Canadian Pension Risk Strategies

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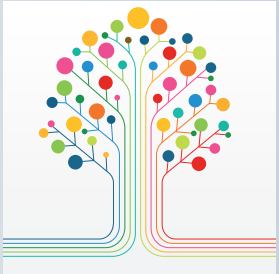

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The Resilience of Pension Derisking

Even as the Canadian economy continues on a path of gradual recovery, with the government focused on increased vaccine availability and decreasing COVID-19 infection rates, the relatively strong funded status of Canadian pension plans last year has helped the Canadian pension risk transfer market rebound from its 2020 drop toward a clean bill of health.

While there was a pause in pension risk transfer transactions in the second quarter last year amid the early days of the pandemic, total Canadian pension risk transfer activity for the year came in at C$4.5 billion in 2020 (or about $3.5 billion in U.S. dollars as of December 2020), which was down from levels seen in 2019, said William da Silva, senior partner and retirement practice director at Aon in Toronto.

Last year was "the third best year that we've had in the Canadian market," said Brent Simmons, Toronto-based head of defined benefit solutions at Sun Life. "That's pretty surprising, given that we were in the middle of a pandemic." Sun Life led several large Canadian pension risk transfers, including GM of Canada's C$1.8 billion deal, of which Sun Life secured C$1.1 billion. It is the largest pension risk transfer deal ever done in Canada, he said. Overall, Canadian annuity market activity has been strong in recent years (see chart).

"We didn't necessarily see a drop-off in volume activity during the pandemic," said Sri Reddy, senior vice president, retirement and income solutions at Des Moines, Iowa-based Principal Financial Group. The U.S. market also had strong market activity, he added, noting that the industry transferred nearly $27 billion in U.S. pension risk transfers in 2020, similar to the level in 2019 of $30

billion (U.S. dollars), according to the Secure Retirement Institute.

"Most defined benefit plan sponsors begin planning and preparing for risk transfers well in advance and have a tendency to implement a strategy to help immunize their portfolios," said Reddy. "This, coupled with both financial and fiscal stimulus as well as robust equity markets, played a part in the market rebound. We saw a fairly healthy clip of business."

Positive trend continues

Strong interest in pension risk transfers in Canada should continue well into 2021, going by PRT activity for the first quarter of this year, said Aon's da Silva. "In fact, we've seen in the first four or five months of this year that the average plan's funded status has actually improved to the mid-90% range. That means there are plans that are over 100% [fully funded] and they're in as good a position as they have ever been for executing their exit strategies."

According to Aon's Canadian Pension Risk Tracker, Canadian defined benefit plans' 2020 funded status was at 90.8% on January 1, plunged to the year's low of 81.3% as of March 21, and then rebounded to 89.6% on September 2, ending the year at 89.4% funded status. Aon's tracker was at 95.2% as of May 31, 2021.

"I was doing a recent presentation for a client," da Silva said, "where I said, 'If you closed your eyes on January 1 and opened them up on December 31, 2020, you would think, 'It's been a ho-hum year; it's been kind of flat.' As people got back to the funded status they saw at the close of 2019 and the beginning of 2020, they have started to revive their de-risking strategies which lead some organizations to transact again in the back end of 2020. While the pandemic did force plan sponsors to take pause, everything recovered and [pension plans] that did not transact in 2020 are now taking a good hard look at executing these trades in 2021." (See chart on Canadian PRT sales.)

Tale of two sponsors

The Canadian pension risk market in 2020 was a tale of two types of plan sponsors, Simmons said. "There were plan sponsors that had well-hedged asset mixes. For them, the pandemic might have been awful from a core business and social perspective, but their pension plan was largely unaffected. They could be opportunistic and take advantage of some of the great pricing that we saw in 2020," he said. Market activity in 2020 was dominated by these well-hedged plan sponsors that had derisked and were able to be opportunistic, he added.

"On the other hand, there were plan sponsors who saw their funded status plummet and then recover. They were on this terrible roller-coaster ride in 2020 but ultimately dodged a bullet," Simmons said. "As we look forward into 2021 and 2022, many of these sponsors are saying, 'You know what? This might be the straw that broke the camel's back. It's time to seriously derisk.'"

Amanda Wilson, managing director and head of U.S. and Canada institutional sales and relationship management at Principal Global Investors, said that stabilization after a turbulent start to the pandemic gives defined benefit plan sponsors a chance to revisit their long-term pension fund strategy.

"It gives [plan sponsors] the opportunity to say, 'How do I prepare for the future now that things are normalizing a bit? How can I better prepare for future shocks or events? How can I ensure sufficient focus on my core business?'" Wilson said. Their experience in 2020 has brought home the realization that managing pension liabilities is not usually the core competency of their business, and that insurance companies tend to be better equipped to handle these liabilities, she said. "Strategically, it could amplify the need or desire for risk transfers going forward or at least demonstrate the value of having someone with the expertise for strategic investing to help prepare you to weather a storm."

As turbulent as 2020 has been, that turbulence

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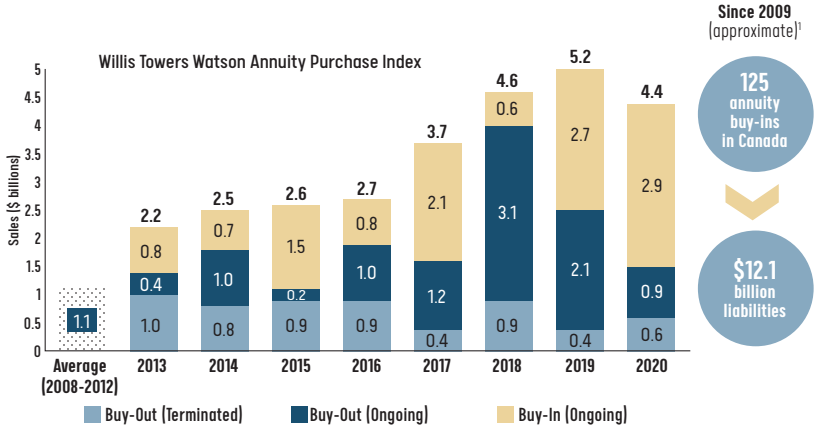
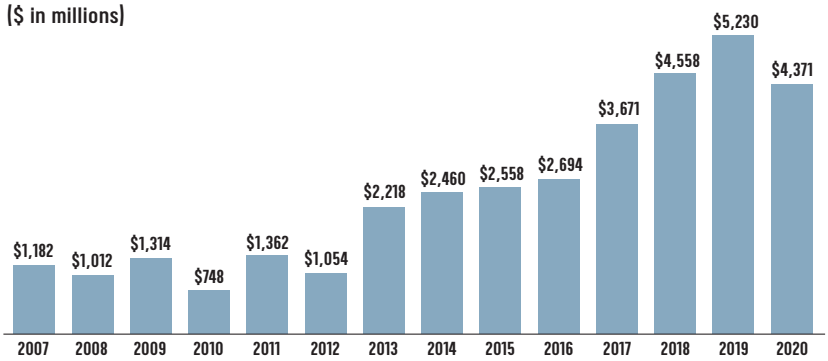
Canadian Annuity Market Activity



Source: Group Annuity Market Pulse, 2020 Annual Review, © (2021) Willis Towers Watson. Used with permission.
[1]Sun Life estimates, as at December 31, 2020.

Annual Canadian Pension Risk Transfer Sales ($ in millions)



Source: Canadian Pension Market Study, Secure Retirement Institute, LIMRA

Investment Strategy that Aligns with the Times

From ESG strategies to a diversified asset mix, pension plans take a broader view

Canadian defined benefit plans that have current or proposed plans to derisk are very focused on adopting environmental, social and governance strategies, and on maintaining a broad asset mix that provides yield and diversification as they move along their investment glidepaths.

"Pensions represent a meaningful pool of capital. It's large institutional capital and it's the type of capital that can have an impact on ESG issues," said Amanda Wilson, managing director and head of U.S.and Canada institutional sales and relationship management, at Principal Global Investors. "So, whether the plan is fully growth-oriented or derisking or moving toward a pension risk transfer, it still has the potential to have a meaningful impact on ESG."

Wilson also said that "the G in ESG – governance – has been a longstanding factor considered by investors and asset managers." In addition, she noted, "we've certainly seen climate [risk] climbing the list of priorities by our institutional investors."

ESG has moved from "nice-to-have to a requirement for institutional investors," and that trend has been heightened by the COVID-19 pandemic, said Eugene Lundrigan, president of Sun Life Capital Management (Canada) Inc. "We have responded to so many ESG requests for proposal over the last 12 months from clients and consultants," he noted, "And it's probably not a surprise that the pandemic has really accelerated the thinking in this space for a variety of societal reasons."

"First, clients really want to understand how ESG factors are considered in investment decisions, as well as in portfolio construction. Every asset manager talks about how they consider ESG in their portfolio decision-making. Clients want more details. They say, 'That's fine, but prove it. Show us real examples,'" Lundrigan said.

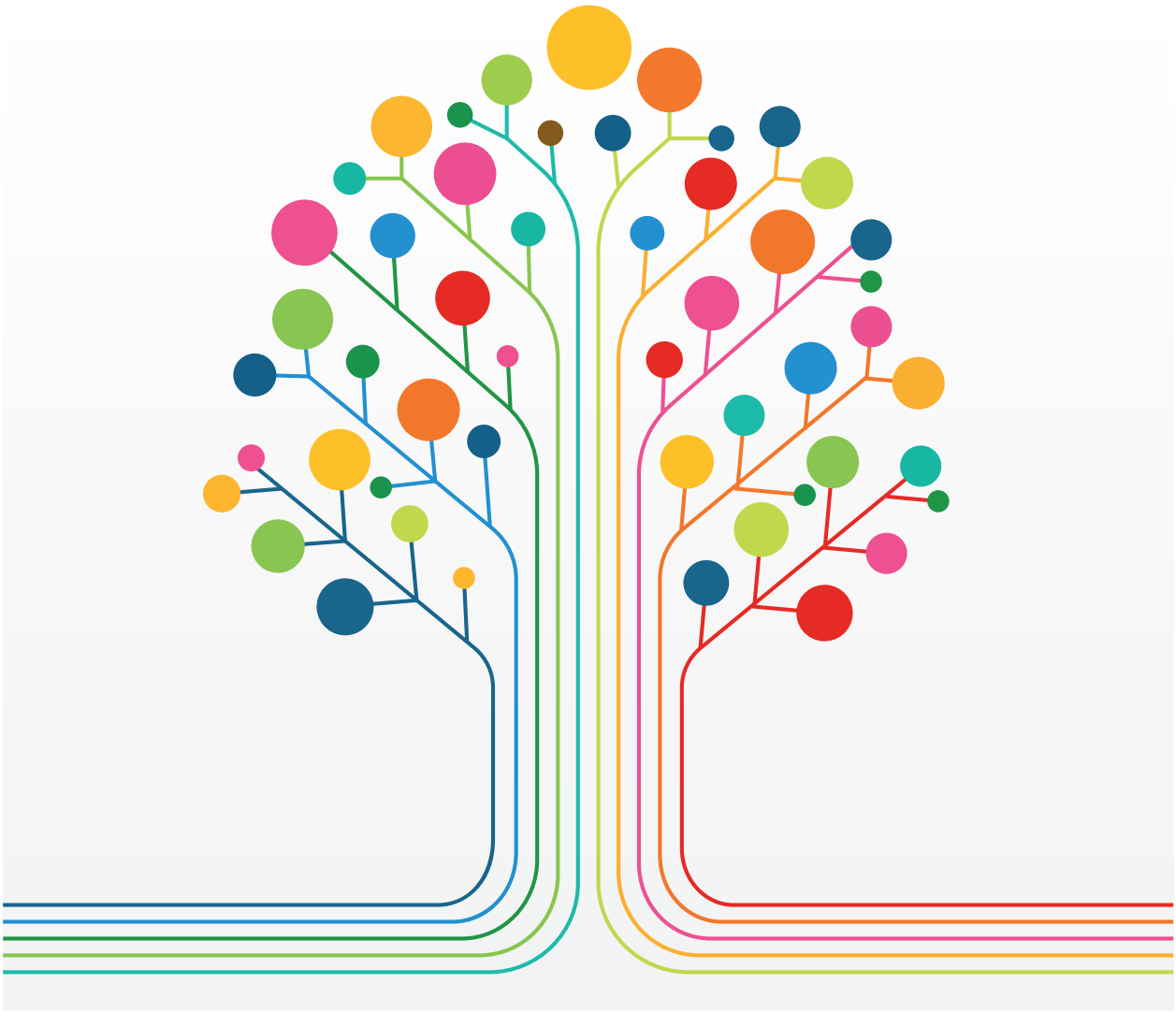
Seeking extra yield

Beyond ESG investments, the asset mix broadly used in a pension risk transfer portfolio today includes illiquid asset class allocations that can provide additional yield, said Brent Simmons, Toronto-based head of defined benefit solutions at Sun Life.

"We've been using illiquid assets like private fixed income for decades for our PRT portfolio. We want to have a well-hedged portfolio to back the promises that we've made to annuitants," he noted. "But we need to always be on the lookout for extra yield. The current environment hasn't changed what we've been doing. But it has shone a bright light on it and made it more apparent to pension plans."

ESG needs careful study

While Canadian pension plan executives might want to incorporate ESG principles into their derisking



strategies, it's easier said than done, said William da Silva, senior partner and retirement practice director at Aon in Toronto.

"You can't attend an investment committee or a pension committee meeting without [ESG] being on the agenda," he said. "It is everywhere. So I think what we're asking is: Is there a direct impact on ESG in pension risk management? I don't think we're there yet because if you think about the whole act of derisking, it's getting out of equities and going into fixed income. And most fixed income is government debt," which may not have direct impact on ESG strategy, he added.

Da Silva said he approaches ESG investing as making a choice in a plan's return-seeking portfolio. "We do an asset allocation study. For instance, we say, 'We want to be 20% return-seeking, 80% liability-hedging, and then we go construct those two sub-portfolios in a certain way,'" he said, adding that for the "return-seeking portfolio, we can say, 'Let's make this very simple. We will invest in global equities.' But now, the conversation is also about, 'When I execute that strategy, how do I factor in ESG?'" That approach leads to more detailed conversations by the investment committee around how to balance the new asset mix with the desired ESG strategy, da Silva said.

When it comes to ESG considerations, in comparison with other countries, Canada tends to fall somewhere between the U.S. and some European countries, said Wilson of Principal Global Investors, although Canadian institutions often have taken strong ESG positions as they relate to their investments. "ESG factors are not required to be considered by all Canadian pensions, but many Canadian pensions are prioritizing ESG factors in their investments and have even aligned together to call for standardized ESG reporting from companies and from asset managers," she noted.

Potential liability hedging

Aon's da Silva pointed out that the impact of ESG investing could indirectly affect liability hedging on the periphery of most Canadian de-risking portfolios, as federal and provincial government debt comprises "most of the liability hedging."

"Some [pension plans] will put a layer of corporates on there just for a little bit of additional yield and a little bit more credit coverage," da Silva said. "[So their approach is to say that the ESG overlay] could impact that because 'I'm OK with using credit there, but I don't want debt from certain companies that do not comply with their own ESG strategy.' So it shrinks the universe down." He added he has not seen much of this activity in allocating to corporate debt as it's a

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Staying the Course on Pension Risk Transfer

Use of going concern vs. solvency valuations doesn't change the goal post

The pace of Canadian pension risk transfers has continued unabated despite the increased use by some organizations of going-concern valuation guidelines in provincial pension regulations to help with the smoothing of pension liabilities, according to industry executives. A going-concern valuation assumes that a pension plan will continue indefinitely, while solvency valuations assume that a pension plan will be terminated with an annuity purchase.

"Different provinces have brought in different rules around zero percent solvency or 85% solvency," said Brent Simmons, Toronto-based head of defined benefit solutions at Sun Life. But for plans with going-concern funding regulations replacing the more stringent solvency-funding rules in several provinces, "we haven't heard a lot of pension plans changing their end game."

"If you're a corporate defined benefit plan, nine times out of 10, you're asking, 'How do I control the risk in my plan?'" Simmons said. "How do I keep the risk of the plan commensurate with my corporate balance sheet? A relaxed solvency-funding regime gives me more flexibility in getting to my end goal. But that end goal hasn't changed."

For example, Sun Life is seeing continued annuity purchases from pension plans based in Quebec, a province that has done away with the solvency-valuation funding, Simmons said. "We haven't really seen a slowdown there. Quebec plans

are still purchasing annuities," he noted.

Managing the liability

The actuarial issues of funding targets, whether through going-concern or solvency rules, are less important than determining how important an ongoing open defined benefit plan is for a company, said Sri Reddy, senior vice president, retirement and income solutions at Principal Financial Group in Des Moines, Iowa.

"All accounting policy changes do is reflect the notional value that's reflected in financial statements," he said. "The real present value of liabilities is no different than if the plan was to surrender today or to pay out full benefits. So the [going-concern] accounting policies may ease the burden now, but they may shift the challenges of meeting obligations 10, 20, 30 years out."

"More importantly, you need to evaluate if the pension plan is strategic to your business. If you're a CEO or CFO, the questions you ask yourself are, 'Is this pension fund causing more of a distraction than managing the business or not? How are my earnings and cash flows today?'" Reddy said. "If they're healthy, which they've been as companies continue to report strong earnings, do you use a portion of those earnings today to settle this liability and get this off the books?" is the central question that many pension plan executives are considering, he added. "And, by the way, because of where equity and bond markets are at, your pension funding level is actually better than it's been, so why kick the can down the road if you can solve for it now?"

Managing through policy changes

If funding regime changes such as the move to a going-concern valuation results in pension plans using a different return assumption, discount rate or longevity assumptions of their participants, "certainly it's going to have an impact on either a target return or the estimated cost of maintaining the plan rather than terminating it," added Amanda Wilson, managing director and head of U.S. and Canada institutional sales and relationship management at Principal Global Investors.

"Anytime there is a change in underlying assumptions or factors or there is policy or regulatory relief, it certainly can have a flow-through impact on the asset allocation or the propensity to transfer risk," Wilson said. "For example, some large US plans were anticipating making a major required contribution to their pension plan, and that would have moved them further down their derisking cycle. Many would have added to their hedged assets, their liability-driven investing portfolio," she said. "However, thanks to COVID relief on required pension contributions enacted following the pandemic, some are opting not to make that large contribution. So it changes the assets that they have to manage, the asset allocation and their ability to transfer risk or the timeline for some risk transfers."

Managing contributions

Now that Canadian provinces including Quebec and Ontario have some level of going-concern funding rules in place, "chances are, in most jurisdictions, you're not under solvency-funding rules unless you're really poorly funded, so you're not required to perform annual valuations," said William da Silva, senior partner and retirement practice director at Aon in Toronto. "So you book your contributions for the next three years."

However, Canadian pension plans can consider ways to book those contributions in an advantageous manner, he said. "During the interim of that three-year period–and we're seeing more and more organizations use this as a tool–it's de-risking the contributions as well," he noted. "During that interim period, you can look to file a valuation at any point. That will buy you another three-year period from that point on."

"If you think about how this played out in 2020, [if a plan considered that] 'I have to perform a valuation at the end of 2020 and that's the end of my current three-year period. But in 2020, I don't know where the valuation is going to end up at the end of year, but chances are I'm going to be lower. It's going to increase my costs. [But] I'm allowed to go back and file the valuation and not recognize the dip in the market, and it gives me another couple of years of cost certainty,'" da Silva explained. "That was one tool from a plan-funding perspective that we've seen a lot of organizations use when these events happen. We even saw some of this in 2008 with the use of strategic valuation filing to help moderate plan funding," he added.

Managing through markets

This year, as many pension fund executives have realized their funding status is back where it was before the pandemic, or even improved, they are actively considering ways to de-risk more, da Silva added, noting, "I think we're seeing a little bit better management of their glidepaths as a result of all of this as organizations continue to trade out of return-seeking assets and into liability-hedging assets."

Positive equity returns in mid- to late 2020, and so far this year, have improved the funding levels and funded status of most pension plans, and "that, of course, will help them move along their glidepath, either increasing their hedge ratio or increasing the affordability of a pension risk transfer," pointed out Wilson at Principal Global Investors. "But most plans are very policy-constrained, so they've got either an investment policy, an asset allocation policy or a glidepath that they're following, and they've for the most part stayed committed to one of those," she said.

"But if you think about how pension plans are going to continue to close a funding gap, their options are primarily regulatory changes that make them look better on paper or contributions or growth in assets," she said. "Those are the wheels that can turn to move their funding status forward."

Managing the low-rate environment

Still, low interest rates can hinder the ability to improve a plan's funded status as the value of liabilities increase, said Reddy at Principal Financial Group. "If you're a plan sponsor that's in the process of asset-liability matching or you're already funded, you're in pretty good shape," he pointed out.

"[But] if you're a plan sponsor that's sitting at a 60% or 65% funding ratio, the problem you have with low interest rates is that [they] make the present value of your liability that much higher and exacerbate the gap," he explained. "For a vast majority of plan sponsors in healthy industries, they're going to be in great shape or better shape than they've been in the last 10 years. For a whole other set, this [low-rate environment] may exacerbate the problem and they probably have to figure out how to deal with it sooner rather than later."

While all plans are different, "generally, there's fatigue around funded status being on a roller coaster," said Simmons at Sun Life. "Last year was a poster child for the benefits of derisking. When things are really bad in your core business, do you really want to be pulled into a pension committee meeting where you're trying to figure out how you can make a $50 million contribution to your pension plan?" That possibility has led more plan sponsors to consider de-risking their plans, he added.

Size matters

There are also variables involved in increasing de-risking strategies, Simmons noted. "It depends

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on things like the size of the pension plan versus the corporate balance sheet. It depends on the accounting situation of the corporate plan and the ability to fund cash contributions."

For example, "If you had a large corporate plan and the corporation was a cash generator, they might shrug their shoulders if they had to put $50 million into a pension plan," Simmons said. "Unfortunately, there aren't a lot of companies in that situation. Companies are anticipating the next black swan and asking themselves how much risk they can afford to take in their pension plans."

Canadian pension plans could reverse engineer the level of risk that they could comfortably manage in case a negative event does occur, Simmons suggested. "If you looked at the annuity market over the last three years, we've done about C$16 billion of risk transfer," he said. Of that total, only C$2 billion of that was companies winding up their pension plan, while the rest was companies purchasing annuities for ongoing pension plans, he said. "They may be purchasing annuities for all or a portion of their retirees in order to shrink the pension plan and make it a little more manageable. That way, when the next bad event happens, the impact is going to be something that the company can manage."

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hasn't changed the reasons that plan sponsors choose to derisk, said Reddy of Principal Financial Group. "They do it for one of three reasons. One, they have already frozen the benefit because of risk to the company and the volatility of earnings has been untenable. Two, [they find that] the investment regime and the volatility due to market accounting to a country-based standard makes core business earnings that much more volatile relative to the pension plan. Three, they recognize strategically that insurance companies are probably better suited to commingle and take on the risks… If you're a CFO or a CEO dealing with a really uncertain global environment, you'd likely rather hold on to whatever capital reserves you have and keep them dry just to see where it all plays out" before you consider your pension liabilities, he said.

Macro trends to watch

While the Canadian pension risk transfer market remained strong during 2020, the COVID-19 pandemic has led to three particular themes that will drive future strategy. The strength of the markets "has given people an opportunity to do some rebalancing that they might not have thought possible after a pandemic," said Eugene Lundrigan, president, Sun Life Capital Management (Canada) Inc.

"The first [theme] is massive government debt and deficits going forward," he said. "As a result, the government-sector weights in key bond benchmarks are about to increase materially. Based on current debt and deficits projections, we expect government-sector weights to increase 5 to 10 percentage points by 2025 in Canada and the U.S., at the expense of corporate bonds. That is a material movement in benchmark composition if investors don't take action." (See chart, page 11.)

"The second [theme] is the commitment from central banks to keep interest rates extremely low for the foreseeable future," said Lundrigan, who worked at the Bank of Canada early in his career. "When the central bank says we're keeping rates low, you don't bet against them. Forward-looking low interest rates mean investors may need to diversify their fixed-income holdings or consider other yield enhancements."

A third theme is the strength in equity markets that no one could have predicted coming through this pandemic, Lundrigan added. "Our view is that, after this period of market volatility, it's very natural that people are going to review their portfolio strategies for resilience going forward."

"These [three themes] are all different than with past events," he noted, adding that Sun Life Capital Management's clients and prospects "are looking at those broad themes and trying to understand how they should reposition their portfolios while staying on a derisking path."

Taking a granular look

The impact of the pandemic, though widespread, has not affected all businesses in the same way, especially when viewed through the prism of available capital, said Reddy of Principal Financial.

"This was a black swan event. But it did not affect everyone proportionally," he noted. "If you're in the hospitality, tourism, or transportation industries, albeit restaurants, airlines, cruise companies or hotels, and were trying to derisk liability, you're in a very different liquidity spot than if you're in other industries. The difference between this [pandemic-related crisis] and other crisis events such as the Global Financial Crisis, is that those occurred and affected specific industries and sectors where we had asset bubbles. [This pandemic] was a global situation that was met with a global response by all developed nations. So when you have that kind of stimulus and fiscal policy, yes, you have economic slowdown, but for the vast majority, while life was different, it didn't really appreciably change for most [people] in terms of what they ate, how they consumed, how they worked."

The pandemic has also "disproportionately and permanently affected small businesses" – those with 100 employees or less – "in ways that medium and larger businesses haven't been affected," Reddy pointed out.

Another result of a catastrophic event like the pandemic, added Wilson from Principal Global Investors, is the challenge of meeting pension plan contribution requirements "just when they can least afford to do so."

"That perhaps feeds into why we insure, why we pool risk," she said. "Having a hedged portfolio does help dampen that volatility or lessen the impact of catastrophic events. Some may not be able to afford to or, for whatever reason, not actually transfer risk. If they are maintaining the assets on their balance sheet, they can take a step in reducing that risk by having greater liability hedging in their portfolio, having diversified assets in both their hedge portfolio as well as their growth portfolio."

Focus on diversification

Diversification into other asset classes besides equities will be prudent for pension plans that are looking to manage funded status risk – as would be the case in any black swan event, said Aon's da Silva. "The best thing you can do in an exit strategy when you have seen improvements in your funded status is to take off some more public market equity risk," he pointed out. "So diversifying outside of public markets into private markets will give you some sort of buffer against that greater volatility in the public markets. But, again, I don't think it's unique to the pandemic and the risk there."

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small portion of the overall liability hedging and is not yet resonating with investment committees.

However, that could potentially change in the future. "ESG is a realization [for many pension plans] and a focus on investing in those companies that you feel are ESG friendly could translate into corporate debt."

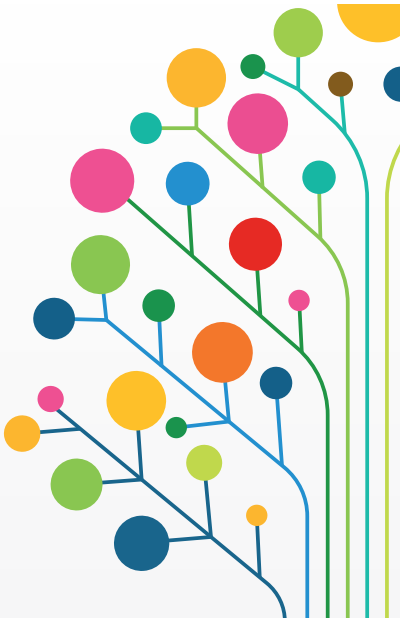
Selective view on private assets

Last year, especially in the spring and summer, interest in asset classes like private fixed income and commercial mortgages slowed materially due to uncertainty about the economic impacts of the pandemic, said Lundrigan of Sun Life Capital Management (Canada) Inc.

"In less liquid parts of the fixed-income market, client activity slowed early in the pandemic," he noted. "Pension plans were focused on their equity investments given the market volatility. Corporate pension plans were also very concerned about their core business. Once clients had assurance that their fixed-income portfolios were performing, they turned their attention to the problem parts of their portfolios," he said.

"As we look forward, we see pension plans and other institutional investors saying that they may want to do different things in their fixed-income portfolio. We're expecting more demand in areas like illiquid fixed income and multi-asset credit to counter the lower interest-rate environment." (See Chart on Canadian Aggregate Asset Mix).

Lundrigan cautioned that for markets like private debt and commercial mortgages, it's not easy for new players to enter the market. "There's no central exchange to trade private debt or commercial mortgages. So a company's presence



in private markets, their market knowledge and investment experience in doing this for 20 to 30 years, that's tremendously important."

Another consideration for pension plans is that the Canadian credit markets are limited in overall size, which makes it necessary to have the scale to invest in foreign bond markets as well, Lundrigan added. SLC Management "has been a large investor outside of Canada given how small the Canadian credit markets are," he said. "We certainly feel that, in a low interest-rate environment in particular, our clients and prospects all understand that being limited just to the Canadian-dollar corporate bond market is a little bit challenging. We think that there are opportunities to work with clients to help them think about exposure outside of Canada, where we hedge the cash flows back in Canadian dollars consistent with their liabilities."

In-kind transfers

Sri Reddy, senior vice president of retirement and income solutions, at Principal Financial Group in Des Moines, Iowa, said they are also seeing interest from pension plans for asset-in-kind transfers, which involve the transfer of securities in the portfolio without buying or selling them.

"We've seen more robustness of new entrants coming to the marketplace, which is healthy because to support all the pension risk transfer opportunities out there, you need an abundance of capital and an abundance of insurers willing to put up their balance sheets," Reddy said. "So even though we've seen fixed income being a little bit sluggish of late, we've actually seen more transactions with assets in kind, which helps mitigate needing to source fixed-income securities."

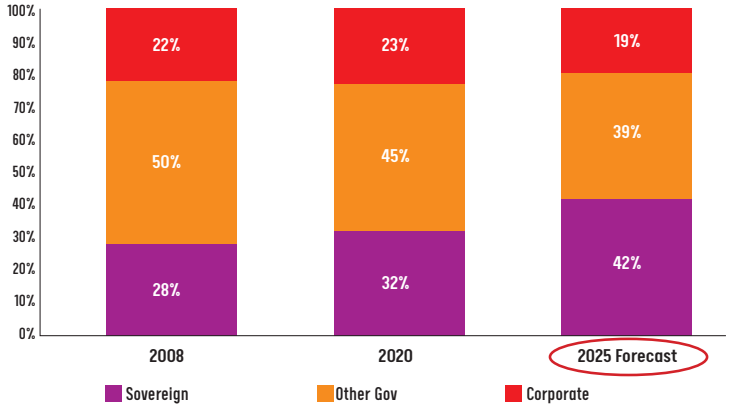
"Rather than a pension risk transfer provider saying [to a pension plan], 'Here's the settlement price to take over your pension obligations,' we're actually working together and saying, 'Let's look at what you already own in terms of assets and liabilities and let's see how many of those we can take on in-kind,' to the extent we can [within] regulatory regimes and what is allowed on insurers' balance sheets. If securities meet our overall risk tolerance and targeted asset mix, we may be able to take them," he said.

Reddy said he expects to see more in-kind transfers being adopted in Canada, the U.S. and elsewhere. The advantages are that the investment portfolio stays intact with no buying or sourcing securities or assets, which makes the transaction more efficient and less subject to breakage, he explained.

"This is happening globally because the fixed-income pool is fairly limited and central bank intervention is adding to the competitive pressure to source assets," Reddy said.

Simmons at Sun Life said they are also seeing increased in-kind transfer deals. "We're seeing a lot of plans, when they decide to buy annuities, consider in-kind transfers. They create an annuity-ready portfolio that contains a high portion of hedging assets, such as bonds, that they can then transfer to an insurer to purchase an annuity," he said. "Doing an in-kind transfer helps with price certainty and can lead to better pricing. Because the insurer is receiving assets, it can reduce some of the margins it would otherwise hold for buying new bonds."

Canadian Aggregate Asset Mix



Source: Government of Canada, Fall Economic Statements 2020, Forecasted build up of Federal Debt through 2025-26.