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Getting Back To Pension Plan Basics

A Fiduciary Approach To Managing The Private Pension Plans Assets Of Entrepreneurial Companies

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Overview:

The global financial challenges over the past several years have been a catalyst for the solvency issues facing so many defined benefit pension plans, not only in Canada but globally. Although lots of discussion has occurred in recent years about the public & large private pension plans, it seems that not as much 'air time' is given to the defined benefit pension plans that are sponsored by private companies connected to the entrepreneurial, owner-operator.

Although many private companies have established, or converted to, various forms of Capital Accumulation Plans (ie: Defined Contribution Pension Plans, Group RRSP/DPSPs) in recent years, the reality is that there continues to exist many Defined Benefit (DB) Pension Plans sponsored by private companies either as active programs or as legacy programs with frozen defined benefit promises.

As we know, all entrepreneurs assume considerable risks in successfully establishing and operating their businesses. The ongoing operation of a defined benefit pension plan creates an additional risk for all companies that sponsor such a plan, but can potentially be a greater risk for small & medium sized private companies as they:

- Do not have ready access to public capital markets to fund capital requirements.
- Lack the internal expertise to manage a defined benefit plan, and
- Incur disproportionate costs for retaining quality external expertise related to defined benefit plans.

The purpose of this article is to provide an overview of the pension plan solvency challenges that such entrepreneurial companies face by sponsoring DB pension plans, to review historical investment practices for these programs and present an investment solution, based upon proven strategies, for how the investments in these plans can be structured to not only meet their ongoing funding obligations but also mitigate the business & financial risks borne by the sponsors' shareholders.

Current Solvency Challenges Facing Private Pension Plans:

The issue of solvency is, unfortunately, well known. ***Mercer's*** "Pension Health Index" measures the ratio of assets to liabilities for a model pension plan. The ratio has been arbitrarily set to 100 per cent at the beginning of the period [1999]. The Index assumes contributions equal to current service cost and no plan improvements. According to this index, plans have been largely underfunded for most of the past decade and continue to be so today, despite the recovery in various capital markets over the past few years [60% at September 30th, 2011].

One of the reasons solvency has become an issue over the years is the asymmetry of pension fund surplus. In simple terms, if employers over-contributed to defined benefit pension plans, the excess/surplus may be deemed to belong to the plan and its members – not the employer. In years gone by, when interest rates were high and market returns positive, pension provisions were improved or negotiated. Cost of Living Allowances and beneficial early retirement enhancements have become increasingly more expensive with an aging workforce and lowered interest rates.

Other reasons for the deterioration in solvency come from a variety of sources:

- Excessive return expectations built into the valuation model. By raising the expected returns, employer contributions have been minimized.
- Greater life expectancy, which increases the number of years in retirement.
- Demographic change which affect funding by altering the ratio of workers to retirees. The pressure of baby boomer retirement, with a corresponding reduction to the overall workforce, will put additional pressure on the cost of funding as a percentage of payroll.
- Interest rates. Simply stated, the cost of a future annuity is determined by long term interest rates ie government bond yields - when interest rates are low, costs are higher.
- Last, but by no means least, poor investment returns over the past decade.

Historical Investment Approaches To Managing Defined Benefit Pension Plan Assets:

In the 1960s & early 1970s, it was not uncommon for defined benefit pension plans to be funded through annuity policies from an insurance company. Through this product, actuaries carefully matched long-term pension liabilities with assets holding similar characteristics such as long-term bonds.

As the investment industry emerged in Canada, Deposit Administration contracts emerged to allow plan sponsors to participate in the investment profits earned by their pension assets and to diversify their investments into equities and other securities in search of greater returns which would serve to lower the cost of the pension promise. As the evolution continued, pension funding moved to trust funds where the sponsor bore all investment and demographic risks. The emerging wisdom at the time was that a pension plan and its sponsor had an infinite time horizon and thus could accept short term fluctuations in equity returns in exchange for a long-term equity risk premium.

In the 1980s, there was a feeling that pretty much "anyone with a pulse" could earn a return of 10% per annum on a diversified basket of investments. This expectation led to gradually increasing discount rates for determining pension liabilities, and for many pension funds, rapidly growing surpluses. At the same time, the investment management business grew rapidly as did the industry of reviewing and rating the performance of investment managers – often on a comparative basis against each other.

In the 1990s, these surpluses were often 'spent' on improvements in benefits and at the same time used to reduce and often eliminate contributions by employers. For most of the decade, defined benefit plans seemed 'Fool Proof'. Even with the rigour of pension reform, it appeared that it was possible to give employees a generous retirement benefit at seemingly no cost – at least in terms of cash. Ironically, pension accounting standards that were introduced to provide a more objective measure of the cost of a pension plan were somewhat confusing and often ignored with being the need for such contributions being the primary measure of a plan's cost being the cash contributions needed.

It was as the Tech Bubble crashed in 2000, that long-term interest rates first dipped below the long-term discount rates set by actuaries and pension plans faced the beginning of what was to become a very difficult decade for funding pension promises. Returns in some years were positive, while in others negative, and expectations for returns greater than 10% per annum all but vanished. At the same time, a continued decline in long-term interest rates near to all time lows has pushed pension liabilities (annuity prices) to highs never anticipated, even by the normally conservative actuaries charged with predicting future costs.

This negative result is important to understand as it has financial implications for sponsoring firms.

Pension Accounting & Increased Volatility

Accounting rules have struggled to accurately reflect the benefits and obligations/liabilities for Defined Benefit Plans.

In June 2011, The International Accounting Standards Board issued a revised standard for Employee Benefits - IAS 19 (Revised).

The new IFRS accounting standard for defined pension benefits is going to introduce more volatility into a company's financial statements. Although some of the impact will not affect the income statement, all changes will affect shareholders' equity shown on the balance sheet and assets or liabilities. Business owners and managers will need to assess how these changes may affect debt covenants and other operating statistics relevant to users of their financial statements.

Three changes that may have large financial statement impacts are:

1. the scope of the pension obligations;
2. the rates used in the measurement of plan assets and obligations;
3. and the treatment of re-measurements, including actuarial gains and losses and past service costs.

Scope of the Obligation

IAS 19 (both current and Revised) may require the accrual of pension obligations sooner, increasing many company's pension deficits (or reducing surpluses).

Measurement Rates

Currently, the plan assets and the plan obligations/liabilities are measured separately. A discount rate appropriate to the entity is applied to plan obligations while an expected rate of return is applied to plan assets.

IAS 19 (Revised), however, requires that an appropriate discount rate (typically a high-quality corporate bond rate) be applied to only the net surplus or net deficit in the plan. The expected rate of return previously applied to plan assets is abandoned. The extent to which the discount rate differs from the previously applied expected rate of return can have a significant impact on the expense for the period and net surplus or deficit. On the other hand, plan sponsors are no longer incented to invest in equities and other assets considered 'higher risk/return' to lower their 'pension expense'. This may encourage more conservative investments where they are considered appropriate.

Plan Re-Measurements

IAS 19 (Revised) requires actuarial gains and losses to be immediately recognized in Other Comprehensive Income ("OCI"). The recognition in OCI segregates the impact from the operating results show in the income statement. Even though the actuarial gain or loss does not affect the ordinary income in the income statement, it will affect the equity shown in the balance sheet. This flow through will again provide sponsors with incentives to better match assets and liabilities where balance sheet volatility is not affordable.

Past Service Costs

The treatment of past services costs under IAS 19 (Revised) is also more volatile than existing Canadian GAAP and existing IAS 19. IAS 19 (Revised) recognizes all past service costs, whether vested or not, as an expense in the income statement with the result that past service costs will affect current year income, rather than being amortized over future years.

Investment Solution To Address Private Pension Plan Solvency Challenges:

Given these accounting changes, it really does become critically important for companies to effectively manage the investment portfolios within their Defined Benefit Pension Plans. We believe that adopting an 'asset-liability' matching structure for investment portfolios is a 'back-to-basics' prudent approach that is vastly different from the common approach of trying to find investment managers who can 'beat the index".

Also known as **Liability Driven Investing,** or **LDI**, this concept isn't something new; as noted earlier, insurance companies have used this technique for decades. In short, the plan consciously allocates to assets which closely correlate (ie: move in the same direction) to the plan liabilities. In other words, if liability values – due to interest rate changes – increase, then pension plan assets increase as well. In the case of underfunded plans allocations to both "correlated assets" like corporate bonds, and to "growth assets" offer an ability to 'match' pension assets to liabilities (ie: so the pension deficit doesn't get worse) plus the potential for superior returns to close the existing funding gap over time in phases which are managed through the plan's investment committee. Segregating asset classes into liability-matching assets versus growth assets can help focus the plan sponsor & investment committee on the ultimate goal of closing the funding gap.

Most people agree that 'bad habits are hard to break'. ***The unfortunate reality though, is that the global investment management industry has developed the really bad habit over the past several decades of trying to convince investor clients that their goal should be to try to consistently outperform the various stock & bond market indices.***

This is an incredibly bad habit as the relative performance of a client's investment portfolio (ie: beating the indices) has absolutely nothing to do with the real investment performance benchmark which is meeting a client's future consumption requirements. In the case of defined benefit pension plans, it's the future pension obligations to plan members.

Such *"relative investment return seeking behaviour"* drives investors — and their advisors — to source securities and investment managers who assume heightened levels of investment risk in order to "beat the index", or in many cases we see, firing investment managers when they've had a few quarters of relative underperformance (despite the fact that their philosophies & processes remain intact) and replacing them with managers who have recently demonstrated outperformance numbers. This is many times, the equivalent of "buying high" and "selling low"…which is never a recipe for investment success! This behaviour also drives many investment managers to move their 'actively managed' fund close to the index so underperformance in any period is minimized with the resultant minimization of termination for poor performance. Unfortunately, these near index funds come at an actively managed price.

The global investment industry needs to break its "bad relative performance habit" and get "back to the pension basics" of being true fiduciaries and get focused on structuring portfolios for pension plans that actually help them meet their future consumption requirements (subject to each client's tolerance for risk to income and/or capital) and stop trying to convince investors that relative investment performance is of primary importance to them – because it's not.

This is not to say that investors should not pay attention to how their investment managers perform relative to their respective market index benchmarks over various market cycles — because they should. Nobody wants to pay for long-term, material underperformance, especially given the range of quality money management expertise, both active and passive, in the marketplace today…..it's just not a responsible use of client assets. It's just that the investment manager relative performance is of secondary importance to whether or not a pension fund's funding requirements are being satisfied in a manner that aligns with its true tolerance for investment risk.

As **Charles Ellis**, in his book, "***Investment Policy: How To Win The Loser's Game*"** states:

1. *"The truly important but not very difficult task to which investment managers and their clients could and should devote themselves involves four steps:*
2. *Understanding the client's needs,*
3. *Defining realistic investment objectives that can meet their needs,*
4. *Establishing the right asset mix for each particular portfolio, and*
5. *Developing well-reasoned, sensible investment policies designed to achieve the client's realistic and specified long-term investment objectives.*

In this work, success can be easily achieved."

Contact

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