McLean Budden
LOOK FORWARD®

The Third Perfect Pension Storm

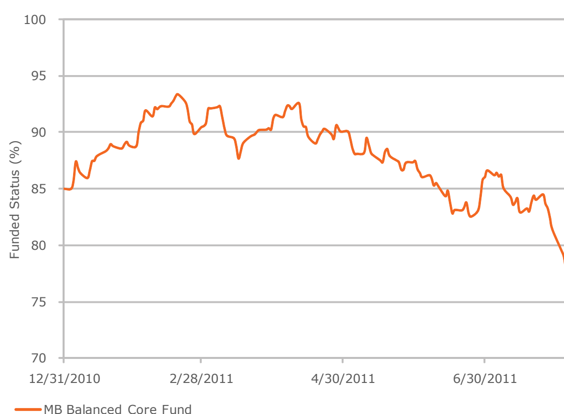
Since the year-to-date-peak of the TSX Index on April 5, 2011, the TSX Index has declined 13.2% and the 10-Year Government of Canada bond yield has dropped 0.83%. Declining equity markets and yields are a devastating combination for pension funds because they negatively impact both the assets and liabilities. Declining equity markets reduces the assets in the pension fund. Declining bond yields increase the liability value of pension funds. The combination leads to an increase in the funding deficit which likely leads to an increase in required contributions.

Funded Status of Pension Fund drops by 15%

To help illustrate the experience of pension funds over the past few months, we have designed a hypothetical pension fund, which is reflective of the average Canadian pension plan in terms of both asset mix and funded status. Complete details of this pension fund are shown at the end of this piece.

For our hypothetical pension fund, we estimate that the funded status of the pension fund declined from 92% funded on April 5, 2011 to 77% funded as of August 4, 2011.

Funded Status of Pension Fund (60% equities/40% universe bonds)



Third Perfect Storm and We Still Haven't Changed Anything

Pension committees are still managing their plans the same way after a decade of tough financial results. The focus still remains on asset returns with little attention on the funded status of the plan. There are many reasons why pension funds have not changed their approach:

1. Committee members have changed over the past decade and have not experienced the financial pain due to the first 2 Perfect Pension Storms;
2. Pension committees have been reluctant to make changes to asset mix due to the fear of being wrong;
3. The current approval structure within pension committees does not facilitate decisions to be made quickly; and
4. Pension committees are not sure what changes they should make.

The Solution: Dynamic De-risking

Dynamic de-risking is an approach where the asset mix of the plan changes as the funded status of the plan changes. Typically, this results in less risk (i.e less equities and more bonds) in the plan as the funded status improves. Dynamic de-risking allows a pension fund to de-risk its plan when it is affordable (i.e when the funded status improves). The underlying premise of Dynamic De-risking is that pension plans will sell outperforming assets and lock in those gains to reduce the likelihood of the deficit increasing in the future.

There are 3 key components to creating a Dynamic De-risking solution:

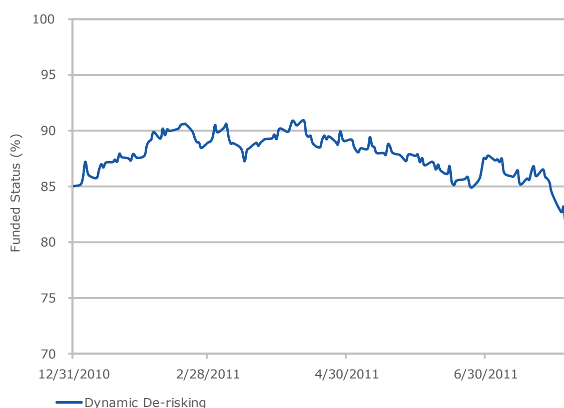
1. The pension committee pre-approves an asset mix schedule that allows the investment manager to alter the plan's asset mix as the funded status of the plan changes.
2. The investment manager evaluates the funded status of the plan on a daily basis. This allows asset mix changes to be made in accordance with the pre-approved asset mix schedule.
3. The plan has a clearly stated financial objective. Examples include: reducing the volatility of contributions by 10% once the plan becomes fully funded; or a target funding level of 115% for an eventual annuity purchase.

The Third Perfect Pension Storm

Funded Status of Dynamic De-risking Fund drops by only 8%

For our same hypothetical pension fund shown on the previous page, we estimate that the funded status of the pension fund declined from 90% on April 5, 2011 to 82% as of August 4, 2011. In other words, the sample plan with the Dynamic De-risking strategy significantly outperformed the sample plan with the 60% equity/40% universe bond asset mix.

Funded Status of Pension Fund (Dynamic De-risking)



Hypothetical Pension Fund

Our hypothetical pension fund assumptions liability duration of approximately 13 years and was 85% funded on January 1, 2011. The initial asset mix for the Dynamic De-risking solution was 35% equities, 25% universe bonds and 40% long bonds as of January 1, 2011. The underlying investments in the Dynamic De-risking solution are the following MB pooled funds: MB Canadian Equity Core, MB American Equity, MB Global Equity Core, MB Fixed Income and MB Long Term Fixed Income. The non-dynamic derisking solution assumed that the plan invested in the MB Balanced Core fund .

Under the Dynamic De-risking solution we rebalanced the portfolio 7 times between January 1, 2011 and August 4, 2011. Below is a summary of the asset mix changes we did over that time period.

January 5, 2011:
Sold 2% equities, sold 3% universe bonds, bought 5% long bonds

February 3, 2011:
Sold 2% equities, sold 3% universe bonds: bought 5% long bonds

June 3, 2011:
Bought 2% equities, bought 3% universe bonds: sold 5% long bonds

June 23, 2011:
Bought 2% equities, bought 3% universe bonds: sold 5% long bonds

June 29, 2011:
Sold 2% equities, sold 3% universe bonds: bought 5% long bonds

July 29, 2011:
Bought 2% equities, bought 3% universe bonds: sold 5% long bonds

August 2, 2011:
Bought 2% equities, bought 3% universe bonds: sold 5% long bonds

If you would like any additional information on McLean Budden's Dynamic De-risking solution please do not hesitate to contact me at Skohly@mcleanbudden.com or (416)361-2260.

Soami Kohly
Vice President, LDI Solutions

Note: Past performance is not an indication of future performance. The examples shown above are for illustrative purposes only.