STRATEGIC EXCHANGE

NEW YEAR, NEW UNCERTAINTY: FACTS AND PREDICTIONS

As one calendar year ends, hope for the New Year begins. We take a look back at some of the investment implications from 2011 and put forward some predictions for 2012 as it relates to pension plan investors.

FIRST, SOME INTERESTING FACTS FROM WHAT WAS A VERY VOLATILE AND COSTLY YEAR FOR DEFINED BENEFIT (DB) PLANS.

1. Worst calendar year for DB plans for 9 years. For DB plans the financial impact is a combination of not only how the value of the assets changes, but also how the value of the liabilities change. For 2011, the real culprit impacting the financial well-being of DB plans was growth in liability value due to the continued decline in long-term interest rates. A typical pension plan would have seen asset values remain relative flat over the calendar year, but the combination of assets and liabilities would have seen a decline of almost 17%[1].
2. Strongest calendar year performance by long bonds since 1997. Despite the low level of interest rates, the DEX Long Bond Index returned 18.1%, its best calendar year return since 1997 when the yield was 6.05% compared to 3.39% at the end of 2011.
3. Real return bonds outperformed long and universe nominal bonds. If the performance of long nominal bonds surprised investors in 2011, then the "real surprise" was real return bonds, whose index performance returned over 18.4%, its best calendar year performance since 1993.
4. Gold faded as the year went by, but delivered 11% for the calendar year. Despite the immense attention that was being paid to the rising price of gold in 2011, it only returned a little over 11%. However, it was still a shining light when you recognize this performance followed returns of approximately 29% and 27% for 2010 and 2009 respectively.
5. Four sectors delivered a positive return domestically and globally in 2011. While it may have felt like all equity stocks were falling in 2011, four sectors - Consumer Staples, Health Care, Telecommunication Services and Utilities - delivered positive returns within both the S&P/TSX Composite and the MSCI World Indices.

AND NOW THE FEARLESS PREDICTIONS FOR 2012.

1. Don't bet on a significant rise in long-term interest rates. A material increase in long interest rates would go some way to reducing the mark-to-market value of a DB plan's liabilities and reducing the size of its deficits. However, despite the low level of interest rates, there could be continued demand for long bonds driven by the adoption of the International Financial Reporting Standards (IFRS) accounting rules as well as regulatory pressures on financial services companies with respect to capital requirements. Therefore, investors hoping long bond yields will materially increase in 2012 could be disappointed.
2. Partitioning of liabilities into retiree and non-retiree will spawn a new trend – Fixed Liability Investing. The historical knock against Liability Driven Investing (LDI) has been the anxiety over low interest rates and the regret risk of moving to much longer-dated fixed income investments at the wrong time and locking in rates at the "bottom", only to experience a subsequent rise in (long) interest rates.

   One way to alleviate this concern is to approach the management of retiree and non-retiree assets differently. The fixed (or largely fixed) liabilities associated with retirees provides an opportunity to reduce the mismatch of assets and liabilities by developing a portfolio that is a blend of the major DEX bond indices to capture the lower duration of the retiree cash flows. Adopting a Fixed Liability Investing (FLI) approach will minimize the difference in the change of the retiree portfolio's value and the cost of delivering the retiree benefits. This will allow the plan sponsor to focus its risk budget and investments in more volatile assets to the longer-duration non-retiree liabilities.

3. Dynamic management of asset mix will increase in prevalence. The recent market volatility has led to many plan sponsors looking for guidance on how to respond to another decline in the financial position of their DB plan. Under the traditional approach to risk management, a fixed long-term asset mix is developed and is periodically reviewed, but generally does not materially change. When markets are trending, the traditional approach is effective, but tends not to be as effective during periods of significant market stress, which happen more often than expected. A dynamic or systematic approach adjusts the asset mix based on how both the assets and liabilities perform, which recognizes that the level of risk varies over time in response to market changes. Adopting a dynamic approach to managing asset mix will gain in prevalence in 2012 and should improve a plan's ability to limit the impact of significant market corrections.
4. Emerging market and global small cap equity mandates will increase in prevalence. While for many Canadian plan sponsors risk management will be of upmost importance, it should not be at the exclusion of return-seeking strategies. Emerging markets and global small cap equities allow investors to benefit from a broader opportunity set and enhanced portfolio diversification as well as improving the odds of beating index returns.
5. Justin Bieber will be the top performing Canadian commodity. Gold has been the darling of the last few years, but not even oil or other Canadian commodities will be able to stop the rise of Justin Bieber's stock in 2012.

For further discussion on these predictions please contact:

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[1] To illustrate the financial impact to a defined benefit (DB) plan, we considered a plan whose assets were invested 20% S&P/TSX Composite Index, 40% MSCI World Index (C$) and 40% DEX Universe Index. The returns of the DEX Long Bond Index were used as a proxy for the growth in the liabilities. The "financial impact" was defined as the asset return less the growth in the liabilities.