Editor's note: For additional information about this topic, see Kendra Kaake, “Reshaping the Canadian Retirement System,” in Investments & Wealth Monitor 31, no. 3 (May/June 2016): 42–46.

Many jurisdictions in Canada are considering arrangements that combine and maintain the attractive features of defined benefit (DB) and defined contribution (DC) pension plans and mitigate many of the flaws inherent in each. This innovation in Canadian pension-plan design will force stakeholders to reassess the long-term investment decision.

Investment returns will play an important role in determining actual outcomes for these newly designed structures such as target benefit plans (TBPs) and shared risk plans (SRPs). Moreover, the strategic asset allocation (SAA) will be a key determinant behind the success of those returns over the longer term (Ibbotson and Kaplan 2000). The challenge is that investors often need to take on more risk than they’re comfortable with to achieve their objectives.

We believe every investor has unique circumstances that, if not properly considered, can lead to additional downside risks without the expectation of positive return—in other words, uncompensated risk. In reality there’s no single solution. But there’s good news. Thankfully, risk is one of the variables investors can manage in their efforts to achieve desired outcomes. A reasoned, disciplined, customized approach will go a long way toward ensuring all stakeholders achieve outcomes aligned with their specific circumstances and long-term strategic aspirations.

This article explains the “design, construct, manage” process Russell Investments deploys to build multi-asset strategies for SRPs and TBPs as well as the investment outcomes we seek in order to help investors achieve their goals.

**Design**

**Develop Clear Objectives**

In the design phase of our investment process, we work with each investor to fully understand specific circumstances, beliefs, expectations, and constraints. From there, we then help the client determine clear objectives and develop an SAA.

When crafting an SRP, three objectives must be considered: return, risk, and surplus. The dual objective of return relative to risk is fairly straightforward, but moving toward a third objective of surplus management (difference between the assets and the calculated liability) can introduce additional complexity. Most plan sponsors are familiar with the concept of surplus management, which is essential to an effective governance framework for SRP designs.

Assigning asset roles helps to align the portfolio with stated objectives. As part of the design process, consider the following three broad roles of asset allocation:

**Growth or return seeking.** This is the growth engine of the portfolio and includes equity-orientated assets (public and private), real assets (listed and unlisted), hedge funds, and return-seeking fixed income (e.g., high yield and emerging market debt); expect equity-like return and risk characteristics.

**Liability-matching or liability aware.** The purpose of liability-driven assets is to mirror liability movement, thus helping to reduce surplus volatility. The composition of these assets will depend heavily on benefit targets and how liabilities are measured, which can vary widely across plan type and jurisdiction. Generally, expect lower returns and lower risk than the growth allocation.

**Surplus risk reduction and diversification.** This category results because the total portfolio design is more than just a sum of the growth portfolio, the liability-matching portfolio, and the rebalancing policy. The total design should include strategies that provide diversification to growth assets and manage the overlap of and interaction among the liabilities, the liability-matching portfolio, and the growth portfolio. Consideration also should be given to limit unintended risks to stakeholders beyond the portfolio level.

Incorporate Strategic Beliefs

Setting a long-term strategic asset mix begins with determining which broad asset classes are appropriate for the plan, and in what proportions. Deciding which markets to invest in should begin with the following principles:
Balance the risk-sharing needs of today with the growth potential for tomorrow.
For most plans this principle will play a key role in the split between liability-driven and return-enhancing (growth) assets. Understanding the liability benchmark is critical when managing risk and determining an appropriate mix. The decision about how to balance risk and return should depend on the plan’s status, risk tolerance, shared appetite, and governance process for varying contributions and benefit payments. Importantly, this decision is likely to have a larger impact on surplus volatility and long-term outcomes than any other strategic decision. Given the nature of the SRP design, these decisions also will be important when assessing intergenerational risk sharing, contribution volatility, and/or benefit levels.

Diversify across multiple investments.
Diversification helps provide a variety of potential return sources and avoids some of the risks associated with concentrated positions. Importantly, investors should keep in mind that the dispersion in returns tends to vary across asset classes even when correlations converge. Historically, diversification has not been as effective during periods of high risk (such as the global financial crisis) because correlations between asset classes tended to increase. However, although diversification cannot guarantee positive returns, it can ease the pain during periods of heightened risk. Consideration should be applied at the surplus level, total portfolio level, asset class level, manager level, and individual factor/exposure level. For open and ongoing plans, growth assets should be included to improve diversification and enhance return.

Maintain awareness of the risks of over-reaching for return. Understanding in advance and defining the downside risks associated with the portfolio (in asset-only and surplus space) for all stakeholders will go a long way toward minimizing the impact of unexpected events. The current challenge is that many investors seek more home-country bias than they can afford and often are forced to take on more risk than they’re comfortable with in order to meet their objectives (Curwood and Myers 2012).

Construct
The next step in the process is to construct an investable portfolio in line with the SAA, where each component contains the most efficient sources of return available.

When constructing the return-enhancing (growth) and liability-matching (risk-reducing) portions of the portfolio, it’s important to consider the following:

- the stated objectives, ensuring they’re aligned with the goals of the portfolio;
- the main drivers of return, ensuring they’re aligned with investment beliefs;
- how interest rates and inflation exposure interact with the liabilities; and
- the stability of the investment approach over time—for example, if an asset manager is highly opportunistic, can the plan tolerate possible extreme exposures?

Risk-Reducing Portfolio
Asset-liability mismatch is a risk that many plans unknowingly take on without a corresponding expectation for additional return. Managing the composition and duration of high-quality fixed income (liability-driven) assets in the portfolio can help determine the extent to which interest-rate risk is hedged, uncertainty is limited, and uncompensated risk is reduced. Shared risk plans attempting to minimize intergenerational inequity may find it useful to link contributions with the market value of benefits.

Manage
Adapt to Risks and Opportunities in the Market
Because markets, managers, and pension plans constantly change, the manage phase of the process is about ongoing, dynamic portfolio management. Change opens up new opportunities and old opportunities fade. The pace of change is increasing so investors need to adapt quickly to capture new opportunities and exit the old. Many pension-plan sponsors identify the ability to respond to rapidly changing markets as a key issue.

Multi-asset investment strategies. These strategies give the investment manager the flexibility to tailor portfolios to meet client-specific objectives. Interactions among asset classes, liabilities, and the broader organization can be difficult to manage at the individual asset class level. The process of dynamically managing these interactions at the total portfolio level allows for improved diversification across liability-matching and growth portions of the portfolio as well as a real-world portfolio of strategies and exposures aligned to execute client-directed objectives. Once the constraints of a stated SAA are determined, a realignment within broad roles (i.e., growth and liability-matching) and among exposures may be recommended periodically to optimize the risk–reward trade-off,
optimize fees/performance, and improve liquidity at the total portfolio level.

Manager research. Responding to market changes begins with manager research. Based on decades of capital market research and investment experience, we believe there are opportunities over the course of market cycles to achieve higher returns than the broad market. A disciplined, dynamic approach to evaluating investment managers and strategies as they evolve can help identify and align managers to outperform benchmarks, after fees, in almost all active investment universes.

Liability responsive asset allocation. Liabilities are never certain, estimates are updated regularly, and the best liability-hedging instrument can change over time. Dynamic strategies such as liability-responsive asset allocation can help when changes in plan funding levels determine the strategic split between growth and liability-matching assets (Gannon and Collie 2009).

Overlay services. In the case of ongoing SRPs seeking to limit intergenerational inequity, there may be a need to invest a higher proportion of the overall allocation into liability-hedging assets (typically, high-quality Canadian bonds with a long duration) than is desirable or consistent with longer-term objectives. So, rather than relying solely on physical assets to hedge interest-rate risk, overlay services (such as futures contracts, swap agreements, and other derivatives) can be used to hedge market exposure without significantly changing the long-term strategic mix.

Canadian Perspectives From a Canadian-based investor perspective, we believe some important opportunities continue to be overlooked.

Defensive equity. The use of market-relative benchmarking for mutual funds and institutional investment accounts historically has supported a preference for dynamic equity exposure even though the end investor would have found defensive strategies more attractive. Although history cannot guide us in the future, this practice still is widespread and seems unlikely to change in the short term (Collie and Osborn 2011). For Canadian investors, who often have a significant overweight to domestic holdings, evidence supports the opportunity for enhanced risk-adjusted returns through defensive strategies. Our research has revealed that the magnitude of this advantage is greater in Canada than in other global regions (Hornung 2014).

Currency. Our research has shown that Canadian-based investors who believe the Canadian dollar will continue to exhibit pro-cyclical behavior can reduce equity volatility by retaining foreign currency exposure, especially to the U.S. dollar. In addition, investors who believe that currencies mean-revert to purchasing power parity (PPP) over the long term can follow a simple dynamic rule to enhance return (Osborn and Kaake 2013). In practice, exchange rates exhibit both short- and long-term deviations from PPP, and as such the interaction between the total portfolio, liabilities, and currency exposure may require ongoing management.

Home-country bias. Canadian equity, with high sector concentrations and limited stock selection opportunities, contributes roughly 3.5 percent to global market capitalization. Despite this, most investors in Canada hold a significant overweight to Canadian equity. Increasing exposure to global mandates can improve diversification opportunities, add value from cross-border stock selection, and create opportunity to capitalize on globally integrated markets.

Socially responsible investing. Recent regulatory changes in some jurisdictions across Canada now require the disclosure of environmental, social, and governance (ESG) factors within the Statement of Investment Policies and Procedures (SIPP). Although the changes have forced sponsors to disclose only their ESG process (or lack thereof if they do not have one), many are reexamining their allocations and considering more-formal integration of ESG into the investment analysis and decision-making framework. There are many approaches, and customized solutions will depend “on a multitude of factors, including where an investor sits on the value vs. values spectrum, stakeholder influence, potential risks and costs of implementing a solution as well as the primary motivation of doing so” (Myers and Kathuria 2016).

Endnotes
1. TBPs and SRPs are used interchangeably throughout this article because in this context they are conceptually the same.
2. SAA is a direct reflection of risk tolerance and is therefore unique to each investor. Investment managers often are given some discretion around SAA, especially in the case of outsourced chief investment officer mandates, clients should retain ultimate decision-making authority over the broad SAA.
3. “Surplus at risk is the amount by which the policy’s asset allocation might outperform its liability exposures” (Kaake 2012).
4. DB plans typically vary widely with respect to demographic characteristics, maturity level (i.e., average participant age and composition of membership cohorts), and plan status. Status in this context refers to whether a plan is open and ongoing, closed to new members (existing members continue to accrue benefits), or closed and frozen to all future service accruals.
5. Stakeholders are diverse and include the individual plan member, the sponsoring enterprise, and less-obvious participants such as taxpayers.
6. In an effort to ensure our clients’ portfolios reflect our best thinking at all times, our portfolio managers (along with our global team of more than 60 research analysts) select investment managers from a broad set of candidates. We then use positioning strategies to precisely manage exposures across managers, across asset classes, and at the portfolio level.
7. Plans that price and fund benefits at market value are sensitive to short-term fluctuations in interest rates.
8. The good news for Canadian investors, especially given how much importance Canadian DB investors put on the permanence of leverage, is that the long end of the Canadian swap market tends to be an attractive market for liability-driven investment transactions. Pension funds often pick up yield as they lock in long-term financing.
9. Sustainable investing or responsible investing are umbrella terms often used to encompass a variety of implementation options. Among these are excluding companies involved in controversial industries, supporting the most sustainable companies, focusing on ESG exposures, and/or using ownership to engage with companies (Myers and Kathuria 2016).

References
Curwood, Bruce, and Heather Myers. 2012. Risk Management is the Cornerstone of Investing. Russell Research (September).

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