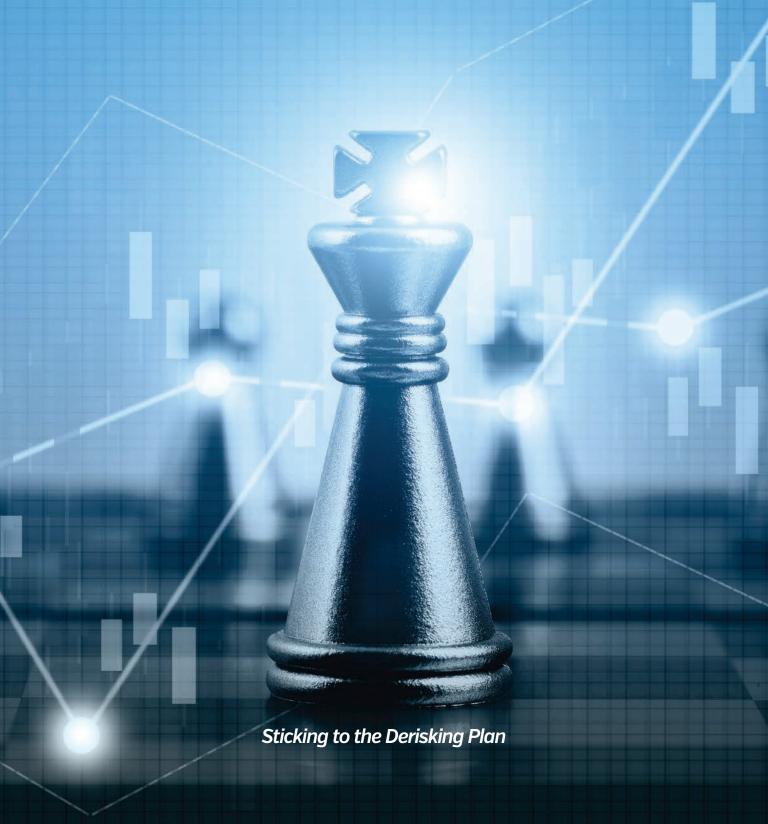
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Sticking to the Plan

Coronavirus pandemic sharpens Canadian sponsors' focus on risk mitigation



rom late 2019 into early 2020, Canadian defined benefit plans were riding rising stock prices to near-record solvency ratios — Aon's median solvency ratio stood at 102.5%, up 7.2 percentage points in the fourth quarter alone.

Then COVID-19 hit. Hard.

"If I think about where we were in February, the idea of a pandemic was still not really on the horizon," said Thomas Lee, chief investment officer at Parametric. "I don't think anyone was talking about shutting down a whole economy both in the U.S. and Canada for an extended period of time."

Today, after massive fiscal and monetary stimulus engineered to keep economies afloat and global efforts to flatten the coronavirus curve, economies are beginning to reopen at varying speeds. Meanwhile, volatility in capital markets remains elevated.

Those two factors, Lee said, have produced a level of uncertainty not seen in years. And

while the worst may have passed, the effects are likely to linger for some time, which can complicate plan sponsors' efforts to derisk. But for those with long-term risk management and asset allocation strategies, keeping an eye on the long term is paramount.

"Plan sponsors should consider this new level of uncertainty as they think about their pension risk strategies," said Brent Simmons, head of defined benefit solutions at Sun Life. He said the pandemic could lead some plan sponsors to begin or extend their plans to derisk. Either way, "if anything, the recent market volatility highlights the importance of practicing good pension risk management," he said.

François Hélou, head of balance she et solutions at BMO Global Asset Management, said market selloffs, such as the COVID-19-driven one earlier this year, can trigger a drop in a pension plan's asset values and an increase in its liability value, a combination that leads to a deterioration in the plan's

funding ratio. "Market selloffs shouldn't be a time for plan sponsors to think differently about de-risking," he said "Rather, they should be a time to adjust a properly established risk management strategy to ensure that it remains focused on protecting and improving the plan's relevant funding ratio and meeting its contractual liabilities."

Lee said a number of Parametric clients are trying to see through the short-term "haze" and structure their portfolios to be protected no matter what the situation — inflation or deflation, for example.

"Given the uncertainty, a lot of our clients are moving to closer adherence to policy targets," said Justin Henne, managing director of customized exposure management at Parametric.

Funded status volatility

To illustrate how the volatility has played into plans' funded status, the Aon median



plan fell to 89% at the end of March from that 102% level at the beginning of the year. It jumped to 95% by the end of April as stock markets recovered

Simmons said that because of the sharp rebound in funding levels some plans may have dodged a bullet. But with volatility — and uncertainty — remaining high, "plan sponsors may have a temporary opportunity to take risk off the table," he said. "After all, no one knows where the markets will go from here."

Funded status can be a tricky measure, another reason plan sponsors should stick to a well thought out and designed derisking plan. According to Statistics Canada, between 1999 and 2018, Canadian plan sponsors contributed \$158 billion to shore up deficits in their DB plans. Yet at the same time, they did not see a material increase in their plans' funded statuses.

Plans that have been able to screen out the noise and continue derisking should see the benefits of that strategy in the near future, particularly as global economic growth, which plunged as economies around the world shut down, remains weak and, as most managers expect, Canadian interest rates remain low.

Long-term nominal interest rates have been on a structural decline for the past 25 years in what is not only a Canadian phenomenon; similar trends have been clear in other industrialized countries. And the pandemic has only strengthened the case that rates will remain lower for longer.

Derisking options

In fact, the idea of negative rates has entered the conversation.

"For a long, long time, there's been a perspective that negative interest rates were unheard of, or something that you could just say, 'There's floor. It's zero on interest rates.' I think the world has come around to quite a different way of thinking on that front and most bond folks are now of the opinion that zero is absolutely not a floor, not in the U.S., not in Canada," said Gregory Johnson, director of client services at NISA Investment Advisors. "Rates can go through zero. They can go negative. We're not predicting that by any stretch, but they certainly can go negative and if interest rates go negative, it's still going to have the same effect on liability values. They're going to get bigger and it's going to have the same effect on asset values. It's the inverse relationship."

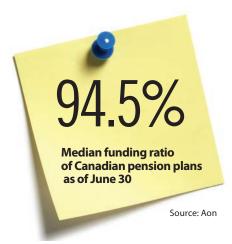
Helou said low rates are "leading to searches for higher yielding, good quality assets in

order to offset the effect that lower long-term interest rates had on plan funding levels."

He cited more use of active investment management strategies such as low volatility equity, alternatives and multi-asset strategies, as well as direct investments in physical assets such as real estate and infrastructure.

Simmons at Sun Life said in the current environment, plan sponsors have other derisking options to consider.

"One way to take less risk in a DB plan is to shift some return-seeking assets to liability-



hedging assets," he said. "DB plans with a large proportion of liability-hedging assets have seen funding levels remain fairly constant over the past few months. These plan sponsors have been able to concentrate on their core businesses without having to worry about their plan members' benefit security."

He also suggested plan sponsors consider actively managed bond strategies as most economists and strategists expect to see low interest rates for the forese eable future.

One other way to reduce risk is to purchase annuities, and Canadian plans have been taking advantage of an annuity market that is growing in depth and breadth. According to the Life Insurance Marketing Research Association, or LIMRA, annuity sales in 2019 reached C\$5.2 billion (US\$3.85 billion), up from \$4.6 billion in 2018. Transactions sizes are growing as well, with two transactions in the fourth quarter of 2019 larger than \$450 million each.

Often, these deals are undertaken as a step on the path to annuity discharge, with the intention of converting the buy-in to a buyout at a future date. In part, this process is a response to the fast-changing global economic environment, which has taken a significant hit from COVID-19 this year.

The Canadian economy doesn't operate in a vacuum, so client conversations always include questions about the global macroeconomic backdrop, the actions of the U.S. Federal Reserve, China and trade, said Earl McKennon, investment director at Fidelity Investments.

In years past, the prospect of lower rates kept sponsors from implementing some liability matching actions. But that's no longer true, especially for sponsors that have implemented liability driven investing strategies in other countries.

Plans that had LDI programs in place when the pandemic hit markets earlier this year found that those programs delivered as expected.

"LDI has been effective" this year, NISA's Johnson said. "It's definitely been a strategy that's worked."

Changing solvency regulations in parts of Canada has turned plan sponsors' focus to funding relief and driven asset allocation discussions

"Because the rules generally give more contribution flexibility, we will potentially see an increase in the risk tolerance of sponsors," said François Pellerin, multi-asset class strategist at Fidelity Investments. But, he added, "When we walk our clients through the fundamentals of what they are trying to accomplish — get fully funded — they're less likely to double down on risk because the rules allow it."

Potential regulatory changes to solvency requirements could impact plan sponsor behavior. Some plan sponsors in Canada — particularly large inflation-linked plans — are using replicating portfolios to calculate their solvency valuations.

The current replicating portfolio methodology can result in a liability that is much lower than the liability calculated using the annuity proxy rate. The Office of the Superintendent of Financial Institutions' (OSFI) rules on replicating portfolios are under review. The new replicating portfolio methodology may also lead to an increase in annuity purchases as the cost of annuities would be closer to the solvency liability that the plans are funding toward.

Beyond regulatory changes, cybersecurity is an issue that pension plans face.

"For all plans, cybersecurity is an issue," said William da Silva, senior partner and retirement practice director at Aon. "We have had many discussions with our clients on the safety of their data with all of their external partners, including their investment managers."

Swept Along in the Tide of Derisking

In March real world test, liability driven investment strategies hold up



There's nothing like the real world to prove the value of a strategy and that's the case with liability driven investment strategies, which held up well during the pandemicinduced market selloff and economic freeze.

"We think that the recent volatility will make plan sponsors even more appreciative of LDI strategies," said Brent Simmons, head of defined benefit solutions at Sun Life, adding that the market turmoil earlier this year proved to be a non-event for plans following these strategies.

To be sure, "From an LDI standpoint, there are headwinds and tailwinds," said Rick Ratkowski, director of investment strategies at NISA Investment Advisors. "The shift away from a solvency-based valuation is a headwind for LDI adoption because it moves the discussion away from the economics of the liability to an arbitrary measure. But the tailwind clearly is global derisking of pensions —and that's come to Canada."

The question for Canadian plan sponsors is no longer, "Are you using LDI?" It's "How many triggers did you reach last year?" And,

"How did you adjust your asset allocation?"

"We are seeing increased rigor in the governance of Canadian pension plans," said François Pellerin, multi-asset class strategist at Fidelity Investments. "Sponsors are either closing or freezing their plans, and most have a firm idea of their end goal. So, it's all about a systematic approach to reaching full funding for either hibernation or plan termination."

Asset allocation, as a result, has become more dynamic, he said. "Glidepaths are stricter and better defined, and, importantly, there's a robust framework for changing the asset allocation as milestones are reached."

Back to policy targets

Some observers trace that discipline to 2018, when equity markets plunged unexpectedly in the fourth quarter. Buoyed by rising stock markets, some plans had put off derisking measures and suffered bigger-than-expected funding declines. If the bounce in markets in 2019 felt like a reprieve, the coronavirus pandemic quickly doused those thoughts.

"Given the uncertainty, a lot of our clients are falling back on closer adherence to policy targets," said Justin Henne, managing director of customized exposure management at Parametric. "While not strictly a risk-off theme, remaining policy neutral does not introduce additional risk beyond the policy allocation."

Simmons said for plan sponsors seeking to adjust their asset allocations, overlays can play a key role by helping to minimize transaction costs "at a time when these can be significant."

In addition, overlays help increase a plan's protection against interest rate movements, whether or not a plan needs to maintain its equity exposure, he said.

"The increase in interest rate and credit spread hedge ratio can be achieved by availing of the return seeking exposure synthetically, through equity, derivatives, or by increasing the fixed income exposure synthetically via repos, futures or swaps," he explained, adding that plan sponsors need to understand the limits of these instruments in times of stress.





Plans with glidepaths have reached trigger points and moved out of equities into fixed income. For plans that don't yet have a glidepath, "there's debate as to whether glidepaths make sense in the new funding world in Ontario and Quebec," where new regulations are in place, said William da Silva, senior partner and retirement practice director at Aon. "Some organizations are even re-risking, potentially taking on a bit more risk because the funding volatility has been somewhat muted by the new rules."

LDI proves its mettle

"Liability driven investing is not a 'de-riskingat-all-costs' strategy," said François Hélou, head of balance sheet volatility solutions at BMO Global Asset Management. "Rather, it is a risk management that must adjust to the plan's balance sheet requirements. Its raison d'être is to always adapt the plan's asset allocation to optimize its ability to meet its liability obligations. Although market conditions could influence the tactical implementation of an LDI, they should not influence the plan's raison d'être, which goes to the core of what a defined benefit plan is all about: to provide income and security to its current and future retirees."

According to Pellerin, more plan sponsors are implementing liability driven investing strategies because they work. What's more, the interest-rate scenario is pushing them in the direction of LDI.

"Interest-rate risk is an uncompensated risk and sponsors are now accepting that it's not possible to predict how low rates will go," he said. "If you accept that you cannot predict how low rates will go and when, then LDI makes that much more sense."

The quick, steep market decline in March, combined with the drop in interest rates and plunge in economic activity likely gave a lot of plan sponsors gray hair, said Gregory Johnson, director of client services at NISA Investment Advisors.

"I'm sure it was terrifying for a lot of folks, but LDI strategies held in there," he said. "They really did. And again, the reason why pensions adopt LDI strategies is specifically to kind of avoid the fright that comes with volatile markets."

Many plan sponsors have interpreted LDI as a fixed income solution, but as interest rates are likely to stay low for some time, some are beginning to consider hedging possibilities available from other asset

"Traditionally, LDI meant looking at the liabilities and their sensitivity to interest rates, and then matching a fixed income portfolio to those characteristics," said David Phillips, director of liability driven investment strategies at Parametric. "It was essentially a fixed income solution.

"We would argue," he continued, "that the solution needs to include all assets because all the investments in a pension plan are driven by the liabilities." That means thinking more carefully about how, for example, equities can fit into the relationship.

"It isn't just the credit spread exposure in a bond portfolio, but also how the relationship between equities and fixed income instruments may have an influence on which, and how much, fixed income you buy," Phillips said.

"We are seeing larger plans looking more holistically at their pension portfolios to see how they move in relation to the liabilities," he continued. "How does the total portfolio influence funded status volatility?"

This is in contrast to the more traditional approach that considered a hedging port-

folio as separate from a growth or returnseeking asset allocation. Some assets, such as private credit and high yield bonds, offer growth and hedging potential.

"We are more commonly working with plan sponsors in Canada to create a custom blend of indices to better match client liabilities with the aim of leading to a hibernation strategy, either a completion portfolio or a custom LDI mandate," said NISA's Ratkowski

Parametric's Henne said the March market activity has broadened the acceptance of derivatives to manage the asset allocation, as physical rebalancing in March was not efficient because of liquidity and transaction cost issues.

"We saw many clients reposition their portfolio, again, largely back to policy allocations, but with derivatives," he said. "The one tool we saw in the midst of the crisis was derivatives-based policy rebalancing."

Going custom

As more Canadian plans become better funded, the trend is to use customized benchmarks.

"This can involve analyzing liabilities on a daily basis, and using a mix of public indices, engineering a benchmark that will do justice to the shape of the liability curve as it evolves," said Earl McKennon, investment director at Fidelity Investments.

"We haven't seen folks say, 'I need to get higher yields from my fixed income' or 'I want to focus on securitized product in Canada to diversify my exposure,'" Ratkowski said. "But that may be a byproduct of being a manager who focuses on the investment grade fixed-income sector, which is most relevant for hedging portfolios.

"We see a higher level of customization within corporates, provincials and federal exposures," he continued. "Sponsors are focusing on certain areas of the yield curve and specific exposures, rather than benchmarking against a standard set of indices."

And depending on the mix, plan sponsors will need to adjust their strategy.

"If you do use different kinds of bonds, you may need to balance the equation using STRIPS or derivatives to get very potent, clean long duration that will make room for more 'exotic' types of hedging assets," said Fidelity's Pellerin.

For example, global credit has duration, but that duration is not as reliable as other asset classes. There is potential for slippage, especially in tail risk scenarios. $\mathbf{1}^{g}$

Annuity Market — Pandemic Style

ast year, more Canadian defined benefit plans than ever took final steps to derisk by annuitizing retirees and thus shrinking their liabilities. Higher solvency rates, thanks to buoyant capital markets, made more of this activity possible.

Annuity sales broke a record with C\$5.2 billion (US\$3.85 billion) in 2019, compared with \$4.6 billion in 2018, according to LIMRA. In the past, most annuity deals closed in the fourth quarter but that trend seems to be shifting.

This year, however, the picture is dramatically different, thanks to the COVID-19 pandemic that closed economies around the world, sent stock markets reeling and drove central bankers to provide historic levels of fiscal and monetary stimulus.

With companies moving rapidly to maintain their businesses amid government stay-athome orders and dramatically shifting global supply chain links, plan sponsors have been no less forced to reexamine their priorities while keeping an eye on their long-term goal.

So while annuities can still make sense, plan sponsors may be delayed in using them.

"The good news is that annuities are currently on sale relative to many plan sponsors' bond portfolios," said Brent Simmons, head of defined benefit solutions at Sun Life, "The biggest challenge for plan sponsors this year is likely bandwidth to consider an annuity purchase given the demands of their core businesses."

Because of this shift in focus, today might be a good time for plan sponsors to lay the groundwork for an annuity transaction in the future, so taking care of issues such as cleaning up data, asking insurers for illustrative quotes and ensuring that governance systems are in place, Simmons said.

"That way plan sponsors can act quickly when bandwidth frees up," he said.

The pricing of an annuity deal is likely to be better when a range of insurers bid on it, and for plan sponsors, price can make or break the decision to annuitize because the company may have to make a contribution — often cash — to the transfer deal.



Boomerang risk gone

The impact of the pandemic on pricing remains to be seen but the market is heating up.

"It's hard to say whether the pandemic will have an impact on longevity assumptions; more studies will have to be conducted to determine whether there will be an impact on pricing," said Diane Liu, head of client relations and operations, group retirement solutions, at BMO Insurance. "At the moment, we haven't seen the pandemic play a role in pricing."

She added that as stock markets rebounded in late April, early May, the annuities market slowly began to pick up steam, and "we are seeing very competitive pricing."

Before the pandemic hit, annuity purchases had become more attractive thanks to provincial pension legislation across Canada that removed "boomerang risk" associated with buyout annuities. That's the risk that the liabilities the plan has transferred to the insurer legally revert to the sponsor should the insurance company become insolvent.

But that is a low risk. "We haven't had an insurance company go bankrupt in Canada since 1994," Liu said.

William da Silva, senior partner and retirement practice director at Aon, said that

Pension risk transfer is a growing piece of the management puzzle for Canadian DB plans

because insurance companies are such big players in the bond markets, they are able to get better yielding product, which "will help the pricing of transfer deals to improve, as has the growth in the number of insurers operating in the Canadian transfer market."

Even with a more diverse annuity market and more favorable regulation, sponsors have a choice when it comes to pension risk transfer.

"If a plan that is fully funded or close to full funding doesn't get the pricing it wan ts in the market for a settlement deal, it will just hibernate until the pricing does become attractive," da Silva said. "But for some very large plans, by default, hibernation will undoubtedly be part of the derisking plan."

Hibernation is often a stepping stone to pension risk transfer — it allows the sponsor to develop a portfolio that will likely be attractive to the insurer. But it also allows the plan to take advantage of attractive pricing.

"When you hibernate, in a natural fashion, the distribution between active and vested terminated employees migrates to retirees," said François Pellerin, multi-asset class strategist at Fidelity Investments. "Every year you save a lot of money by waiting because purchasing annuities for retirees is much cheaper than for non-retirees.

"The cost of hibernation is expected to be lower than the cost of termination," he continued. "Many may use convoluted math to convey that it's cheaper to terminate but I rarely buy it." But, Pellerin conceded, "Termination does buy some peace of mind."

When purchasing an annuity, plan sponsors can pay in cash or in securities. Cash has the advantage of speed, but a sponsor using cash needs to have liquid assets available to minimize basis risk. In-kind transfer requires the plan have securities available that the insurer wishes to take. As Liu noted, "although certain high-quality bonds may be listed as acceptable, the insurer may be required to sell them because of asset allocation limits and this would result in additional expense

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Embracing Overlays

COVID-related market volatility highlights potential for derivatives to manage downside risk, portfolio changes

In a fast-changing investment environment, overlay strategies can prove immensely useful. Plan sponsors in Canada are using derivative strategies for a variety of purposes, from implementing a simple duration extension to smoothing the process of asset allocation changes to providing short-term downside risk mitigation.

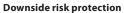
This year has proven the point, with the sharp market drop in March related to the coronavirus pandemic, the massive fiscal and monetary stimulus from central bankers seeking to keep their economies afloat, and

the post-March market recovery.

"As the market has risen pretty quickly here, we're seeing clients think about protective hedges," said Justin Henne, managing director of customized exposure management at Parametric.

"We have seen a lot of bond overlay activities in pension liability hedging," said François Hélou, head of balance sheet solutions at BMO Global Asset Management. "Given the low level of conventional quality bond yields, bond overlays use synthetic instruments to extend duration, hence allowing plans to remain invested in growth assets such as equities." Some managers suggested that pension plans think about using overlay strategies as a method of smoothing their derisking path.

"Most pension plans have a glidepath with targets, which when met, trigger asset allocation changes," said David Phillips, director of liability driven investment strategies at Parametric. "Those transitions can take time and can be hard to implement immediately." By using derivatives, he said, a plan can put the new allocations in place quickly and adjust the overlay as the physical assets transition.



Overlay strategies beyond those specific to interest rates can provide the means for plan sponsors to implement tactical preferences and adhere to glidepath allocation while maintaining alpha-producing exposures.

"We are seeing more interest in the use of derivatives to manage equity exposure in Canadian plans," said Rick Ratkowski, director of investment strategies at NISA Investment Advisors. "Our conversations concentrate on the idea of downside risk protection."

These solutions could involve the synthetic sale of equity beta, which involves capturing manager alpha plus a cash yield as opposed to getting the entire equity return. Investors may use this strategy when they

have a tactical view that stocks are poised to fall. Or when sponsors are considering tailrisk hedging, which could include the use of zero premium collar strategies.

"We've also seen some sponsors taking that idea one step further and use delta hedging as a way to synthetically replicate their desired equity distributions," Ratkowski said.

Overlay programs give plan sponsors the flexibility to run their plans on a more risk-aware basis, allowing them to transition to a new asset allocation more quickly than they could using physical investment vehicles.

"Some sponsors want to derisk immediately after they've hit a trigger," Henne said. "They can do this with derivatives and not miss an opportunity to realign risk."

Capital efficient

The use of downside risk protection does suggest an attempt to time an equity market selloff, but Ratkowski said many times, plan sponsors use derivative strategies "to manage portfolio risk in advance of a physical de-risking event that could occur sometime in the future."

"Forgetting about practicality for a minute, you could use all sorts of derivative combinations to sell the upside and protect on the downside," said François Pellerin, multiasset class strategist at Fidelity Investments. "It can be expensive, but also effective. We advocate using these strategies when there is a short-term definite goal."

An example would be to nail down the funded status of a plan that is involved in a long corporate merger negotiation; in that case, the protection would mean that the pension will not be a distraction during the merger talks.

According to Thomas Lee, chief investment officer at Parametric, it isn't possible to hedge for little or no cost and add value. "If you are going to own equity and hedge, that will cost you over the long term," he said. "There are continued on page 14





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Diversification Rules

Sharp market moves once again prove value of seeking uncorrelated asset classes

As a result of the COVID-induced spike in volatility — as stock prices plunged, interest rates sank, economic activity dried up and central banks went into overdrive to provide stimulus to keep economies functioning—plan sponsors may redouble their efforts to diversify even as stocks have largely recovered from their March lows.

François Hélou, head of balance sheet solutions at BMO Global Asset Management, said plan sponsors should consider diversification across asset classes within the context of funding ratio and liabilities.

"Correlations are an important measure of the level of asset diversification based on historical behavior, but the crux of an asset allocation for a pension plan is in its ability to assess the plans' assets in relation to its liabilities so as to reduce the volatility of its funding ratio while maintaining enough growth to support the increase in its liabilities," he said.

And despite the steep drop in equities in March, "some plan sponsors are taking the view that 'even though equities got us into this mess, we'll still need more of them to get out of it," said Brent Simmons, head of defined benefit solutions at Sun Life, adding that any additional equity allocation should be the product of careful consideration of the plan sponsor's long-term objectives rather than a desire to leverage the plan further or as the result of past decisions that were not successful.

'Two camps'

"Innovation comes rarely in the pension world, but today we see some of our clients expanding the universe of fixed income instruments they are willing to use to enhance yield and diversification," said François Pellerin, multi-asset class strategist at Fidelity Investments. Examples include global credit and government bonds.

"We see two camps of DB plans in Canada," said William da Silva, senior partner and retirement practice director at Aon. "Some are moving away from holding return-seeking assets and locking down their liability hedging.



The others are in it for the longer haul, even if the plan is closed or frozen. These plans are thinking about re-risking a bit — not necessarily back into equities but possibly into private markets to provide some more diversification and better risk-adjusted returns."

In many cases, the quest for non-traditional investments is leading Canadian plans to illiquid alternative assets.

"We see a continued migration of pension investors into alternative assets," said Justin Henne, managing director of customized exposure management at Parametric. "This can be private credit as well as private equity and hedge funds."

But Canadian plan sponsors moving more assets into alternatives need to be aware of the illiquidity they bring to their portfolios.

"It makes sense to harvest the illiquidity premium, but to do that you need to be a committed long-term investor," warned Pellerin. "If the plan is expected to be terminated any time soon, then you may shy away from illiquid assets to preserve optionality."

In addition, Canadian plans continue to

move assets outside the country, with some sponsors even ditching the domestic-international divide for global mandates.

The currency factor

Globally, Canada represents just a small market for both equities and fixed income, so it can also pose sector concentration risk. "As active investors, we always ask for a healthy dose of out-of-index allocation to provide the diversification we think is necessary," said Fidelity's Pellerin.

On the other hand, investing outside the home market adds risk to the portfolio in the form of currency mismatch between assets and liabilities.

"Plan sponsors should approach currency risk similarly to an insurance company," said Diane Liu, head of client relations and operations, group retirement solutions at BMO Life Assurance. "Insurance companies hedge their currency risk as the capital charges for currency exposure are quite punitive. It is an additional risk that is disconnected from the

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liability."

"We don't think that in the long run, currency risk can be translated into repeatable, reliable alpha, so in our LDI portfolios, we hedge global fixed income back into Canadian dollars," Pellerin said.

"We do see some investors deciding that currency isn't a risk from which they expect to earn a long-term premium," Henne added. "In that case they may decide to hedge their currency risk with the expectation that this allows them to utilize part of their risk budget elsewhere in their portfolio."

"To the extent that Canadian plans are using global equity benchmarks, we would argue that they should be hedging a significant portion of the currency risk because developed international currency risk is generally viewed as uncompensated," said Rick Ratkowski, director of investment strategies at NISA Investment Advisors.

Despite the advice to hedge, plan sponsors may not be heeding it.

"We do see more diversification outside of Canada in all asset classes, but we don't see much currency hedging going on," said

Gregory Johnson, director of client services at NISA Investment Advisors, said the pandemic-induced spike in asset class volatility highlighted an area of diversification that can easily get overlooked: diversification of managers.

"We've seen some plans who use one overlay manager for interest rates and a different overlay manager for risk asset overlay, and we've seen a couple clients get very frustrated with sourcing liquidity to satisfy margin calls," he said. "So I could see folks being a little more thoughtful with how they assemble their managers or their programs to make sure there's some diversification."

Embracing Overlays continued from page 10

more sponsors willing to do that now — or at least willing to have those conversations."

Still, BMO's Hélou said derivatives are capital efficient tools that can complement real assets to achieve an overall balance sheet risk management suited to a plan's funding level and liability cash flows. This is especially relevant in volatile market environments.

Annuity Market

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to the insurer." Thus, it is important to discuss with insurers the use of in-kind transfer early in the annuity purchase process.

In the past year, the use of in-kind transfer on larger size deals has increased.

"In-kind transfers can provide savings as a plan would not have to incur transaction costs to liquidate assets and, to some extent, if the portfolio that is transferred in kind can be used by the insurer," Liu said. The same is not true for smaller deals, where insurers are unable to offer much savings. However, "with the current market condition, we have seen an increased use of in-kind transfers, on both large and small deals, to address liquidity risk brought on by market uncertainty."

Sun Life's Simmons said plan sponsors know that "fairly material savings" are in the offing if they can do an in-kind transfer when purchasing annuities.

Five years ago, few deals involved in-kind transfers in Canada. Only deals over \$500 million would have considered that approach and these were few and far between. Today, however, most transactions over \$200 million involve in-kind transfer, Simmons said.

"In these days of tweets that move the market, you don't want the assets to be out of the market for 24 or 48 hours; if a plan transfers cash, we have to put in margins to protect against those issues," he said. "With in-kind transfer, we can release those risk margins."

Though pricing still dominates the conversation around annuity deals, insurers report that plan sponsors are doing deep dives into other issues, including client service and communications with retirees. "These deals are becoming larger and more complex, so having a dedicated and experienced client service team during implementation and for ongoing servicing provides the plan sponsor

with peace of mind," Simmons said.

Annuitization may not be the right route for every plan, or indeed every cohort within a plan. When a plan has a high proportion of younger participants, an insurance company would likely demand a higher premium to transfer these relative to more stable liabilities — retirees.

"Transferring only the stable liabilities leaves companies with a more volatile remaining plan that becomes hard to manage — harder to manage than if they had actually kept the other liabilities," said David Phillips, director of liability driven investment strategies at Parametric. "The percentage of the liability that is transferred is often much higher than the percentage of the risk transferred.

"I suspect that many plans go down the path of risk transfer without completely understanding what they are giving up vs. what they are keeping," he said. "The amount of overall risk in the plan is reduced through transfer to an insurance company, but it is also usually possible to reduce the same amount of risk through a simple asset allocation change."

Most sponsors of frozen or closed plans would like to clear them off the balance sheet.

"One way to do that is to terminate the plan, but we would strongly advise against partial plan termination," said Fidelity's Pellerin. "In those cases, when say, you just terminate your retirees, you're letting go of the good stuff in terms of risk and keeping the bad stuff.

"If a sponsor adopts a hibernation strategy, they retain optionality," he continued. "Nothing stops them from terminating down the road when the time is right. We have seen plans start hibernation with the intention of terminating within two years, but then deciding to stick with hibernation for the long term because it works."

In his view, rather than asking whether they should use derivatives, plan sponsors should ask if their risk management strategy could afford not to use derivatives in managing uncertainty.

Some plans integrate hedging into their long-term portfolio strategy. "When you look at the payoff profile of a zero-premium collar, which means financing a put premium by selling call options, it can look quite expensive," said Gregory Johnson, director of client services at NISA Investment Advisors.

"You don't get much upside for the downside protection. We more frequently see these strategies used in a systematic program, not a one-off solution."

Even with so much uncertainty – over markets, economies, inflation, etc. – derivatives strategies still make sense.

A derivative strategy that is targeted at hedging risk should provide more certainty during times of uncertainty," said Brent Simmons, head of defined benefit solutions at Sun Life. "As such, it can be worth it."



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