Sleep well at night – investing like an insurer

Let's take a trip down memory lane and recall the 2008 financial crisis, which dramatically reduced the funded status of defined benefit (DB) plans and negatively impacted the financial statements and contribution requirements of their sponsors. Meanwhile, the annuity portfolios of Canadian life insurance companies came through the crisis relatively unscathed. How did they do it?

Traditionally, pension plan investing has been about taking risks to generate returns, which led to a mismatch between assets and liabilities, while the insurance company approach has been about matching assets and liabilities in order to reduce risk. Many sponsors of DB pension plans are realizing that taking risk by making calls on equity markets and interest rates has cost them a lot of sleep and now want to understand and leverage the lower risk investment strategies used by insurers.

Plan sponsors want to know...
- How do I make my pension plan more sustainable?
- How do I reduce contribution volatility?
- How do I reduce financial statement volatility?

Plan sponsors are asking...
- How do insurers invest?
- What risks do insurers take?
- How do insurers manage risk?

The answers to plan sponsors' questions can be found in the three golden rules that many insurers follow:

We don't make calls on interest rates

We take carefully curated credit risk

We harvest illiquidity premiums

These rules translate into concrete actions that plan sponsors can take now to reduce pension risk and focus on their core business. Even in today's challenging conditions, it is possible for plan sponsors to benefit from these rules.

Challenging conditions for plan sponsors
- Historically low interest rates
- Underfunded pension plan
- Desire to maintain equity exposure to bolster expected rate of return assumption

If this is you...
You can still benefit from the golden rules by making your current fixed income portfolio work smarter.

Sun Life INVESTMENT MANAGEMENT

Let's look at each of the three golden rules in more detail and how they apply to an insurer's group annuity portfolio:

INSURANCE COMPANY GOLDEN RULES

We don't make calls on interest rates

Liability driven investing is core to an insurer's business

In our experience, interest rate risk is an unrewarded risk. As such, we closely match the duration of our assets with the duration of our liabilities. In addition, we rely exclusively on fixed income-type assets.

This philosophy of not making calls on interest rates or on equity markets aligns with our fundamental objective of keeping the promises that we've made to our policyholders. Our insurance regulatory framework, which sets out our reserve and capital requirements, supports our investment philosophy.

We are true liability driven investors.

Rule in action: We closely match the duration of our group annuity liabilities with fixed income assets at six key rate duration points. We do not use equity in our group annuity portfolio.

We take carefully curated credit risk

Investment grade corporate bonds are key to an insurer's portfolio

We believe that investment grade credit risk is a rewarded risk and provides superior risk-adjusted yields. As such, about 90% of our bond portfolio has exposure to domestic or international credit.

Our dedicated global credit research team includes 12 analysts who follow names, sectors and geographies.

Every morning, they hold a daily call to review earnings reports and business news to determine what credit to get into, what to avoid – and just as important, when to get out.

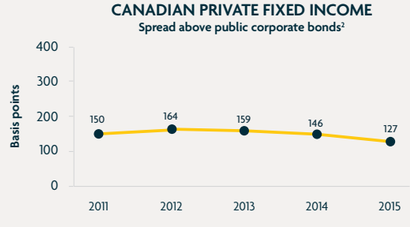
Rule in action: In our group annuity portfolio, over 90% of our fixed income assets are allocated to investment grade credit.

We harvest illiquidity premiums

Private assets can provide superior yield and diversification

In our experience, liquidity risk is a rewarded risk and provides superior risk-adjusted yields and broader diversification than the Canadian corporate bond universe.

- Over the past several years, private fixed income assets have yielded on average over 100 bps more than a comparable public bond[1] as shown in this chart.
- The FTSE®/ TMX Canada All Corporate Bond Index is heavily weighted towards the financial sector. Adding private assets can allow for broader sector diversification.



Rule in action: About half of our group annuity portfolio is in private assets.

[1] Performance for Sun Life Assurance Company of Canada's General Account private fixed income portfolio; sources are Bank of Canada, Sun Life Financial. Yield enhancement is based on a comparison of individual private and public fixed income assets of similar duration, credit rating and term. Spreads are dollar weighted. Past performance does not guarantee future results, which may vary. Credit losses are dollar weighted and basis points are estimated over the companion year's average asset base. All private bonds are managed by the private fixed Income team for Sun Life Financial's General Account.

[2] Stated on a gross relative value basis versus comparable corporate bonds.

Now let's look at how plan sponsors can apply the three golden rules to better manage their pension plans:

APPLYING THE GOLDEN RULES TO PENSION FUNDS

Don't forecast interest rates

Reduce interest rate risk and equity risk

To take interest rate and equity market calls off the table, plan sponsors can take action on multiple fronts:

- Reduce allocation to equities and increase allocation to fixed income.
- Align duration of fixed income assets to duration of liabilities.
- Align key rate durations to protect against non-parallel interest rate shifts.

In some situations, it might be appropriate to determine triggers, based on market conditions or funded status, which need to be met before an action is executed.

Opportunity: Reduce pension risk and minimize pension volatility significantly by addressing equity market risk and interest rate risk.

Use credit spread assets for better matching

Reduce credit mismatch risk and enhance yield

The FTSE®/ TMX Universe only has a 25% allocation to corporate credit whereas a pension plan's liabilities are calculated using a discount rate that assumes a much higher proportion of credit. For example, accounting liabilities assume a 100% allocation to corporate credit while non-indexed solvency liabilities for retirees assume a significant allocation to corporate credit.

This means that plan sponsors who increase their allocation to corporate credit may increase their expected yields and also better match their liabilities.

Of course, retaining an investment manager that has demonstrated experience managing corporate credit is critical to this strategy.

Opportunity: Reduce credit mismatch risk and enhance fixed income portfolio yield by increasing investment grade corporate credit.

Enchance yields using private assets

Enhance yield and increase diversification

Plan sponsors can add private assets to their fixed income portfolio to increase expected yield and reduce risk. The risk reduction comes from the additional diversification effect of private assets, along with robust credit processes. The increased yield comes from harnessing the illiquidity premium inherent in private assets.

Opportunity: Add exposure to private fixed income assets to further enhance the fixed income portfolio yield and provide additional diversification.

KEY OPPORTUNITY: MAKE YOUR CURRENT FIXED INCOME PORTFOLIO WORK SMARTER

- ✔ REDUCE INTEREST RATE AND EQUITY RISK
- ✔ INCREASE ALLOCATION TO INVESTMENT GRADE CORPORATE BONDS
- ✔ ADD PRIVATE FIXED INCOME ASSETS

Applying these golden rules to your pension plan's fixed income portfolio may result in:

- **Over 100 bps of additional yield versus a blend of FTSE®/ TMX indices[1]**
- **Broader sector diversification than the FTSE®/ TMX Canada All Corporate Bond Index**
- **Reduced interest and equity rate risk**
- **Reduced credit mismatch risk**

WITH THOSE SORTS OF POTENTIAL BENEFITS, TAKE ACTION NOW AND START SLEEPING BETTER AT NIGHT.

About Sun Life Investment Management

The Sun Life Investment Management group of institutional investment management companies comprises Bentall Kennedy Group in North America, Prime Advisors, Inc. and Ryan Labs Asset Management Inc. in the United States, and Sun Life Institutional Investments (Canada) Inc. in Canada. Sun Life Investment Management is supported by the investment division of Sun Life Assurance Company of Canada, which manages the investment process and investments for Sun Life Institutional Investments' clients as well as Sun Life Assurance Company of Canada's own general account.

Sun Life Institutional Investments collaborates with Sun Life Assurance Company of Canada's Defined Benefit Solutions team to provide liability driven investing solutions. Sun Life Institutional Investments manages the underlying investments that constitute the LDI mandates and partners with DB Solutions to develop customized strategies, grow new business and provide ongoing client servicing.

ABOUT THE AUTHORS

Brent Simmons, FSA, FCIA, Senior Managing Director, Defined Benefit Solutions

Brent leads Sun Life Financial's Defined Benefit Solutions team, which helps some of Canada's largest employers manage the risks in their defined benefit pension plans with innovative, customized solutions that address the specific challenges of each plan sponsor.

Heather Wolfe, FIA, FCIA, FSA, Managing Director, Client Relationships, Defined Benefit Solutions

Heather works closely with consultants and plan sponsors to develop innovative, customized solutions to the challenges they face in their defined benefit pension plans.

For more information about Sun Life Financial's de-risking solutions, visit **sunlife.ca/DBSolutions**

[1] *40% FTSE®/TMX Canada Universe Bond Index, 60% FTSE®/TMX Canada Long Term Overall Bond Index*