News From Aon

As solvency hits new highs, diversification, de-risking and market dynamism on pension agenda for 2017

Aon's index of Canadian pension health ends 2016 at highest level in more than two years

TORONTO (January 5, 2017) – The median solvency ratio of Canadian defined benefit (DB) pension plans – a key measure of their financial health – finished 2016 by surging to its highest level in two and a half years, according to the latest quarterly pension plan solvency survey from Aon Hewitt, the global talent, retirement and health solutions business of Aon plc (NYSE: AON).

Two themes emerged in 2016 – strong equity market returns throughout the year and increasing bond yields (decreasing prices) in the fourth quarter, both of which were positive for pension funds. Amid an equity rally and a selloff in government bonds, pensions' asset returns soared while their liabilities fell due to rising bond yields. Overall the pension solvency ratio increased dramatically in the last quarter, and a far greater proportion of surveyed plans ended the year fully funded. That relative newfound strength presents Canadian pension sponsors with an opportunity to consider strategies to enhance risk management and diversification in their portfolios, as well as to position themselves to respond effectively to the renewed volatility likely to characterize markets in 2017.

The Aon survey measures plans' assets compared to their liabilities to calculate their solvency funded ratio, and is based on results from Aon Hewitt-administered DB pensions from the public, semi-public and private sectors. Median solvency on January 1, 2017 was 94.9%, up 8.8% year-over-year from 86.1% on January 1, 2016. Meanwhile, 35.2% of plans ended the year fully funded versus 10.7% at the beginning of the year – a significant improvement.

Two-thirds of the increase in the annual pension solvency ratio was driven by equity and alternative assets, especially the S&P/TSX in Canada (4.5% in Q4, for a 21.1% year-to-date return) and the U.S. S&P 500 (5.9% in Q4, for 8.1% YTD in Cdn $) as the so-called "Trump rally" extended the bull run in equities. Emerging markets declined through the quarter by 2.2%, but still finished the year with a 7.3% gain, while EAFE (Europe, Australasia and the Far East) gained 1.3% in the last quarter but lost 2.5% over the year. In alternative asset classes, the end of the year erased some previous gains: global real estate lost 3.5% through Q4, for a 1.4% YTD return, while global infrastructure returned 8.6% (Cdn $) over the year.

Since bond yields are inversely related to pension liabilities, the Q4 bond selloff adversely affected bond asset returns for pension plans but it had a bigger impact on their liabilities. Bond yields soared, with an increase of nearly 80 basis points in the fourth quarter – completely turning around the pension solvency ratio for the year. The combined impact of yield change on bond returns and pension liabilities accounted for 75% of the increase in the Q4 pension solvency ratio. FTSE TMX Universe and Long Term Bonds declined by 3.4% and 7.5%, respectively.

"2016 was a remarkable turnaround story for markets and for Canadian DB pension plans, whose solvency ratio had been declining for much of the year," said Ian Struthers, Partner and Investment Consulting Practice Director at Aon Hewitt. "The fourth quarter made all the difference and it was not all about the U.S. equity market rally. The steep rise in bond yields since September, and the robust equity markets despite Brexit had a remarkably positive impact on pension solvency The question now for pension plans is, how do they leverage their strength to prepare for challenging market conditions?"

While investors are clearly anticipating a return of inflation and favourable conditions for equities, it remains to be seen whether political expectations – fiscal stimulus in the U.S., along with tax cuts and regulatory reform – will be fully realized. Even before the U.S. election, North American stock valuations were looking steep; the November-December rally has made them even less attractive. In the medium term, pension funds, like other investors, are likely to face more limited returns in many traditional return-seeking asset classes. The areas for potential opportunities include emerging markets, private credit markets and alternative asset classes that have less reliance on market direction. For pension plans with a focus on matching their liabilities and managing interest rate risk, the increase in government bond yields presents an opportunity to de-risk at a more attractive price.

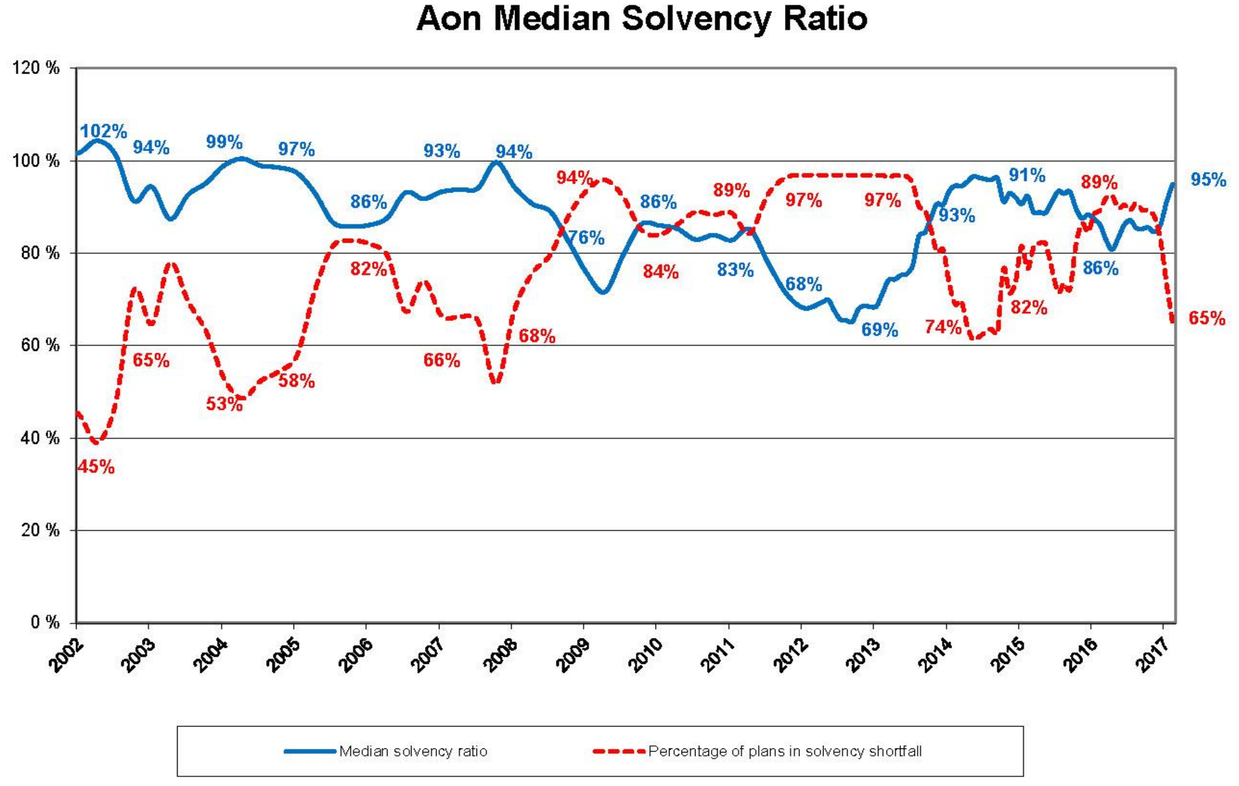
“In this environment, it makes sense for pension plan sponsors to consider a ‘3-D’ approach, focusing on diversification, de-risking and dynamism in their approach to responding to market opportunities,” says Struthers.

With traditional risk-seeking assets so expensive, smart diversification into alternative asset classes may be worth considering, along with interest rate and currency hedging to mitigate risk. For some plan sponsors, more aggressive de-risking strategies, such as plan windup or outsourced administration, might be an appropriate means to lock in gains.

Another factor for plan sponsors to consider in 2017 is their ability to respond effectively when market opportunities and volatility return. In addition, Canadian pensions will continue to face industry and regulatory changes in 2017 that pensions can address through broader risk management assessments.

“Now is an ideal time for plan sponsors to re-evaluate their investment strategies and their governance models to ensure they can capture market shifts,” adds Struthers. “Beyond capital market factors, Canadian pension plan sponsors should look at the risk in their plans and how to act on those risks. For instance, the solvency funding regulations for Quebec-registered plans were recently changed, and other jurisdictions might follow suit. That’s an unknown risk to existing funding strategies, and many plan sponsors are already looking at adjustments to future contribution levels. The beginning of the new year, especially one in which pensions have historically strong solvency, is the right time for plans to assess these and other issues – and to explore their options.”

Aon’s Median Solvency Ratio measures the financial health of a DB plan by comparing total assets to total pension liabilities in the event of plan termination. It is the most accurate and timely representation of the financial condition of Canadian DB plans because it draws on a large database and reflects each plan’s specific features, investment policy, contributions and solvency relief steps taken by the plan sponsor. The analysis of the plans in the database takes into account the index performance of various asset classes, as well as the applicable interest rates to value liabilities on a solvency basis. Actuarial valuation data are refreshed on an annual basis as new valuations are filed keeping the database always up to date.



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