Another reason to celebrate on Canada Day: pension plan solvency remains healthy, Aon Hewitt survey finds

Aon Hewitt’s key measure of defined benefit pension plan health shows continued strength in second quarter, as advantages of de-risking emerge

Toronto, June 30, 2014 – As Canadian equity markets kept on a roll through the second quarter, the health of Canadian defined benefit (DB) plans continued to slightly improve in the April-June period, according to the latest pension plan solvency ratio survey by Aon Hewitt, the global human resources solutions business of Aon plc (NYSE:AON). However, as long-term interest rates declined, plans that had put in place a de-risking strategy outperformed traditional plans and improved at a faster pace.

More than 275 Aon Hewitt administered pension plans from the public, semi-public and private sectors participated in the survey, and their median solvency funded ratio – the market value of plan assets over plan liabilities – stood at 96% at June 26, 2014. That represents an improvement of 0.6 percentage points over the previous quarter ended March 31, 2014, and a significant 19-point increase from the same quarter in 2013. In fact, this quarter’s median solvency ratio was the highest since September 2007. As well, approximately 37% percent of the surveyed plans were more than fully funded at the end of the quarter, compared with 36% in the previous quarter and 5% in Q2 2013.

This quarter, however, a clear divergence emerged between pension plans with traditional asset mixes and those that have adopted a de-risking strategy. As equity markets have performed well, long-term interest rates (a key factor in plan solvency) declined, resulting in the average pension plan having a flat quarter. In fact, much of the slight increase in the median solvency ratio can be explained by contributions made by plan sponsors, according to William da Silva, Senior Partner, Retirement Practice, Aon Hewitt. By contrast, plans with risk management strategies in place continue to experience improvements in overall solvency, and ended the quarter with a solvency position that was two to three percentage points better than those plans with a more traditional approach to managing risk.

“Canadian companies sponsoring defined benefit plans might be tempted to light some extra fireworks this Canada Day, but these results should be cause for preparation rather than celebration," said William da Silva. “As the solvency of Canadian DB plans has risen over the past year, we have been encouraging sponsors to rethink their funding and investing strategies to better manage risks. This quarter’s survey clearly shows the value of having a clear risk management strategy. Organizations were rewarded for staying invested in equity markets, while not being hurt as greatly by the negative impact of falling interest rates. Sponsors who stuck with their overall strategies saw real benefits and produced substantially better results."

Several recent developments in the marketplace for pension risk management create opportunities for plan sponsors to modify their funding and investment strategies. Beyond simply analyzing their plans’ risk profiles as capital markets continue to change, other end-game options include full immunization of assets to plan liabilities, partial settlement and full plan wind-up. Over the first two quarters of 2014, Aon Hewitt has seen more plan sponsors exploring these strategies to mitigate risk over the long term and preparing for their implementation.
The solvency ratio for participating plans benefited from generally strong investment returns. For the second quarter, average plan return stood at 3.3%, for a year-to-date return of 7.8%. The best-performing asset class to the end of Q2 has been Canadian equities, which returned 5.6% on the year to June 26, while global real estate rose nearly 4.4%. Emerging markets performance was also relatively strong, with a 3.1% return to the end of Q2. Meanwhile, bond returns (as measured by the performance of the FTSE TMX Universe and FTSE TMX Long-term Bond indices) were decent thanks to a decline in fixed income yields over the quarter. Notably, the resurgence of the Canadian dollar decreased the domestic value of U.S. and international equities, which returned 2.0% and 0.59% respectively over the quarter compared with 4.6% and 3.4% in Q1. But the strength of the domestic market more than made up for that decline.

“Plan sponsors who have benefited from equity markets’ performance in 2013 and in the first half of 2014 may have become dangerously complacent,” said Ian Struthers, Partner, Investment Consulting Practice, Aon Hewitt. “Volatility, and therefore risk, is still there. If we go through a market correction this summer, their solvency ratio may very well go back down again. Also, in one quarter, we have seen the beneficial currency effect of Q1 reverse, and we have seen benchmark fixed-income yields continue to decline. As we have said before, diversification in pension plans’ investments is more important than ever in conditions like these.”

The solvency funded ratio measures the financial health of a defined benefit plan by comparing total assets to total pension liabilities in the event of plan termination. Aon Hewitt’s median pension solvency ratio 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.
About Aon Hewitt’s Median Solvency Ratio
Aon Hewitt’s Median Solvency Ratio is developed using a database of more than 275 pension plans from all sectors (public, semi-public and private) and from most Canadian provinces. Each plan’s characteristics and data are used to project their solvency ratio on a monthly basis. These projections take into account the increase in financial indices for various asset classes, as well as the applicable interest rates to value liabilities on a solvency basis.

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