Mercer

welcome to brighter

Defined benefit top priorities 2023

Risks and rewards

The environment for defined benefit (DB) pension plans is changing. Is your plan ready?

The threats of geopolitical instability, inflation and volatility that loomed large at the beginning of 2022 have become reality as the year closes. From the war in Ukraine and the energy crisis in Europe to rollercoaster public global markets, a shifting policy environment in Canada with Bill C-228, and the ending of new real return bond issuance, the only constant is change.

But here's the good news: Pension funds are generally in an enviable funded position. Now is the time to take stock, reassess your risk exposures and search for opportunities.

Here are some key actions you should be looking to take in 2023:

Make sure your investment strategy is in shape

Many DB plans are in a strong financial position — but markets are shifting. The entire investment industry has had to navigate a substantial amount of short-term volatility. This volatility is due in part to massive geopolitical events such as the Russian invasion of Ukraine, the recent protests against China's zero-COVID policy and the subsequent shift in that policy.

In addition to these geopolitical movements, inflation remains high, central banks continue to tighten the screws to fight it and public markets provide no safe haven for investors fleeing the rollercoaster of daily trades.

In this environment, all investors — but especially sponsors of DB plans — must review their investment strategies, assessing their exposure to market risk against their objectives and tolerances. We are not living in the same world we were living in a year ago.

Investors should also look to capitalize on higher long-term yields on fixed income investments while they are available.

Diversification is always important, but in the current environment, investors should sharpen their focus – so as to absorb increased risks. We do not know what will happen in the medium or long term. Will the lifting of China's zero-COVID policy be disruptive? Will the Russian invasion of Ukraine be resolved? What will happen to interest rates and inflation? A properly diversified investor can better build resilience into their portfolio. This will be necessary, as more volatility may lie ahead.

Take stock of your surplus

Although the strong financial position of many DB plans may be counterintuitive given depressed asset values, this is the result of liability tailwinds from higher interest rates.

If your plan has a surplus, you may wish to simply retain it. A surplus buffer can be an effective safeguard against uncertainty and will allow you a degree of flexibility should unexpected events occur. You may also wish to engage in an off-cycle valuation, which would allow the surplus position in the plan to be locked in for the next three years.

If you want to spend some surplus, then, with careful deliberation, you could use it for an employer or employee contribution holiday or, in Ontario, for reduced Pension Benefits Guarantee Fund premiums. You could also consider benefit improvements, such as an increase in retirees' pensions, given the inflationary environment.

Due to geopolitical tensions, globalization may be slowing, thus negatively affecting economic growth.

Inflation may continue — but uncertainty is certain

While inflation has been one of the defining themes underlying financial markets around the world in 2022, it is not the only source of uncertainty. Indeed, many forecasters expect it will continue to ease going into 2023.

Risk from inflation now comes from several sources, and a number of macro factors may remain in the long term.

Due to geopolitical tensions, globalization may be slowing, thus negatively affecting economic growth.

Significant challenges with respect to energy infrastructure exist — particularly in Europe, which is undergoing a significant energy crisis due to conflict-driven sanctions.

There remains the risk of a so-called wage-price spiral, where wages increase due to higher prices, although the risk of this happening is still lower than in the 1970s.

Trends in the pricing of consumer electronics seem to be changing. Decreasing consumer technology prices have long been an "anchor" for inflation, but this may play out differently in the future.

All of this means that inflationary forces may be around for a few more years. Your portfolio should be structured to handle more than just the "base case." It should be able to navigate different inflationary regimes. An examination of the lessons of the 1970s may be in order, along with selecting investments that provide long-term, inflation-sensitive revenues.

Find operational alpha

In an environment where predictable returns are difficult to come by, you must look for them in every possible place — including within your own processes. In an uncertain economic environment, plan sponsors have their hands full managing their businesses and making plans for the future and may not have time to maximize returns on their investments.

Finding the right partner to manage your investments can be an important source of efficiency as this allows you to rededicate your resources to managing your business — and your partner can ensure that your portfolio is performing at its peak. Further, the pooled purchasing power of a large organization like Mercer can help reduce your costs.

Position to transition

Climate-driven weather events have made headlines in Canada, and these show no signs of abating. Climate change is now an economic fact and presents a systemic risk to investors' portfolios. Though all investors will be at different points in their transitions, they must have transition plans.

This means integrating ESG factors into portfolio management — to both reduce climate risk and identify potential opportunities that may arise as the world transitions away from fossil fuels.

Climate change is now an economic fact and presents a systemic risk to investors' portfolios.

Consider an alternative approach

Interest rates may no longer be at their historical lows, but there is still a strong case for investment in alternative assets and private markets.

In a volatile market, private assets are better positioned to capture the long-term opportunities that exist — such as innovation.

Certain alternative investments, such as real assets or infrastructure, can provide some protection against inflation and volatility — either through the nature of their business model or the fact that they provide a welcome relief from the rollercoaster of the public markets. Liquidity may be a concern, but liquidity is less pressing for pension funds, which tend to have very long time horizons and can plan cash flows many years into the future.

Be aware of the investment environment. Where you see opportunities, private markets may be a way to profit. Options are available that can help you assess your risk and choose the right option.

Update your assumptions

As globalization stalls and employers and employees react to or are affected by this or developments with inflation, market performance and public health, now may also be the time to ensure your plan's assumptions reflect the world we live in. Do demographic factors such as mortality, average retirement age and years worked still hold? Mercer has launched an enhanced version of our mortality model that provides timely insights, and further pension industry research is underway.

It may be time to perform an experience study to ensure your assumptions are up to date and that you're ready for whatever comes next.

Plan governance

Many Canadian regulators — among them the Financial Services Regulatory Authority of Ontario and the Canadian Association of Pension Supervisory Authorities — have signalled that governance expectations are increasing for plan sponsors. Plan sponsors are expected to establish a governance framework and document it in a formal policy.

Development of these policies isn't just for the purpose of checking a box. These ensure that roles and responsibilities are well understood, that there are processes in place to manage risk and enhance outcomes, and that plan members will be able to receive the benefits to which they're entitled.

Now isn't the time to fall behind. Review your plan governance — and if you need to bring your plans up to speed, contact your Mercer consultant today.

Contact us

To learn more about how we can help make your defined benefit plan ready for the uncertain year ahead, contact your Mercer consultant today.

Reshaping the future

About Mercer

At Mercer, we believe in building brighter futures.

Together, we're redefining the world of work, reshaping retirement and investment outcomes, and unlocking real health and wellbeing. We do this by meeting the needs of today and tomorrow. By understanding the data and applying it with a human touch. And by turning ideas into action to spark positive change.

For more than 75 years, we've been providing trusted advice and solutions to build healthier and more sustainable futures for our clients, colleagues and communities.

Welcome to a world where empathy and economics make a difference in people's lives.

Welcome to brighter.

For further information, please visit www.mercer.ca.

Join the conversation

@MercerCanada Mercer Canada

How we can help

Continuously rethinking purpose and priorities drives HR transformation. Shaping the future of work requires improved strategies around investment and retirement, health and wellness benefits, talent and communications. We believe in the value of investing in the future to build resilience for your business and your employees.

Investments and retirement require sophisticated solutions. We approach these with a big-picture view that prioritizes long-term financial wellness. We offer research and advice on assessing risk and designing benefits programs while keeping in mind the need to optimize throughout changing times.

A business of Marsh McLennan