

## **CHALLENGES AND CONCERNS FOR DEFINED BENEFIT PLAN SPONSORS**

*Managing and Implementing Strategies for Success*



Sponsors of Canadian defined benefit (DB) pension plans face numerous challenges staffing and resourcing a pension function that is generally not a core competency for the organization. The Northern Trust team was curious to find out what challenges are top-of-mind for these sponsors, particularly given implications of ongoing changes in the regulatory and investment environment. We queried Canadian pension executives to explore major trends and challenges of investment management.

We asked a cross section of DB plan sponsors to identify their concerns and challenges. While many answers confirmed our expectations, a few surprised us. One particular surprise was the sponsors' lack of awareness of outsourcing opportunities to mitigate common staffing, education and resourcing issues.

### **DIFFERENT OBJECTIVES BUT COMMON THEMES**

It is clear from our conversations that DB pensions in Canada are not homogenous. Open and closed plans target different asset allocations, and funded status determines plan priorities. DB pension sponsors are clearly thinking as much about liabilities as about assets, especially as the plans become better funded.

Nonetheless, there are common themes across all respondents. A noteworthy theme is the ongoing reduction in investment allocations to Canadian equities and the increase in alternative investment allocations. DB sponsors also share a concern about increasing complexity; the need for better board and committee education and its impact on timely decision making.

We found that most sponsors continue to manage DB pensions in-house. Staffing budgets continue to be tight and our conversations with plan sponsors reveal increasing stresses on time and resources. Respondents told us that managing the plans now takes more than 80% of their time and growing regulatory burdens are putting more pressure on internal staff, committees and board members.

### **CLOSED PLANS OVERVIEW**

#### **Priorities & Concerns**

The top-ranked priorities for the executives of closed plans were de-risking and protecting capital, as the majority of their closed plans were more than 90% funded. Closing funding gaps and reducing volatility were less critical, perhaps an indication these plans are already moving down a de-risking glide path. Executives of closed DB plans may be less concerned with traditional plan management such as evaluating manager performance and making timely decisions. Instead, executives may be more focused on gaining the support of the board and complying with regulatory concerns as they de-risk their closed plans and look to discharge their liabilities in a cost-effective manner.

#### **Asset Allocations**

Closed plans were primarily focused on increasing their allocations to long bonds, low volatility, and alternatives. Typically, the increase in long bond allocation has the benefit of reducing funded volatility by improving asset and liability matching. Increased exposure to low volatility (i.e. smart beta strategies) may shrink overall



market risk while still offering growth over complete market cycles. Additionally, plans were increasing their exposure to alternatives at the expense of Canadian equities – possibly indicating a reduction in home country bias and the pro-cyclical volatility that comes with it. Broadly speaking, these responses were in-line with our expectations that closed plans would prioritize de-risking solutions.

### **OPEN PLANS (LESS THAN 89% FUNDED) OVERVIEW**

#### ***Priorities and Concerns***

The top-ranked priorities for the executives of open pension plans with 89% or lower funded status were reducing asset volatility and closing the funding gap, the exact opposite of those with closed plans. To reduce the funding gap without adding funding volatility, these plans seem to be turning to alternatives, which may require additional staff and board communications to effectively administer alternatives' new assets classes, managers, and trading strategies. Not surprisingly, for these respondents the blocking and tackling of daily operational, governance, and fiduciary tasks provide the biggest challenge, likely due to divided priorities between corporate and fiduciary responsibilities.

#### ***Asset Allocations***

To achieve their dual goals of reducing asset volatility and closing the funding gaps, we found these plans were significantly increasing their exposure to low-volatility equity strategies and alternatives, while reducing their exposure to Canadian equities. Low volatility strategies offer equity market growth with reduced market sensitivity, while alternatives offer a diversifying source of growth to equities. Among all strategies discussed, two alternative strategies: infrastructure and real estate, exhibited the highest interest level.

### **OPEN PLANS (GREATER THAN 90% FUNDED) OVERVIEW**

#### ***Priorities and Concerns***

The top-ranked priority for the executives of the open pension plans with greater than 90% funding, not surprisingly, was protecting plan capital. Their primary concerns were complying with regulatory requirements, committee and board education, and evaluating manager performance.

#### ***Asset Allocations***

To achieve their goal of protecting capital, we found that these plans were significantly raising their exposure to alternative strategies while moderately increasing exposure to long bonds and low volatility strategies. We infer this as increasing emphasis on liability management. As mentioned in the closed plan asset allocation discussion, low volatility strategies are designed to reduce both the funded volatility and overall asset risk for plans. Alternative investments also have the potential to smooth out funding volatility due to the relative infrequency of valuations for investments in strategies like private real estate, infrastructure and private equity.

### **COMMON THEMES**

#### ***Reducing Exposure to Canadian Equities***

Both open and closed plan sponsors plan to reduce allocations to Canadian equities, with no respondent indicating an intention to increase Canadian equity allocations. This appears to be both a long term reduction in home country bias and a short term desire to shrink directional market exposure. Plan sponsors are thinking about absolute return and there is a clear desire to reduce volatility in the investment portfolio and the annual funding requirement. In the past few years Canadian equity allocations benefitted from

a cyclical increase in valuations but the outlook for low growth implies more equity volatility and lower returns looking forward; plan sponsors are diversifying their risk.

### **Increased Allocations to Alternatives**

Low interest rates and high asset values are creating a challenge for pension plans to increase asset returns without also increasing funding volatility. As equity valuations become more expensive and bond yields remain stubbornly low, DB pensions are shifting assets into alternative asset classes like real estate and infrastructure seeking an alternative source of yield and diversification. The current low growth, low rate environment makes it increasingly difficult for plan sponsors to achieve sufficient returns from traditional asset classes alone to ensure their organizations are fulfilling the pension promise. New investment categories like hedge funds, infrastructure and private equity hold a promise of diversification and better risk adjusted returns at the cost of additional operational and educational strains on staff, investment committees, and pension trustees.

### **Board and Committee Education Challenges**

Respondents told us that the complexity, time and resource commitment to managing DB pension plans is increasing; managing the plans now takes more than 80% of their time. With improved funded status, governance considerations are putting more pressure on committees and board members. Most respondents identified Board and committee education as a significant challenge and an obstacle to timely decision making. The required knowledge, experience, and time commitment will likely continue to be a challenge for DB plan sponsors as they consider freezing, derisking, merging, modifying, or terminating DB plans. Additional considerations like Environmental, Social

and Governance (ESG) investing are equally stretching Board and committee knowledge and experience.

### **Conclusion**

Most sponsors continue to manage DB pensions in-house. Staffing budgets continue to be tight and our conversations with plan sponsors reveal frustration with the growing demand on time and resources. Given the rising complexity around managing plans, we were surprised by the sponsors' lack of awareness of full and partial outsourcing opportunities. Pension outsourcing is still relatively new in Canada and many respondents still have not educated themselves on this solution to mitigate common staffing, education and resourcing issues.

Given the current low rate environment, plan sponsors must find the balance between matching assets to liabilities and seeking returns in order to ensure their organizations are financially able to afford the cost and volatility of providing the pension promise. The required knowledge, experience, and time commitment will likely continue to be a challenge for DB plan sponsors as additional issues such as ESG investing emerge.

Outsourcing (OCIO) providers have existing infrastructure to address the complexity that DB pensions increasingly demand. DB plan sponsors can focus scarce resources on pension governance while availing themselves of the subject matter experts and implementation experts OCIOs offer.

### **A CUSTOMIZED APPROACH**

Northern Trust has been providing outsourcing solutions to Canadian DB pension sponsors since 1979. As a leading investment manager, trustee and custodian, we provide an integrated suite of investment solutions to meet the planning and administrative goals

of retirement plans, foundations, endowments and sophisticated family offices like yours. Our experienced multi-manager solutions team provides both full and partial outsourcing for discretionary or non-discretionary assignments including multi-asset solutions,

single asset class solutions and alternative asset class solutions. We also provide outsourcing for pension de-risking assignments, employing either pooled and/or customized third party implementation vehicles.

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