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## Two paths, one destination

### Helping to decide whether to de-risk internally or fully transfer pension risk

Fixed income yields rose during the second half of 2016, and rate-rise expectations remain strong in 2017. In the pension world, the recent increase in yields coupled with the tailwind of last year's favourable equity performance, have helped plans achieve a more favourable funded status.

However, despite improved funding positions, pension plans may still face significant headwinds as market volatility remains a real threat. Therefore, many plan sponsors are looking at ways to address pension risk. Plans have a few options when it comes to pension risk management, including plan design changes, a partial risk transfer through an annuity buy in, a full pension buyout through annuitization or de-risking internally. The main consideration is whether to fully transfer the risk or not. This cost/benefit decision is very plan-sponsor specific and requires the de-risking team (client, consultant and asset manager) to work closely together to explore all options and understand associated costs. In this article we explore the merits and costs of transferring risk versus retaining and managing it.

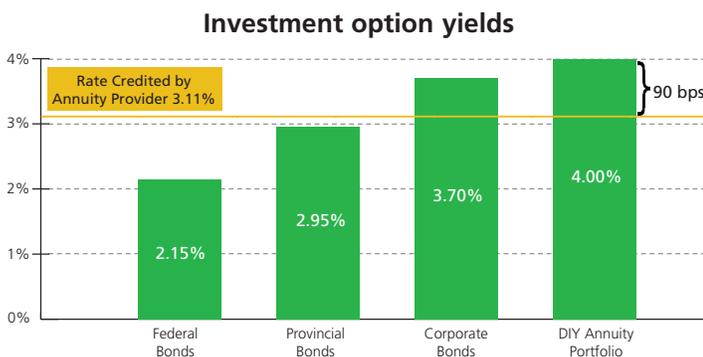
### De-risking through annuitization

For many plan sponsors, the costs associated with a full pension buyout have been an obstacle to transacting. Evaluating the cost of annuitization is relative. For some, "cost" is relative to the plan's funded status. If a plan is fully funded (or slightly overfunded) on a solvency valuation basis, then annuities are viewed as fair value and plan sponsors are more willing to annuitize. This is generally easy to evaluate. For others, "cost" is relative to the risk adjusted return proposition. Plan sponsors with that view think about the economic or opportunity cost of purchasing annuities versus how they could otherwise invest their plan assets while minimizing the risk retained. This is a little more difficult to evaluate.



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The general lack of transparency on annuity pricing requires plan sponsors or their consultants to perform periodic price discovery directly with providers. They can also use the data collected and published quarterly by the Canadian Institute of Actuaries ("CIA"). This data includes actual annuity purchases that have taken place and bona fide annuity quotations where the purchase does not take place, both of which inform the guidance the CIA provides around proxy annuity rates. For example, at December 31, 2016, the three most competitive annuity providers quoted an illustrative medium duration (duration 11.0), non-indexed group of annuitants at an average credited rate of 3.11%. This data allows for a comparison to other investment instruments/options as shown in the chart below. For a plan sponsor considering purchasing an annuity for a similar duration profile group of plan members, the 3.11% rate would be equivalent to the yield they could expect to earn by investing in a fairly conservative liability matching portfolio of 80% provincial bonds and 20% corporate bonds.



Source: TD Asset Management. As of December 31, 2016.

**Rationalizing the rate**

To better understand the rates annuity providers are willing to offer the plan sponsor, it is important to understand their risk management model. Life insurers tend to place a high priority on minimizing short term earnings volatility. For example, Canadian insurers are required to perform periodic tests to ensure that the expected cash flows from their investment portfolios will sufficiently meet their expected liability obligations. To the extent that the insurers are not perfectly cash flow matched, they are exposed to costly reinvestment and/or disinvestment risk.

In addition, regulators require insurers to hold additional capital (surplus assets) to ensure the company can remain solvent in future, potentially stressful environments. To mitigate these risks, life insurers generally adopt strict cash flow matching (or slightly less onerous key-rate duration matching) strategies composed of fixed income or liability hedging assets only. Because return-seeking assets, such as equities, do not have liability cash flow matching properties and attract significant additional regulatory capital requirements, they are generally excluded from a life insurer's asset mix.

Since insurance companies operate within smaller risk budgets, portfolios are constructed with prudence and conservatism. As a result, this low tolerance for volatility may be passed along in their product pricing. Consider again the plan sponsor seeking to purchase the medium duration group annuity. As shown in Chart 1, if the annuity provider were to invest in a combination of public bonds and private debt, they may be able to earn a yield of approximately 4.00 %<sup>1</sup>. From the insurer's perspective, the 90 bps difference between what they earn and what they credited to the plan sponsor is required to cover expenses, asset defaults, profit margins and capital charges. From the perspective of a plan sponsor who is comfortable with risk, but would also consider the purchase or exchange \$100mm worth of plan assets for these annuities, this represents an opportunity cost of approximately \$10mm<sup>2</sup>.

The question for the plan sponsor, in terms of economic costs, is then: "Can I invest directly in the same assets as the annuity providers?" Or put differently, "How can I do this myself?"

**The impact of LICAT**

On January 1, 2018 a new regulatory capital regime (LICAT) comes into effect for insurance companies that amongst other things significantly increases the capital insurers are required to hold when investing in long term assets<sup>3</sup>. Against this backdrop, an important question to ask is how much more expensive will annuities become as providers look to offset the increased OSFI capital requirements?

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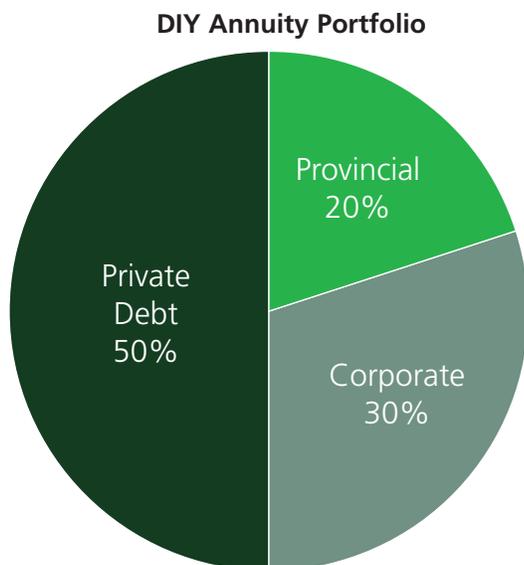
**A Do-it-yourself annuity portfolio**

While plan sponsors have long had access to assets such as commercial mortgages, real estate and equities, the high-barrier-to-entry primary ingredient in an insurer's annuity portfolio is private debt. Fortunately, improved access to private debt, through vehicles like pool fund trusts, means that plan sponsors can build their own annuity portfolio—a do-it-yourself (DIY) annuity portfolio, sometimes referred to as a "hibernation" portfolio<sup>4</sup>.

Since the group payout annuity has no surrender, withdrawal or portability features, annuity providers typically match these illiquid liabilities with a high allocation to illiquid credit. If a plan sponsor were to structure their plan's assets similarly, it might look something like the chart below:

- 50% private debt to harvest long-term illiquidity premiums
- 30% public corporate debt
- 20% provincial bonds & strips for rebalancing liquidity and long tail protection

The obvious benefit to creating a DIY annuity portfolio is that a plan sponsor can save the \$10mm opportunity cost. The other benefit is that the savings can be used to help manage the harder to hedge, longer duration actives and/or deferred vested liabilities that often remain after annuitization.



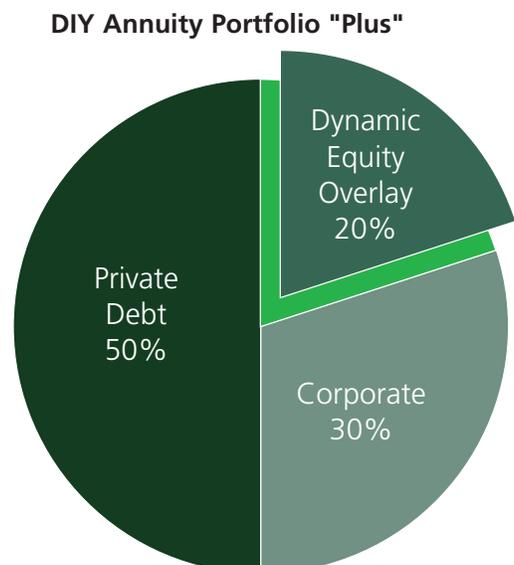
Source: TD Asset Management. For illustrative purposes only.

**A tailored strategy**

The other benefit of the DIY annuity portfolio is that there is flexibility to "right risk" the portfolio as part of a more tailored strategy. This allows the plan sponsor to change the investment strategy or amount of risk in the future. For example, if a plan is looking for additional growth to, say, close a funding deficit or perhaps pre-fund future longevity costs, there may be some appetite for a limited amount of risk taken in a disciplined fashion.

To this end, an interesting way to tailor the strategy is to create a DIY annuity portfolio with a dynamic equity overlay ("DIY annuity portfolio Plus"). By implementing an equity overlay where gains are periodically/tactically harvested and redeployed to the DIY annuity portfolio, a plan could continue to seek the benefits of an appreciating equity market while the plan's underlying liabilities enjoy a high degree of protection.

While a buy-in annuity may be viewed as part of the asset portfolio, it unfortunately cannot be used as collateral for any sort of overlay. However, when the plan continues to own the assets of the DIY annuity portfolio, overlays remain possible. The DIY annuity portfolio Plus strategy can easily be integrated into a broader de-risking glide path strategy allowing the plan sponsors the ability to adjust the size of the equity exposure over time.



Source: TD Asset Management. For illustrative purposes only.

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**Preparing for a full pension risk transfer**

Despite the benefits of a DIY annuity portfolio, for some plan sponsors who have weathered years of funded status volatility and costly contributions, the simplicity of transferring risk to an annuity provider is attractive. However, protecting capital throughout this risk transfer is critical, and each of the sponsor, risk-transfer consultant, annuity provider and asset manager play important roles. There are three basics steps in helping a plan sponsor prepare for a risk transfer and preserve plan assets:

1. Build buyout aware portfolios
2. Transition portfolios to a liquid annuity ready state
3. Liquidate portfolios or execute in-kind asset transfers to annuity providers

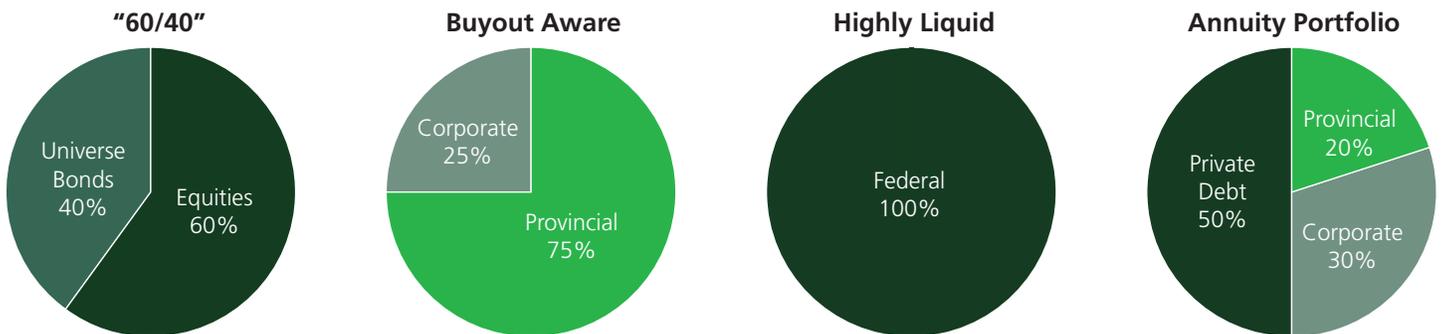
Trying to perform a risk transfer when a plan has a high equity allocation is problematic as there is little alignment between the market sensitivity of the sponsor's assets and the price of an annuity. Plan sponsors should evaluate the annuity purchase from a position of solid footing. At TD Asset Management, our investment philosophy for building buyout aware portfolios, which are better aligned with annuity pricing, is to utilize a segregated portfolio where assets are managed directly to the plan's underlying

liability cash flows. Moreover, we believe in employing active credit security selection of provincial and corporate bonds to keep pace with the expected liability growth assuming solvency growth rates.

In addition we exercise pragmatism recognizing that actuarial solvency guidance contains many market inconsistent assumptions and overly precise asset portfolios can be fallacious and/or prohibitively expensive, potentially eroding a plan's funded position. During the process, we can also seek to reduce costs on behalf of the sponsor by:

- Maximizing the use of existing securities in building the buyout aware portfolio thus reducing transaction costs
- De-emphasizing less liquid securities with larger bid/ask spreads
- Cash flow matching only the most near-term plan liability payments to reduce risk of having to sell assets in potentially adverse market conditions
- Accessing liquidity through cross-trading
- Executing in a fashion to minimize market disruption

**Buyout ready portfolios**



Source: TD Asset Management. For illustrative purposes only.

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As the annuity purchase draws nearer, we believe a checklist approach can help ensure a smooth process:

<b>Annuity Purchase Checklist</b>	
<b>Early in the Process</b>	
✓	Analyze plan liability characteristics and set liability benchmark
✓	'Steady' portfolio by reducing equity exposure and restructure a buyout aware portfolio relative to the agreed upon liability benchmark
✓	Provide plan sponsor with frequent and clear reporting of assets relative to underlying liabilities to make their governance role as administrator easier
<b>Closer to the purchase date</b>	
✓	Perform price discovery with annuity providers
✓	Provide potential annuity providers with in kind asset basket for evaluation as they compete for the plan sponsors' business
✓	Transition Buyout Aware portfolio to a highly liquid portfolio and make appropriate investment management agreement changes
✓	Days prior to annuity purchase finalize asset listing , halt trading and prepare custodian teams
<b>On purchase date</b>	
✓	Asset manager liquidates portfolio or initiates the in-kind transfer while mindful of settlement dates

### **The benefit of choice**

Whether plan sponsors choose to de-risk internally and effectively manage the risk in a DIY annuity portfolio, or fully transfer pension risk, significant thought and preparation is vital to properly prepare and take advantage of market opportunities as they arise. Through effective collaboration with their consultants and asset managers, plan sponsors will have the opportunity to maximize the benefits from the path they have chosen. ■

<sup>1</sup>Based on indicative data using TD Emerald Private Debt PFT and TD Emerald Long Private Debt PFT

<sup>2</sup>Approximated as \$100mm x 89bps x 11 years duration.

<sup>3</sup>Effective January 1, 2018, the OSFI Life Insurance Capital Adequacy Test (LICAT) guideline will replace the Minimum Continuing Capital and Surplus Requirements (MCCSR) Guideline, in place since 1992. For example, under MCCSR where a rating is not available for a long-term bond or private placement, from a specified rating agency, the factor used should be based on the insurer's internal rating. The minimum factor that may be used is generally 2%. For example, under LICAT if it is not possible to infer a rating for a bond or loan the risk factor to be used is 6%.

<sup>4</sup>A do -it-yourself annuity portfolio can be augmented with longevity risk protection for an even more comprehensive solution.

## Staff updates

Additions	Prior experience	Date
Vikram Thirukkonda Programmer/Analyst, Quantitative Equity	Programmer at an IT service provider	2/2017

Departures	Reason	Date
Tim Thompson, CFA Chief Operating Officer	Transfer to TD Personal Banking	1/2017
Anish Chopra, CFA Managing Director, Head of Innovative Solutions	Reorganization	1/2017
Anita Bruinsma, CFA Vice President & Director, Analyst — Canadian Equity	Transfer to TD Investor Relations	2/2017
Jonathan Shui Vice President & Director, Portfolio Manager — Target Return	To pursue another career opportunity	2/2017

## Products updates

Fund Launches	Date
TD <i>Emerald</i> Low Volatility Global Equity Non-Taxable Investor PFT	Trust Established on January 1, 2017
TD <i>Emerald</i> Global Equity Index Non-Taxable Investor PFT	Trust Established on March 31, 2017

Fund Closures	Date
TD <i>Emerald</i> Real Return Bond Overlay PFT	Effective February 8, 2017
TD <i>Emerald</i> Low Volatility Plus Canadian Equity PFT	Effective March 31, 2017
TD <i>Emerald</i> U.S. All Cap Value Equity PFT	Effective March 31, 2017
TD <i>Emerald</i> U.S. Large Cap Value Equity PFT	Effective March 31, 2017

## Industry Outlook: Articles to read

Click on the title below to view the article

**[The Trump Tailwinds, Forward Perspectives](#)**

*By: Bruce Cooper, CFA, CEO, CIO, TD Asset Management, March 2017*

**[Trump and Trade: What are the Risks? Epoch Investment Partners](#)**

*By: William W. Priest, CFA, CEO, Co-CIO, Portfolio Manager and Kevin Hebner, PHD, Managing Director, Global Portfolio Management, Epoch, February 2017*

**[Muting the noise around low volatility equity strategies](#)**

*January 2017*

**[Vox Populi: In 2017 the Eurozone Will Bend, But Not Break, Epoch Investment Partners](#)**

*By: William W. Priest, CFA, CEO, Co-CIO, Portfolio Manager and Kevin Hebner, PHD, Managing Director, Global Portfolio Management, Epoch, January 2017*

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Telephone: 1-888-834-6339 E-mail: [inst.info@tdam.com](mailto:inst.info@tdam.com)

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