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Strategic asset allocation reviews for DB plan sponsors

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One of the most important choices defined benefit (DB) plan investment committees will make is deciding the type and amount invested in asset classes over the long term. The process for making this decision is known as the strategic asset allocation review. Generally, a strategist with expertise in both assets and liabilities completes the analysis and communicates the results to sponsors. Sponsors ought to be mindful of the following:

1. The plan's specific liability characteristics, existing policies, capital market outlook, and plan sponsor goals and risk tolerance all play a significant role in the strategic review.
2. Strategic reviews ought to be completed every three years or more often if there has been a significant change to plan or sponsor circumstances.
3. The main decision points in the strategic review are the split of liability-hedging and return-seeking assets, then the composition within each of those categories.

One of the most important choices DB plan investment committees will make is deciding which asset classes they will invest in, and how much they will invest in each one. Few other choices will have a greater impact on plan sponsors achieving their goals, and thus it constitutes a crucial element of a well-designed investment policy statement. While some investment decisions, such as manager selection, can be outsourced, in most cases the decision on how to appropriately allocate assets rests with the investment committee.

No two DB plans (nor their corresponding sponsors) are alike in every way, and each case requires thoughtful analysis to determine the allocation that most appropriately aligns with plan sponsor goals and objectives. Making a poor asset allocation decision, or "staying with" a decision that might not, today, be deemed appropriate, can lead to a

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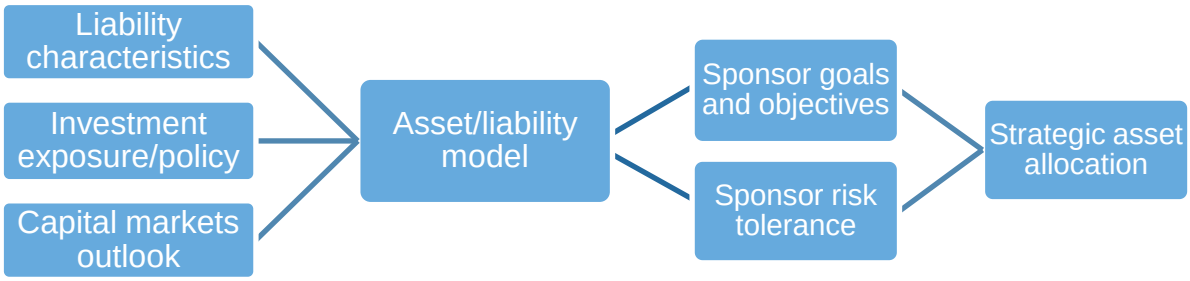

number of undesirable outcomes for the sponsor, both near and long term, such as excess volatility in funded status and contributions, or contributions far greater than they would otherwise have needed to be. Further, investment committee members have the fiduciary responsibility to be prudent in their investment decisions. Ignoring the need to review decisions, or oversimplifying the quintessential asset allocation decision, could potentially constitute a breach of those fiduciary duties and, ultimately, place an undue burden on the sponsoring organization.

The process for setting sound strategic asset allocation policies is the focus of this note. The process culminates in a strategic asset allocation review (hereinafter, also "strategic review" and "review"). These periodic asset/liability studies ought not to be superficial discussions. Instead, to be completed properly, they require significant insight into the mechanics of the plan, a broad knowledge of capital markets and an in-depth understanding of the sponsor's objectives and risk tolerance.

Purpose of, and contributing factors to, strategic asset allocation

The purpose of a strategic review is to assist the sponsor in setting an appropriate asset allocation for the DB plan and its beneficiaries. A strategist with expertise in both assets and liabilities (often, an existing service provider) completes the analysis and communicates the results.

Many factors influence the strategist's advice. The most common include:

- The plan's liability characteristics. A thorough understanding of the plan's liability characteristics is critical in recommending an appropriate asset allocation. Why? Because plan sponsor objectives are so often liability-related. For example, it is impossible to assess with any precision how an increase in equities will affect sponsor contributions if plan liabilities haven't been accurately modeled. This requires a proper understanding of current pension regulations. The sponsor's existing funding policy (how much a sponsor contributes) plays into this as well, as it ideally works in tandem with the investment policy.
- Existing investment policies. While investment policies can certainly change after the strategic review is complete, the strategist ought to understand the existing investment policy statement (IPS) and, ideally, the rationale that led to its provisions. These include the current strategic asset allocation, permitted asset classes and liability-hedging goals.
- Capital markets outlook. An understanding of capital markets now and expectations for the future are central to the strategic asset allocation review process, since market behavior will influence how asset classes perform – their range of returns, volatility and interaction with other asset classes. Of particular importance to DB plan sponsors are expectations for bonds, since liability discount rates are derived from high-quality corporate bond rates and from bonds' expected returns relative to equities' returns.
- Plan sponsor goals and objectives. These typically describe where the sponsor would like to see the plan in the future (e.g., in 5 to 10 years), given where it currently stands. Perhaps the sponsor intends to fund the plan at the minimum possible level, or to purchase annuities for retirees. Plans to close or freeze the DB plan would also be critical to the strategic review process. As contribution volatility and funded status volatility are typically key concerns, making each of these metrics more predictable and stable could be an objective. Whatever the goal is, it will influence the appropriate asset allocation.
- Plan sponsor risk tolerance. While this is a key input to many investment decisions, translating risk tolerance into a specific allocation can be tricky. Strategists often prepare risk-analysis tools to help identify and quantify risks for the sponsor. The size of the plan relative to the size of the sponsoring company can be a key factor, as is the plan's current funded position. Questions such as "Does the sponsor need to take on extra investment risk to offset what could otherwise be overwhelming contributions?" or "How much downside contribution risk can the sponsor afford?" may be asked to determine the risk-tolerance level of a DB plan sponsor.

For each plan, the myriad changes in circumstances that can emerge from these categories necessitate an individualized set of recommendations from the strategist, and this is part of the reason why the review process can take a few months to complete.

Strategic review frequency

When any of the circumstances noted above change significantly, a new strategic review may be merited. For example, a plan freeze can cause liability characteristics to change dramatically and would almost certainly necessitate a review of the current strategic asset allocation. Likewise, if a large portion of the plan's liability is transferred out through lump-sum benefits payout or annuity purchase, initiating a new review would be valuable. We believe, at a minimum, a plan's asset allocation strategy should be reviewed in depth every three years.

The most common reasons for initiating a new strategic review include:

- A plan change that significantly alters the demographics of the participant population. Examples include a large reduction in workforce, a major risk-transfer transaction, a merger with another plan or a spin-off of participants to a new plan.
- A plan's closing to new entrants or freezing of participants' benefits accruals.
- A major plan design change, such as conversion to a cash balance formula.
- A major change in plan sponsor objectives or risk-tolerance level.
- A large change in funded status that can significantly affect the asset allocation recommendation. Having a strategy in place that changes asset allocation as funded status improves – i.e., a liability-responsive asset allocation (LRAA) strategy – can help mitigate the risk of funded status being misaligned with asset allocation.
- Passage of three years' time since the last study. Even if circumstances have not significantly changed, we believe regular reviews are important, to avoid the asset allocation's growing stagnant or outdated as compared to current best practices.

Other matters that could lead to a strategic review, but that may have a smaller overall impact, include changes in funding policy, actuarial assumptions (such as mortality) and pension legislation.

Strategic review process

The review process can take a few months from beginning to end, as it has several distinct steps:

- Initial discussion. During this stage, the sponsor and the consultant agree on objectives for the review and set parameters, such as budget (unless strategic reviews are already included in the scope of services), timing and overall goals for the project.
- Data collection. Since plan sponsor objectives are commonly aligned with asset/liability metrics, the strategist completing the review will collect detailed plan liability information, including projected cash flows, from the plan's actuary. The strategist ought to become familiar with the assumptions, methods and provisions used in the actuarial valuation, as these can affect how plan liabilities are projected. The current IPS, including asset allocations and their current market values, should be collected too, if that information is not already at hand.
- Data calculations. Using the data collected from the actuary, the strategist completes asset/liability projections to use as a basis for comparing the outcomes of various portfolios. These projections are run *stochastically,* meaning hundreds, or even thousands, of scenarios are run in order to capture probabilities of certain events. Ancillary to this step is the completion of risk-assessment exhibits, to assist the sponsor in defining risk tolerance.
- Data analysis. After calculations are complete, the strategist considers plan sponsor objectives, risk tolerance and asset/liability metrics in order to formulate recommendations. Or, if the sponsor's risk tolerance is not known, a few options of varying risk-tolerance levels are summarized for the sponsor's consideration.
- Presentation of results and recommendations. The strategist meets with the sponsor (perhaps with the full investment committee) to present findings and provide recommendations. This can also be a key opportunity for the strategist to help the sponsor understand the plan's risk exposure, and to quantify risk tolerance. This is a substantial conversation, which will require sufficient time to effectively lay the groundwork, provide results and answer questions. New issues could be raised in this meeting that had not been considered previously, requiring follow-up.
- Plan sponsor decision making. In this step, the sponsor takes the steps necessary within the organization to choose a path forward. This step can be completed during the meeting or in subsequent meetings, but should not be delayed too far beyond the strategic review presentation, as plan circumstances and market outlooks change over time.
- Follow-up. The presentation of strategic review results can spawn discussion of other topics that require follow-up, by either the actuary or the strategist. This also includes follow-up on the sponsor's decision-making process.

The last couple steps are critical, since the strategic review process is not intended to be just educational. While of course this is a good opportunity for the sponsor to view the plan from the strategist's eyes, the intent is for the review to lead to a specific course of action for the sponsor. Perhaps the best path forward could be to maintain the status quo, but such choice should be made deliberately (rather than through inaction) in the decision-making process.

Plan sponsors' decision points

As part of the review process, the strategist will likely provide recommendations on several different decision points. The strategist begins the presentation of the results by providing sufficient background for the sponsor to make an informed decision. They review the projection of the key pension metrics, such as contribution and funded status. For DB plan sponsors, key decision points typically include:

- **The split between liability-hedging and return-seeking assets.** Broadly speaking, there are two types of assets within a DB plan trust that is asset/liability–focused: liability-hedging (L-H) and return-seeking (R-S). The purpose of L-H assets is primarily to reduce interest rate risk by aligning asset movements with liability movements, thus helping reduce funded status volatility. L-H assets are predominantly high-quality bonds. R-S assets include everything else but cash. The decision of how to split these two broad categories is heavily influenced by the sponsor's risk tolerance and has a significant impact on the plan's long-term outcomes.
- **The composition and duration of liability-hedging assets.** Along with the split in L-H and R-S assets, this decision helps determine the extent to which interest rate risk is hedged. Sponsors not fully engaged in liability-driven investing (LDI) could be using fixed income simply as a diversifier against equities (generally, the use of fixed income outside of liability-related assets), and may use a duration far less than the liability duration. For sponsors implementing LDI, the duration will be higher and focused on high-quality U.S. bonds (Treasury and credit). Certain derivatives can also be used for liability-hedging purposes.
- **The composition of return-seeking assets.** These assets are made up mostly of equities (public and private), real assets (real estate, commodities, etc.), hedge funds and return-seeking fixed income (e.g., high yield, emerging market debt, bank loans, etc.). The strategist may recommend the introduction of new asset classes for consideration, to improve diversification or to enhance return potential – or recommend removing asset classes that no longer help the sponsor achieve its objectives, for reasons such as concerns over return expectations, fees/performance or liquidity. Once asset classes are determined, a realignment of assets within this group could be recommended to optimize the risk/reward trade-off.
- **Dynamic and/or multi-asset strategies.** The strategic review presents a good opportunity to consider and model the impact of dynamic asset allocation strategies, including LRAA, which as noted previously automatically adjusts the allocation between L-H and R-S assets as funded status improves. Other strategies, such as multi-asset strategies that give the investment manager the flexibility to make short-term tactical tilts, can also be considered.

The strategist may also offer supplementary recommendations related to funding policy, risk transfer, etc., but these would not typically be the focus of the strategic review.

Risk tolerance assessment

As mentioned above, the sponsor's risk tolerance is a key input to the strategist's asset allocation recommendations. Two sponsors with "identical" plans could rightly receive different recommendations from the same strategist, if the sponsors' risk tolerances are much different. For example, the risk tolerance could be high for a sponsor of a plan that is small relative to company size, but low for a sponsor of a plan that is as large as the company itself.

There are a few means of assessing a sponsor's risk tolerance. Each is designed to determine what level of funded status or contribution risk the sponsor is willing to accept. For a DB plan, risks should be measured relative to liabilities, not simply on expected asset returns and volatility.

Examples of risk-analysis tools include scenario/stress testing, which shows how key pension plan metrics could change under stressed or historical conditions. This helps the sponsor determine how much risk it is willing to accept. Much more complex, and often more informative, analysis involves probabilistic (stochastic) calculations that attempt to place chances on certain scenarios occurring.

Throughout the strategic review process, it is important to keep in mind the relevant time horizon. While strategic (unlike tactical) asset allocation generally maintains a long-term view, risks are often short-term in nature. Catastrophic (or exceptionally favorable) market events lasting only a few weeks may have a notable short-term impact on the plan, but they can also have long-term effects, something sponsors need to be aware of. This is why some risk-assessment tools focus on what could happen in the near-term (one year or less).

Final thoughts

The strategic asset allocation review process is an essential step in good DB plan governance. When executed properly, a strategic review can offer the sponsor valuable insights into the mechanics of the plan, and lead to the making of sound investment choices for the benefit of plan participants and the organization as well. Following through on a well-thought-out and well-designed investment strategy will help the sponsor to satisfy its fiduciary responsibilities while seeking to reach long-term goals.

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