Executive Summary

For corporate defined benefit plans in the United States, the calamitous decade since the collapse of the tech stock bubble in 2000 marked a turning point. In 2010, large corporate plans are commonly closed to new entrants and many of those are completely frozen—committed to paying only those benefits earned by employees in past years. A decade of declining interest rates and low, single-digit equity returns finds most pension plans reporting sizable deficits. In many cases, their sponsors acknowledge that these deficits won’t go away on their own—large cash contributions will be required to fill them.

Given the current picture, it would be easy to miss the transformation that is occurring. Our 2011 Aon Hewitt US Pension Risk Survey finds this transformation taking place in the attitudes, strategies, and governance practices of plan sponsors. This transformation is taking place at plans large and small, underfunded and well funded, open, closed, and frozen. In our view, this represents one of the most important shifts in pension plan investment management practices since the 1980s.
While it’s tempting to condense this shift to a single word or phrase, our survey finds that it has several dimensions:

- Investment policy, rather than plan design, has become the primary risk management tool for plan sponsors.

- Traditional asset-based performance benchmarks are ceding top billing to liability benchmarks.

- With the shift to liability-based benchmarks, there is greater awareness of the liability-hedging characteristics of various asset classes and instruments.

- Static investment policies are giving way to dynamic policies that explicitly incorporate plan-specific objectives such as funded status to optimize, rather than minimize, plan risks.

Looking back on our prior surveys, we see the speed with which this transformation has occurred:

- Our first Global Pension Risk Survey was performed in early 2008, just prior to the Great Recession and the worldwide stock market crash. Sponsors’ attention was absorbed in implementing the provisions of the Pension Protection Act, unaware of the tsunami that was to come. The 2008 survey tallied a few sponsors adopting leading-edge risk management practices in what turned out to be the nick of time.

- Our second Global Pension Risk Survey was taken in late 2009, as sponsors struggled to repair the crash’s damage amid a creeping recovery. Funding levels had partially recovered from their March 2009 lows, but deficits still loomed large, driving cash and accounting budget projections to actionable levels. If 2008’s theme was a fatal lack of urgency, 2009’s theme was very different: “Everything is on the table.”

- Our third survey was performed in late 2010 and early 2011, and while funding levels continued to creep up from dangerously low levels, we saw sponsor attitudes had changed enormously from 2008. Confusion and anxiety have faded somewhat, and we find that most sponsors have made substantial changes in the management of their retirement programs:

  - We see strong momentum in de-risking strategies, mostly at the expense of exposure to domestic equities. While many flavors of de-risking are popular now, LDI, the 2009 favorite, has been surpassed by 2009’s dark horse: dynamic investment policies.
Plan closings and freezes continue, but a large percentage of US plans continue to accrue benefits for at least some portion of the employee population. And while the majority of surveyed plans are closed to new entrants, most sponsors that were contemplating full plan freezes in 2009 chose not to do so. For now, it seems, the plan freeze decision has been asked and answered, and for about half of the survey respondents the answer was “No” or, at least, “Not now.”

Overall, survey results show a greater awareness of pension risk, an understanding of the capabilities and limits of the available risk management tools, and an acceptance that achieving a manageable level of risk takes time, planning, and patience—but that it can be done, after all.

Highlights of the 2011 Survey

The 2011 study found the persistence of old trends amid the emergence of new ones:

- The largest shift from last year was the rise in acceptance and adoption of dynamic investment policies. This shift was in evidence in many of the responses to the survey questions, and in our view it represents the most important finding from this latest survey.

- Asset allocation changes during 2010 saw the continuation of 2009’s strongest trend: sponsors sold domestic equities and bought long-duration bonds, primarily credit bonds.

- There was renewed interest in expanding allocations to alternatives, and to a lesser extent global equities. De-risking wasn’t just about extending bond duration in 2010—diversification of the return-seeking portfolio was just as important.

- Major plan design changes, such as closing the plan to new entrants or freezing benefit accruals, seem to have tailed off.

- There was continued strong interest in delegation of the entire investment process, or portions of it, to outside vendors. This suggests rising awareness of the added resources needed to implement risk-controlled strategies such as dynamic investment policies, as well as an urgent sense that missed opportunities can be costly.

- There was a decline in interest in risk-transfer solutions such as annuity purchase, either as a plan investment (“buy-in”) or as a plan settlement (“buy-out”). This is confirmed by the current low level of activity in these areas, in particular the failure of any real “buy-in” activity to emerge in the US.
Funding policies have changed little over the year. Roughly 37% contribute the minimum required plus amounts necessary to avoid benefit restrictions, while half that number contribute just the minimum.

Survey participation has again increased by nearly 50%, indicative of the rising importance of pension risk to sponsors, as well as the expanded reach of the Aon/Hewitt/EnnisKnupp combination.

After years of turmoil, a new level of clarity seems to be emerging. Sponsors are shifting their risk mitigation efforts away from benefit design, funding policy, and even actuarial smoothing techniques, and focusing them where they can have the greatest impact—on investment strategy.

In the US we received a total of 227 responses, with 45% of responses coming from sponsors of plans with 10,000 or more participants.

### Survey Participation

<table>
<thead>
<tr>
<th>Size Distribution—Estimated Number of Members in DB Plans</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>0-1,000</td>
<td>11%</td>
</tr>
<tr>
<td>1,000-5,000</td>
<td>26%</td>
</tr>
<tr>
<td>5,000-10,000</td>
<td>18%</td>
</tr>
<tr>
<td>10,000+</td>
<td>45%</td>
</tr>
</tbody>
</table>
### Industry Classification—Which Industry Classification Best Describes Your Organization?

<table>
<thead>
<tr>
<th>Industry Classification</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aerospace/Defense</td>
<td>2%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>13%</td>
</tr>
<tr>
<td>Beverages</td>
<td>4%</td>
</tr>
<tr>
<td>Charitable Organizations</td>
<td>4%</td>
</tr>
<tr>
<td>Chemicals</td>
<td>3%</td>
</tr>
<tr>
<td>Computer Services</td>
<td>4%</td>
</tr>
<tr>
<td>Conglomerate</td>
<td>9%</td>
</tr>
<tr>
<td>Construction</td>
<td>1%</td>
</tr>
<tr>
<td>Consumer Products Manufacturing</td>
<td>8%</td>
</tr>
<tr>
<td>Consumer Services</td>
<td>1%</td>
</tr>
<tr>
<td>Diversified Nonmanufacturing</td>
<td>4%</td>
</tr>
<tr>
<td>Electronics/Electrical</td>
<td>1%</td>
</tr>
<tr>
<td>Energy/Utilities</td>
<td>3%</td>
</tr>
<tr>
<td>Food</td>
<td>1%</td>
</tr>
<tr>
<td>Health Care</td>
<td>2%</td>
</tr>
<tr>
<td>Industrial Manufacturing</td>
<td>6%</td>
</tr>
<tr>
<td>Insurance</td>
<td>6%</td>
</tr>
<tr>
<td>Media</td>
<td>2%</td>
</tr>
<tr>
<td>Member Organizations</td>
<td>7%</td>
</tr>
<tr>
<td>Metals/Mining</td>
<td>4%</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>2%</td>
</tr>
<tr>
<td>Retail (includes wholesale and distribution)</td>
<td>1%</td>
</tr>
<tr>
<td>Telecom</td>
<td>2%</td>
</tr>
<tr>
<td>Transportation Services</td>
<td>1%</td>
</tr>
</tbody>
</table>
In a signal shift, the focus of pension risk management has moved away from Product (long bonds; swaps; futures) and toward Process. The fastest growth in the investment-based risk management world is in the adoption of dynamic investment policies, or “glidepaths.”

In their simplest incarnation, dynamic investment policies reduce the level of pension risk as the plan’s funded status improves, by shifting investments out of return-seeking investments (public equities; alternatives) and into liability-matching investments (long-duration bonds; swaps; futures). This transition usually is structured to occur as funded status improves.

Glidepaths are generally structured so they can be approved at the committee level and implemented by staff and/or vendors. They can be understood as a reaction to the missed opportunity from the time of our 2008 survey, when most pension plans were in a surplus position. Survey respondents could have avoided much pain and expense by moving to liability-matching investments at that time, but even those who desired to do so frequently ran into obstacles in the form of committee education, consensus-building, and implementation. By anticipating these needs up front, developing a glidepath, gaining stakeholder approval, documenting the procedures, and instituting a monitoring mechanism, sponsors seek to overcome the obstacles that made de-risking cumbersome when it was most needed.

Adoption of Glidepath Effective January 1, 2009
Investment Changes – What Changes Have You Made to Your Target Investment Strategy?

-80%       -60%       -40%       -20%       0%       20%       40%       60%       80%

US equities
Global equities
Bonds
Intermediate duration bonds
Long duration bonds
Fixed government bonds
Inflation linked government bonds
Corporate bonds
Alternatives
Equity downside protection
Guaranteed or structured products
Liability matching assets
Interest rate derivatives
Dynamic asset allocation strategy

Reducing  No change  Increasing
Investment Changes–
What Changes Will You Make to Target Investment Strategy?
Next 12 Months

- US equities
- Global equities
- Bonds
- Intermediate duration bonds
- Long duration bonds
- Fixed government bonds
- Inflation linked government bonds
- Corporate bonds
- Alternatives
- Equity downside protection
- Guaranteed or structured products
- Liability matching assets
- Interest rate derivatives
- Dynamic asset allocation strategy

In 2009, 15% of respondents were in some stage of implementing dynamic investment policies. In 2010, 21% had adopted some form of dynamic investment policies, and 29% intend to operate dynamic policies in the future.
While last year’s responses showed a flight from public equities in general, this year’s aversion was more specific to domestic equities.

- Fully 38% reduced their exposure to domestic equities in 2010, and the same percentage of respondents expects to do so in 2011. Just 4% expect to increase domestic equity exposure.

- More sponsors raised (20%) than lowered (13%) their global equity exposure in 2010. Looking forward, roughly equal proportions expect to raise and lower this exposure in the next 12 months.

- More sponsors raised (21%) than lowered (10%) their exposure to alternative asset classes in 2010, and 19% expect to raise exposure to alternative categories in 2011 against just 8% who plan to lower.

Despite the recent narrowing of credit spreads, long-duration corporate bonds seem to be the liability-matching asset of choice. Allocation to long-duration bonds is expected to rise for 32% of respondents, and 24% expect a rising allocation to corporate bonds vs. just 13% for fixed government bonds. As we see the Federal Reserve winding down QE2, the market seems to believe that the decades-long Treasury rally has finally run out of gas.

Comparing results in the UK to the US, an interesting contrast emerges: In the US, just 4% expect to reduce their exposure to corporate bonds. In the UK, this proportion has risen significantly in the past year, and now sits at 20%. In the UK, there is the sense that the corporate bond move was an opportunistic play, and that once spreads returned to normal levels the time was right to move on. Time will tell (in next year’s survey, perhaps) if this view takes root in the US as well.

We were interested in finding if return-seeking portfolio diversification and dynamic investment policies represent mutually exclusive approaches to de-risking. Will sponsors adopt glidepaths in lieu of further diversification into alternative asset classes or global equities? In most cases, the answer seems to be “No.” Of sponsors adopting glidepaths, 33% also expect to raise their allocation to the alternative asset categories, against just 14% of sponsors not adopting glidepaths. Proportions are similar for global equity allocations. It seems that sponsors seeking to de-risk are inclined to reach for multiple tools to do so.

While one might view the rise of dynamic investment policies as transformative, remember that glidepaths are not an asset class or product. In their most common form they represent a measured, preplanned way of increasing allocations to liability-matching assets, and so can really be understood as a transition management plan for long-duration bond strategies. Dynamic investment policies do not replace LDI—as it turns out, for many sponsors they make LDI possible.
Why Are Dynamic Investment Policies Growing So Quickly?

We offered eight possible reasons for why glidepaths are appealing. In the survey, respondents could select up to three reasons to explain glidepath appeal.

In the most common response, glidepaths were viewed as a prudent way to reduce risk as funded status improves. Others found them an appealing way to take the emotion out of de-risking decisions, while 33% noted that they offer the potential to reduce long-term plan costs. A small proportion indicated an interest in using interest rates or credit spreads as de-risking triggers. These findings are consistent with our client discussions, and suggest that the appeal of glidepaths lies primarily in their fiduciary benefits—prudent reduction of risk, based on a predetermined, pre-approved approach that can be implemented in a mechanical fashion.

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prudent to reduce risk as funded status improves</td>
<td>78%</td>
</tr>
<tr>
<td>Takes emotion out of asset allocation change decisions due to rules-based approach</td>
<td>42%</td>
</tr>
<tr>
<td>Minimizes long-term economic cost of plan</td>
<td>33%</td>
</tr>
<tr>
<td>Allows for budgeting for pension expense increases associated with de-risking</td>
<td>19%</td>
</tr>
<tr>
<td>Achieves economic benefits of “buy low/sell high” rebalancing strategy</td>
<td>18%</td>
</tr>
<tr>
<td>Addresses the operational challenges with making a large de-risking action all at once</td>
<td>17%</td>
</tr>
<tr>
<td>Allows for explicit use of interest rate levels as triggers</td>
<td>13%</td>
</tr>
<tr>
<td>Allows for explicit use of credit spread levels as triggers</td>
<td>3%</td>
</tr>
</tbody>
</table>
Strategy and Objectives

By our definition, dynamic investment policies require a long-term strategic goal or endpoint. To shed light on what this endpoint looks like, we asked two long-term strategy questions:

- What is your long-term strategic goal? and
- How long do you expect to take to get there?

Pension plan strategy has traditionally focused on maximizing long-term returns. Before the “Lost Decade” of 2000–2009, most sponsors were comfortable with the financial risk inherent in their plans, relying on sundry actuarial smoothing techniques to dampen the volatility to a manageable level. With the majority of plans now closed and a significant minority frozen, one might expect that sponsors are now planning to wind up and exit the defined benefit business entirely.

Long-Term Strategy – What Is the Long-Term Strategy for Your Pension Plans?

- De-risk to self-sufficiency 55%
- De-risk to buy-out 14%
- No long-term strategy 16%
- Other long-term strategy 15%

On the contrary, our survey finds that only one in seven sponsors have a long-term strategy that extends to exiting the plan—over half, in fact, expect the plan to be around for a long time, and aspire to reduce risk and maintain a self-sufficient plan for an indefinite period. The high cost of annuity settlements certainly contributes to this view, but this also suggests that many sponsors still think risks can be brought down to manageable levels with the right approach.
How long do they expect this process to take? Twenty-one percent think it will take less than five years (or are there already), while over a third have a time horizon of five to ten years, and 10% think it will take longer.

Fully a third don’t have a specific time horizon, instead linking their risk-reduction objective to achievement of a specific financial target—usually plan funded status, but in a few cases linked to the financial position of the sponsoring employer. These findings are consistent with the most common form of the glidepath approach described above, and with the notion that sponsors look to improving funded status to make lower-risk investment strategies affordable.
Benefit Changes

The post-crash wave of plan closures and freezes seems to be tapering off in the US. While half of last year’s respondents thought benefit accrual freezes were “very likely” or “somewhat likely,” the percentage of respondents actually reporting frozen plans remained nearly even at 32%, while only 17% of this year’s respondents indicated a freeze was at least “somewhat likely.”

Plan Freezes – Proportion of Plans Closed/Frozen for Existing Members

Of those who haven’t frozen their plans, the top three reasons cited were:

- Defined benefit plan aligns with our total rewards philosophy (75%)
- Competitive issues (46%)
- Union pressure (39%)

Reasons for Remaining Open – Top Three Reasons for Keeping Plans Open

<table>
<thead>
<tr>
<th>Reason</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>DB plan aligns with our Total Rewards philosophy</td>
<td>75%</td>
</tr>
<tr>
<td>Competitive issues</td>
<td>46%</td>
</tr>
<tr>
<td>Union Pressure</td>
<td>39%</td>
</tr>
<tr>
<td>Employee pressure</td>
<td>38%</td>
</tr>
<tr>
<td>Senior management resistance</td>
<td>36%</td>
</tr>
<tr>
<td>We think the process will be too painful</td>
<td>29%</td>
</tr>
<tr>
<td>Required following corporate transaction</td>
<td>11%</td>
</tr>
<tr>
<td>Publicity</td>
<td>9%</td>
</tr>
<tr>
<td>Don’t want to be first in our sector</td>
<td>8%</td>
</tr>
</tbody>
</table>
On the other hand, 66% of surveyed plans had already closed their plan to new entrants (63%) or were likely to do so (3%). Surprisingly, of those reporting that their DB plan “aligns with our total rewards philosophy,” 45% had closed their DB plans to new entrants. Two interpretations are possible here:

- These organizations have a two-tier total rewards philosophy; or
- Something’s gotta give.

On the other hand, 29% were “unlikely” to close their plan to new entrants in the future, and 51% were unlikely to freeze accruals to existing members. After the dismal experience of the past decade, it appears that these plans will still be an important feature of the benefits landscape for many organizations and industries.

What Is Your Attitude to the Following Strategies Over the Next 12-24 Months?

<table>
<thead>
<tr>
<th>Strategy</th>
<th>0%</th>
<th>20%</th>
<th>40%</th>
<th>60%</th>
<th>80%</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Closing plan to new entrants</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Closing/Freezing for existing members</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reducing pension benefit levels</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reducing ancillary/discretionary benefits</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changing to defined contribution (DC) plan</td>
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</tr>
</tbody>
</table>

Of the liability settlement options on the table, 48% of respondents have implemented a lump-sum option (43%) or are likely to do so in the near future (5%). As the mandatory lump-sum basis for US plans will become most favorable to sponsors in 2012, this is likely to gain traction as an issue for 2011. Next year’s survey will be a real test of how readily sponsors take to the lump-sum option as an inexpensive way to achieve ongoing liability defeasance. And ultimately, the rate of lump-sum elections by plan participants will dictate how effective this strategy will be.
Insured options still lag by a wide margin, with annuity settlements “very likely” to be implemented by just 5% of sponsors. High costs and large settlement accounting charges are the likely obstacles. “Buy-in” deals, frequently touted by insurers and certain consulting firms, were “very likely” to be implemented by… not a single sponsor (0%).

Intriguingly, 16% of sponsors were “very likely” to implement longevity hedging strategies, and 10% claim to have already done so. Even if we assume that this latter category consists largely of sponsors who have converted to hybrid plan designs that don’t become more expensive as longevity improves, this suggests that investment-based longevity hedging vehicles may find a small but receptive group of buyers in the US as providers and sponsors gain more experience with them.

Funding Strategies

The funding picture has improved since the last survey, with 67% of sponsors expecting to make additional contributions in the next 12 months, down from 83% in the last survey. Fully 89% of those sponsors expect to be able to raise the cash for those contributions from operating cash flow (66%) or cash reserves (23%). Just 10% expected to issue debt (6%), contribute company stock (2%), or use some other means to make the expected contribution (2%).
Source of Extra Contributions – What Is the Source of Additional Contributions to Your Plan?

- Reducing the pension deficit (18%)
- Avoiding benefit restrictions (17%)
- Realizing tax benefits and accelerating contributions otherwise due (tied at 15%)

Additional Contributions – What Are the Top Reasons for Making Additional Plan Contributions?

- Reduce reported pension deficit 18%
- Avoid benefit restrictions 17%
- Realize tax benefits 15%
- Accelerate contributions otherwise due 15%
- Reduce PBGC premiums 11%
- Achieve earnings differential on cash versus pension investments 9%
- Take advantage of low cost of debt 7%
- Increase invested assets to achieve critical mass 4%
- Not applicable 3%
- Other 2%
Some of the more arcane aspects of funding changed little since the last survey:

- Eighteen percent chose to fund the minimum required contribution as a matter of policy, while 37% chose to fund the minimum plus any additional amounts needed to avoid benefit restrictions.

- Asset smoothing was used by 37% of respondents, while 51% preferred to use fair value in computing their minimum required contributions under the Pension Protection Act.

How Do You Calculate the Value of Assets for Purposes of PPA plan Funding calculations?

- Fair value: 51%
- Average value: 37%
- Don’t know: 13%
On the other hand, use of the three-tiered “segment curve” has gained in popularity, now preferred by 63% of respondents, up from 46% last year. Preference for the full yield curve dropped from 32% last year to just 20% this year—not surprising given the mid-year interest rate plunge. And we are gratified that only 17% replied “Don’t know” to this question, down from 22% last year.

Are You Planning to Take Advantage of the Pension Funding Relief Enacted in 2010?

<table>
<thead>
<tr>
<th>Response</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>No need for pension funding relief</td>
<td>46%</td>
</tr>
<tr>
<td>Don’t know</td>
<td>32%</td>
</tr>
<tr>
<td>Yes, under the 15-year amortization approach</td>
<td>9%</td>
</tr>
<tr>
<td>Yes, under the 2+7 amortization approach</td>
<td>7%</td>
</tr>
<tr>
<td>No, due to the restrictions for excess compensation</td>
<td>3%</td>
</tr>
<tr>
<td>No, due to the restrictions for extraordinary dividends or stock redemptions</td>
<td>2%</td>
</tr>
</tbody>
</table>
Hedging

Hedging of investment risks continues to be an area where there can be strongly polarized opinions from sponsors.

The chart below summarizes the attitudes toward hedging of various components of risk. Some of these are long-established hedging mechanisms—such as dealing with currency risk. Others, such as longevity, are very much emerging opportunities. We asked respondents to describe whether they would hedge at any price (since they believed the risk was an unrewarded risk), whether they would hedge at what they believed was fair value, whether they had a predetermined strategy (e.g., hedging using determined trigger points), or whether they would not hedge these risks at all. The final category relates to those who had no policy in relation to hedging the risk in question.

Despite the trend toward global diversification, only a few respondents acknowledged a strong preference for hedging currency risks. In our conversations with US sponsors, we find that foreign currency exposure is viewed as a partial hedge against the decline in the value of the US dollar, and in this view hedging currency risk may actually increase overall risk. The percentage that reported they had no policy for dealing with interest rate risk has declined steadily over the years during which we have carried out these surveys. Is it a concern that there remains a meaningful minority who state they simply “will not hedge” interest rates?

Not surprisingly, perhaps, policies on dealing with longevity or credit spreads still remain uncommon in light of relatively new instruments available for dealing with these risks.

What Is Your Attitude to Hedging?

<table>
<thead>
<tr>
<th>Longevity</th>
<th>Currency</th>
<th>Credit spreads</th>
<th>Interest rates</th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0%</td>
<td>20%</td>
<td>40%</td>
<td>60%</td>
<td>80%</td>
</tr>
</tbody>
</table>

- We will hedge at any price (these are unrewarded risks)
- We will hedge at what we believe is fair value
- We have a pre-determined strategy for hedging using triggers
- We will not hedge these risks
- We do not have a policy in relation to hedging these risks
The most common approach to dealing with hedging of risks remains that plans will hedge at what they believe is “fair value.” The issue here is deciding what constitutes fair value. Some sponsors had been through the process of working out what they consider to be fair value and now have a strategy for hedging, which is implemented once certain trigger points are reached. The chart below looks at the growth in plans with some form of trigger policy for hedging their interest rate exposures, compared with those who said they would deal at fair value.

Against a background where many feel that interest rates are near secular all-time lows, it is encouraging to see that over a third of plans should be able to remove their exposures if rates increase as expected. If investment committees cannot meet more frequently, or the matter is not delegated to an external body, trigger strategies have the great merit that market opportunities are not missed and sponsors can place controlled limits on the overall risk exposures they are prepared to tolerate.
Measuring Pension Risk

Historically, most of the pension plan sponsor’s time and energy was expended on looking at the asset side of the balance sheet. The performance of the investment managers against their peers and indices was discussed at great length and in great detail. The relationship between the assets and liabilities was an ancillary topic, commonly discussed during annual valuation reviews or during the somewhat infrequent asset liability studies. Long overdue, change has finally arrived, and the vast majority of respondents to our 2011 survey indicated they regularly monitored both their assets and liabilities, together with funded status. The chart below shows that just 3% indicated they now solely monitor their asset performance, with a further 21% indicating they monitor asset performance regularly and their liability or funded status on an ad hoc basis.

Monitoring Pension Risk – Describe Your Practice for Reviewing Components of Pension Risk

- We monitor asset liability and funded status regularly: **76%**
- We monitor asset performance regularly and liability/funded status performance on ad-hoc basis: **21%**
- We monitor asset performance only: **3%**
Improvements in computer technology have led to the creation of regular reports on both assets and liabilities as part of the regular monitoring process. This change in itself helps sponsors gain confidence in exercising a more dynamic asset allocation approach.

The chart above shows that the emphasis on assets in isolation is rapidly changing. We asked participants about the strategic focus of their investment committees. Although one in three indicated they still focus more on assets and investment manager issues, over half indicated they had a balanced focus on the assets and funded status issues. The days of looking at assets in isolation from liabilities are receding.

**Monitoring**

Also encouraging is the greater degree of professionalism with which sponsors monitor the financial risks associated with their pension plans. In our prior survey, nearly one in six plans indicated they had no specific measure for their pension risk, and two-thirds of plans said they looked at their risk metrics on an annual or less frequent basis. The 2011 survey shows (in the chart on page 23) that while 12% do not currently monitor their pension risk, this percentage drops to just 5% who say they have no plans to implement a monitoring process.
One in six expects to increase the frequency with which they monitor their pension risk. But perhaps the most encouraging change relates to those who measure pension risk on a quantitative basis—using a quantitative, statistical measure such as Value at Risk (VaR). Over 20% of plans reported they used a quantitative measure of their pension risk—over double the level reported in the 2009 survey.

The credit crisis was a massive wake-up call and has driven distinctive changes in monitoring behaviors. One in six plans indicated they measure their pension risk as part of their overall Enterprise Risk Management (ERM) program. One would expect the use of VaR for companies in the financial services and insurance industries. We found instead that the practice extended across a broad range of industries, although concentrated in the larger organizations.
Delegation

Regardless of how achieved, risk reduction carries with it additional burdens in measuring, monitoring, and managing pension financial risk. More sophisticated strategies such as glidepaths usually require a greater level of expertise than can be summoned from in-house resources.

### Delegated Investment – What Is Your Attitude Towards Delegating Aspects of Plan Management?

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<td>Asset manager monitoring</td>
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<td>Tactical asset allocation changes</td>
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- Monitoring of asset manager performance continues to be the likeliest area for delegation, with almost 65% already delegating, very likely to, or somewhat likely to delegate.

- Over a third have already delegated or are very likely to delegate other important areas of investment activity—namely the selection of new asset managers or dealing with tactical asset allocation changes in response to market variability.

- Over a quarter of respondents have delegated or are likely to delegate the introduction of new asset classes.

- Thirty-two percent have already delegated the full responsibility for the implementation of their investment policy, or are either very likely or somewhat likely to do so in the future.

Typically, full delegation involves the sponsor working with the partnering firm to design the parameters of the investment policy. Then, having set these parameters, the implementation of the entire investment policy is delegated to the external partner. This model is increasingly popular in continental Europe, and appears to be poised for substantial growth in the US.
Looking Forward

“Things do not change; we change.” — Henry David Thoreau

A summary of the key findings of this year’s survey reveals these broader trends:

- In the wake of the recent wave of plan freezes and closings, attention has shifted from design to investments as the key lever for controlling pension plan risk.

- For most sponsors, funded status has gained recognition as an important performance and risk metric.

- For many sponsors, a logical consequence of this view is that the level of risk a plan incurs should decline as funded status improves. Dynamic investment policies represent the translation of this view into policy, and are gaining rapid acceptance as a result.

- This new approach requires greater time and expertise than many sponsors can summon from internal staff. Those who recognize this are increasingly open to delegation of some or all of the investment process to outside professionals who can implement the new governance model efficiently and effectively.

As Thoreau suggests, we have indeed changed, and for many sponsors this change has translated into action. They have overhauled their policies and practices to align with this new mindset. But for many others, a changed attitude resides within the traditional “assets-in-isolation” focus. As the evolving liability-focused mindset takes hold, we expect the gap between attitude and action will continue to close.
About Aon Hewitt

Aon Hewitt is the global leader in human capital consulting and outsourcing solutions. The company partners with organizations to solve their most complex benefits, talent and related financial challenges, and improve business performance. Aon Hewitt designs, implements, communicates and administers a wide range of human capital, retirement, investment management, health care, compensation and talent management strategies. With more than 29,000 professionals in 90 countries, Aon Hewitt makes the world a better place to work for clients and their employees. For more information on Aon Hewitt, please visit www.aonhewitt.com.

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