silva, senior partner and national retirement practice leader at Aon Hewitt. "The other group is looking to maintain the plan, are very sophisticated and want to ensure that they understand the magnitude of the risks they are carrying — and have assessed how best to manage them."

The cost of miscalculating how long people will live can be high. About one-half of Canadian defined benefit pension plans offer inflation-linked benefits. Although these are largely public-sector plans, the practice is still more prevalent in Canada than, say, in the U.S. The effect of indexation means that any mistake in calculating longevity is magnified, thus making the issue more concerning to those sponsors affected by it.

There is a question of materiality, though. Generally, the two biggest risks that determine pension surplus volatility are interest-rate and equity risk. Longevity falls further down that list. "It's a risk that plans may consider when they become well-funded and reach end-state," said Richard R. Ratkowski, director of investment strategies at NISA Investment Advisors. "The true risk isn't increases in longevity; it's the unexpected increases in longevity. The actual volatility of unexpected increases to longevity is quite small — we estimate it at about 60 basis points annualized."

Just to clarify the point, Gregory W. Johnson, director of client services at NISA Investment Advisors, explains that plan sponsors need to build in some expected increases in longevity, in much the same way that insurance companies do. "When mortality tables change, there can be large shifts in liability values," he said, "but in most years there are no changes to the tables. Longevity volaility needs to be understood in annualized terms over the long period between updates. That's where our 60 basis point estimate comes from."

Getting a handle on the volatility of longevity risk may not be as easy as it sounds. An insurance company will have a vast actuarial infrastructure that allows it to follow the impact of medical breakthroughs and mortality studies closely. This information may not be as easily available to plan sponsors, as they generally rely on the mortality tables issued by the Canadian Society of Actuaries. Thus moves by insurers and consultants to better support plan sponsors in this area are welcomed.

Of course, there are ways to cope with longevity with finality. "The traditional — and the easiest way to eliminate longevity risk is to get rid of the whole liability," said Aon Hewitt's da Silva. ⌫

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P&I | CONFERENCES and AON present

Canadian Pension Risk Strategies

April 25 | Toronto

When considering the risks associated with defined benefit pension plans, one risk is paramount: the inability to meet all of its obligations at the end of the day. Canadian plan sponsors are continuously exploring different ways to manage the myriad risks, but this can be a daunting task.

REGISTER for the Canadian Pension Risk Strategies Summit for an inside look at the most successful investment strategies, as well as ways to avoid pension risk pitfalls. P&I once again partners with Aon Hewitt for this one-day event that provides an arena where plan sponsors can discover the best ways to navigate the often complex process of risk management. Thought-leaders will weigh the ongoing financial risks and increased market volatility with various discussions.

Agenda sessions include:

WORKSHOPS

- Investing in a Rising Interest Rate Environment
- Behavioral Drivers and Investment Opportunities
- Cracking the De-Risking Code
- Investment Grade Private Debt: Debunking the High-Risk Myth
- Liquid Alternative Solutions - The Next Generation of Hedge Fund Investing

PANEL DISCUSSIONS

- Managing Risks that Impact Liabilities
- Exploring the De-Risking Continuum
- Balancing Risks and Returns

Complimentary registration at www.pionline.com/CRISK2017*

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Questions? For more details please contact Elayne Glick at (212) 210-0247 or pi-registration@pionline.com

*Registration is only open to pension plan sponsors, endowments, foundations and a limited number of investment consultants.

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