DEVELOPING A STATEMENT OF
INVESTMENT POLICIES AND GOALS
FOR PENSION PLANS

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Introduction

The purpose of this paper is to stimulate discussion on the process for developing a statement of investment policies and goals for pension plans, and the role of the consulting actuary in such a process.

Recent legislation in Ontario, soon to be followed by similar legislation in other provinces, requires pension plan sponsors to prepare a statement of investment policies and goals which must be filed with the regulatory authorities and reviewed annually.

Pension plan sponsors may elect to develop the statement themselves, or they may seek outside assistance from their pension fund manager or consulting actuary. In practice, relatively few plan sponsors have the internal resources to develop the statement themselves and consequently most sponsors turn to outside help. In the author's experience, many pension fund managers have been reluctant to undertake this task for fear of conflict of interest, and consequently the burden of preparing the statements has largely fallen on the consulting actuary.

An opportunity exists to establish a set of investment policies and goals which will not only satisfy the new legislative requirements but will also meet the financial needs of the plan sponsor. In some cases, the investment policies that have been developed to date have ignored the overall financial planning of the plan sponsor.

A careful review of the investment process would include the following steps:

1. Establish objectives for the investment of the pension fund.

2. Develop an outline of the investment policy and goals.

3. Test the investment policy outline using asset modelling.

4. Implement investment policy.

5. File the statement of investment policy and goals with the regulatory authorities and notify the persons affected.

6. Monitor investment policy and performance.

This paper addresses steps 1 and 2 only. Steps 3 and 6 are subjects of interest to consulting actuaries that deserve separate treatment and are considered outside the scope of this paper.

Background

Prior to January 1, 1988, pension fund investment in Ontario was regulated by legislation which prescribed specific quality and quantity tests for investments, and limits known as "basket clauses" for investments not meeting the quality tests. The legislation also sets out certain prohibitions and exceptions (for example on conflict of interest). This approach was often referred to as the "legal for life" approach for the following reason.

The authorized list of investments for pension funds was largely adopted from the list of investments and loans legal for life insurance companies registered under the Canadian and British Insurance Companies Act. However the limit of 25% in equities does not apply to pension funds. The legislation which has governed insurance company investment policy since the late 19th century has emphasized both quality and security of investments. Over time the legislation has been strengthened. In particular, in the early 1930's restrictions were placed on equity investment in response to the financial crisis encountered by a major life insurance company as a result of the stock market crash.

The Ontario Pension Benefits Act, 1987, represents a significant departure in investment policy and regulatory requirements from previous legislation. The authorities perceived the former "legal for life" approach to pension plan investment as too restrictive and not conducive to modern portfolio management. Through consultation with plan sponsors and the investment industry, more efficient investment policies and rules have been adopted which allow for an expanded range of investment opportunities. Relaxation of the investment rules, however, has been balanced by new requirements for prudence and greater disclosure to members.

Under the "modern portfolio" approach the selection of investments is made with consideration given to the overall context of the investment portfolio. There should be no undue risk of loss or impairment and a reasonable expectation of fair return or appreciation given the nature of the investment. Thus the prudence of any investment is judged in the context of the entire portfolio. An investment which might be considered too risky on its own, might be prudent if balanced against a very conservative investment held in the portfolio.

The concept of prudence in the Act provides that the administrator "shall exercise the care, diligence and skill in the administration and investment of the pension fund that a person of ordinary prudence would exercise in dealing with the property of another person". This responsibility extends to decisions of the administrator's agents, including the investment manager, custodian, professional adviser or anyone else involved in the administration of the plan.

Under the rules, most pension plans registered in Ontario are required to file a statement of investment policies and goals. Minimum requirements for the statement are prescribed in the regulations. Once the statement is established, the administrator must consider the investment policy, and either confirm or alter it at least annually, in light of changing pension plan priorities.

The adoption of a clear policy applies to both defined benefit plans and defined contribution plans. In the latter case, the authorities have taken the view that whether or not the plan provides that members may elect how their contributions are invested, the administrator has an obligation to carefully monitor fund performance and report results to members.

The rules also apply to smaller plans whose funds are invested in pooled or segregated funds offered by financial institutions, although the filing requirements are somewhat simplified. For this purpose, a central registry has been established and a pooled fund vendor is requested to deposit the pooled fund document with the Pension Commission of Ontario to be placed in the central registry. The plan administrator in developing the required statement can refer to the pooled fund document without repeating or describing the contents of the document.

Members of a plan will have access to the investment policy statement, any amendment to that statement, and receipt of the financial reports of the fund. The statement provides a means for administrators and plan members to measure and monitor performance against stated expectations.

The current attitude of the Pension Commission is that they intend to scrutinize the rate of return and the administrator may be called upon to defend policies if the return is lower than "normal". The regulatory authorities are feeling their way with the new rules, and the pension industry can expect changes in the regulations to address any abuses or changing conditions.

<u>Developing An Investment Policy Statement</u>

Pension plan finance is an integral part of corporate finance. In recent years, pension finance and pension asset investment policy have received greater attention in corporate financial considerations for the following reasons:

- As a result of the accumulation of contributions and favourable investment returns, pension funds are greater relative to corporate assets.

- Maturity of the pension plan membership causes pension cost to become a more significant part of the operational cost of the plan sponsor.

- Recent market volatility has raised concerns of management about the investment of pension assets.

- Accounting rules create a direct link between the pension expense shown in the employer's financial statements and investment performance of the pension fund.

- Since the solvency valuations required by pension plan legislation introduce a heavy penalty on underfunded plans, the level of contributions is directly affected by investment performance.

- Pressure from the investment industry to widen the allowable range of pension fund investments and raise the 10% foreign investment limit.

- New financial vehicles allow greater flexibility in investment choices.

In the absence of a written policy statement by the plan sponsor, most investment managers in Canada have a uniform policy for investing the assets of their pension clients. It is only through a properly developed statement that the characteristics and needs of the plan sponsor can be identified and addressed.

The establishment of objectives and policy is a fundamental process which corporations follow in their daily operations. Applying this process to pension plan assets ensures that the correct investment decisions are being made. In addition, it establishes the rules under which the investment manager will operate and how the manager's performance will be measured.

It is important that the investment manager has input into the development of the statement of investment policies and goals. The manager may participate throughout the process or review a preliminary statement developed by the plan sponsor before it is finalized.

One approach to developing an investment policy statement, which has worked well in practice, is outlined below. The key steps are:

- Determine risk posture of plan sponsor.
- Examine pension plan characteristics.
- Set over-all investment objectives and constraints.
- Review asset classes and their characteristics.
- Prepare investment policy statement.

A fundamental principle of investment theory is that, over long periods of time, there is a positive relationship between the level of risk assumed and the level of return likely to be earned by the investor. In other words, the higher the risk the higher the expected return. For example, historically stocks have produced a higher return than bonds, but these returns have been more volatile (i.e. riskier). Appendix A to this paper provides information on rates of return in the Canadian investment markets.

The cumulative effect of investment performance on the ultimate cost to the pension plan sponsor is very significant. A rule-of-thumb, well known by actuaries, is that a 1% increase in annual return over very long periods of time can reduce the ultimate pension cost by about 20%.

Thus, the expected rate of return depends on the asset mix which in turn depends on the risk tolerance of the plan sponsor.

There are three key factors that affect the risk tolerance of an organization in its pension investment program:

- Financial characteristics.
  What is the financial outlook for the organization? How strong is its balance sheet? Does it expect favourable revenue and profit growth? Are revenue and profits volatile? Are pension plan contributions significant relative to total expenses? Are major pension plan improvements planned in the foreseeable future?

- Demographic characteristics.
  What are the current demographics? How will this change in future? Is any re-structuring of the workforce planned? Is the termination and retirement pattern likely to change? What pay increases are expected in the near-term, long-term?

- Actuarial/funding characteristics.
  How strong are the actuarial assumptions? What is the type of plan? What is the relationship between assets and liabilities (ongoing, solvency, expensing basis?). What is the future policy regarding these relationships?

Examination of questions such as those outlined above will help the plan sponsor determine its risk tolerance, i.e., its ability to take risk. The next step would be to explore how much risk the plan sponsor is <u>willing</u> to take in the investment of pension assets. How comfortable is it in taking risks and at what level? What are its attitudes towards taking investment losses, protecting plan assets, and predictability/variability of investment return?

Having determined the risk posture of the plan sponsor, the process could then move on to determining the over-all investment objectives and constraints. It is important that the rate of return goal be meaningful and measurable. Bearing in mind the risk posture of the plan sponsor, what is the rate of return goal? Should the goal be expressed in real and/or nominal terms? Over what period of time should the rate of return be achieved? Should the rate of return be measured relative to a passive portfolio or pension fund universe? Are there any restricted/prohibited investments?

At this stage, the process would review asset classes and their characteristics. Some of the asset classes that might be considered are:

- Stocks - common and preferred
- Bonds - federal, provincial, municipal and industrial
- Cash equivalents
- Mortgages
- Real Estate and Leasebacks
- Non-Canadian equities and bonds
- Venture capital
- Pooled and mutual funds.

In each category the plan sponsor might want to determine the type of investment to be used, any constraints, quality rating of investment, and minimum/maximum percentages of the fund. Historical and trend data might be utilized for this purpose.

Any legislative restrictions would have to be respected. The Ontario regulations place limits on the amount that may be invested in any single investment, investment in real estate or resource properties, mortgage investments, and investments representing more than 30% of the voting shares in an corporation. Not more than 10% of the fund may be invested or loaned to any one corporation.

A plan sponsor subject to Ontario legislation would also have to determine policy with respect to:

- Policy to be followed if there were an actual or perceived conflict of interest.
- Lending of cash or securities.
- Retention or delegation of voting rights.
- Basis for valuation of investments not regularly traded.
- Investment in futures and options.

A comprehensive review might also include the following:

- Delegation of responsibility.
  Who has responsibility for hiring/discharging fund managers, actuaries, performance measurers, etc.? Who is responsible for the administration and interpretation of plans? Who is responsible for maintaining a written record of meetings?
- Choice of investment vehicle.
  How frequently should meetings be held with the investment manager? What should be included in the agenda for the investment meetings? Who is responsible for maintaining a written record of meetings? How should investment performance be reviewed (frequency, standards)?
- The role and responsibility of any advisory committee appointed under the Act.

The above discussion has outlined in some detail one approach to developing a policy statement. Modification to the approach would be necessary, for example, if the investment manager is given full discretion. Also in the case of defined contribution plans where the emphasis would shift from plan sponsor considerations to member considerations.

Contents of Statement of Investment Policies and Goals

The Ontario regulatory authorities have prescribed the minimum contents for the statement of investment policies and goals. The statement must detail the plan's policies on at least the following items:

- Type of pension plan
- Nature of plan liabilities
- Portfolio diversification
- Asset mix policy
- Rate-of-return expectations
- Allowable investments and loans
- Conflict-of-interest disclosure
- Securities or cash lending
- Retention/delegation of voting rights
- Valuing not-regularly-traded assets.

The fund investment manager can only invest in investments and loans that are specifically permitted and for which guidelines are established in the statement of investment policies and goals. Therefore, it would be advisable to make the statement as broad as possible so as not to inhibit the investment opportunities for the plan assets.

Each plan sponsor will have to decide how much detail should be provided in the statement filed with the regulatory authorities. The plan sponsor may decide to file basic information and have a more detailed statement for internal purposes. In any event, the plan sponsor may wish to document separately the sensitive information with respect to company philosophy and economic outlook and the rationale for the decisions that went into the development of risk tolerance. Appendix B to this paper provides an example of a statement filed with the regulatory authorities by one employer.

Conclusion

A new flexibility exists for pension fund investors in Ontario. No longer are they confined to the restrictions and artificialities of the former system. However, with this flexibility comes new obligations and some uncertainties. These uncertainties arise in knowing what the attitudes of regulators and judges will be to the prudent person rule. Over time these attitudes will become clearer as specific practice emerges. In any event, the new system should result in the better management of pension fund investments for the benefit of plan members and plan sponsors. However, some critics argue that the new system will benefit only consultants and paper manufacturers!

APPENDIX A

Average Annual Compound Percentage Rates of Change/Return for Selected Intervals.

Period	Consumer Price Index	Wage and Salary Index	Canada Common Stock Index	Canada Long Bonds	Provincial Bonds	Industrial Bonds	Conventional Mortgage Index	91 Day T-Bills	Real Estate Index
60 Yrs 1929-1988	3.51	5.32	9.04	4.92					
50 Yrs 1939-1988	4.60	6.39	11.01	4.69					
25 Yrs 1964-1988	6.14	7.60	10.65	6.92	7.62	7.86	9.54	8.48	
15 Yrs 1974-1988	7.48	7.91	11.75	9.05	10.14	10.36	12.41	10.81	13.71
10 Yrs 1979-1988	6.68	6.58	14.23	11.00	11.67	11.74	13.43	12.07	13.53
5 Yrs 1984-1988	4.08	3.60	9.36	13.46	14.64	14.10	12.53	9.94	13.38

Standard Deviations of Annual Percentage Rates of Change/Return for Selected Intervals

Period	Consumer Price Index	Wage and Salary Index	Canada Common Stock Index	Canada Long Bonds	Provincial Bonds	Industrial Bonds	Conventional Mortgage Index	91 Day T-Bills	Real Estate Index
60 Yrs 1929-1988	4.64	3.97	19.20	8.44					
50 Yrs 1939-1988	3.84	3.12	16.82	8.72					
25 Yrs 1964-1988	3.25	3.15	16.11	11.09	11.03	10.41	6.74	3.97	
15 Yrs 1974-1988	3.22	3.86	18.31	12.67	12.54	12.01	6.24	3.40	6.17
10 Yrs 1979-1988	3.41	3.44	17.64	14.36	14.17	13.20	6.91	3.52	7.33
5 Yrs 1984-1988	0.22	0.72	9.99	9.17	9.12	7.30	7.30	1.28	2.63

SOURCE: REPORT ON CANADIAN ECONOMIC STATISTICS, 1924-1988
CANADIAN INSTITUTE OF ACTUARIES

APPENDIX B

Pension Plan for Salaried Employees of XYZ Company Limited

Statement of Investment Policies & Goals for the Pension Fund

Purpose

The Purpose of the Statement of Investment Policies & Goals for the Pension Fund is to set out the framework under which the assets of the Pension Plan for Salaried Employees of XYZ Company Limited are to be invested. The Statement has been prepared in accordance with the Ontario Pension Benefits Act, 1987 and its Regulations.

The XYZ Company Limited is the Plan sponsor and the legal Administrator of the Plan. For all matters related to the investment administration of the Fund, the Company relies on the advice of the Investment Committee. Independent counselling firms act as agents of the Company in the day-to-day management of the Pension Fund in accordance with this policy. Each investment manager shall adhere to this policy and shall follow the investment policies and goals with the care, diligence, and skill that a person of ordinary prudence would use in dealing with the property of another and shall use all relevant knowledge and skill that the investment manager possesses or ought to possess. Each investment manager shall not knowingly permit its interest to conflict with its powers and duties with respect to the investment of the assets of the Plan. The Trustee/Custodian is a major Canadian trust Company.

Profile of the Pension Plan

(i) Type of Pension Plan

The Pension Plan for Salaried Employees of XYZ Company Limited (the Plan) is a contributory defined benefit plan. The Plan provides an annual benefit equal to years of participation times the sum of (a) and (b) below:

(a) 1.4% of final average salary (last 36 months) up to the 3-year average of the Year's Maximum Pensionable Earnings (YMPE).

(b) 2% of final average salary in excess of the 3-year YMPE.

Required member contributions under the Plan each year are 3.5% of salary up to the YMPE, plus 5% of salary in excess of YMPE.

Additional voluntary employee contributions are permitted under the Plan and deposited in a separate investment vehicle.

Pensions in payment under the Plan are increased each year by an amount equal to 60% of the annual increase in the Consumer Price Index (CPI).

(ii) Nature of Plan Liabilities

As of ________________, the going concern liability of the Plan was $______ million while the market value of assets was $______ million. Approximately 68% was related to active members, with another 30% related to retired members. The remaining liability was attributable to terminated vested members. On a wind-up basis the assets are substantially in excess of the liabilities.

The going concern liabilities are influenced by salary increases, CPI increases, turnover, mortality, and retirement age patterns. Appropriate allowance is made for these factors in the assumptions used for actuarial valuation purposes and it is not expected that actual experience will vary significantly from the assumptions used, in the long term. In the foreseeable future, there will be no special liquidity demands on the fund.

Given the above, a moderate risk investment policy is acceptable.

(iii) Plan Demographics

As of __________________________, the date of the latest actuarial valuation, there were _______ active members ________ retired members, and ________ terminated members. The average age of active members was _____ years, average service _____ years, and average compensation $________.

Objective of the Fund

The objective of the Pension Fund is to provide participants in the Plan with retirement benefits as described in the Plan documents. To this end, the assets of the Fund shall be invested in a manner to achieve the maximum total rate of return through a combination of capital appreciation and current income subject to diversification and quality standards established hereunder.

Asset Mix Guidelines

The Fund is to be invested within the following asset mix ratios (based on market values):

	Minimum	Maximum
Equity securities (including convertible bonds, and preferred stocks)	35%	65%
Fixed Income Securities (maturing beyond one year)	30%	50%
Short-term investments and cash equivalents	0%	20%

Categories

Within the above asset mix guidelines, the following specialized categories of securities may be purchased up to the maximum shown opposite (expressed as a percentage of the market value of the total fund).

Equity and equity-related securities subject to the following limitations:

Foreign common stocks -	maximum permitted under Revenue Canada regulations without incurring a penalty
Venture capital -	5%
Real Estate -	10%
Resources properties -	10%

Fixed income and debt-related securities:

Foreign pay bonds, debentures, notes,- etc. of foreign debtors	difference between maximum permitted under Revenue Canada regulations and foreign common stocks held in the Fund.
Foreign pay bonds, debentures, notes,- etc. of Canadian debtors	10%
Mortgages	15%

Minimum Quality Standards for Bonds, Debentures, Notes, etc.

Corporate Bonds, debentures and other debt securities purchased for the Fund shall have a rating of "BBB" or better or the equivalent thereof according to a recognized bond rating service. In the case of private placements not rated by a recognized bond rating service, the manager shall apply standards consistent with a minimum BBB rating.

Short-term notes and other evidences or indebtedness of corporations, banks and trusts companies shall have a R-1 or the equivalent thereof according to a recognized bond rating service.

Investment Restrictions

Within the overall objectives and the asset mix policy described above, each investment manager shall not, without the specific written consent of the Investment Committee:

(i) invest more than 10% of the market value of the fund under his control in the securities of a single issuer or group of affiliated issuers;

(ii) purchase more than 30% of the voting shares of any one corporation;

(iii) invest more than 7% of the market value of the common stock portfolio under his control in the common stock of any one company;

(iv) invest more than 50% of the market value of the common stock portfolio under his control in any one industry or group of companies forming a sub-index of the Toronto Stock Exchange 300 Index;

(v) underwrite securities;

(vi) borrow money for the purpose of purchasing securities;

(vii) engage in the purchase and sale of commodities or commodity contracts;

(viii) purchase securities on margin or make short sales.

Investment in any one parcel of real estate may not exceed 5% of the book value of the total fund.

Unit Trusts, Mutual & Pooled Funds & Limited Partnerships

To facilitate the investment in any of the categories or sub-categories of investments listed above, a manager of the Fund may purchase units of a trust, mutual or pooled fund or a limited partnership provided the investment policy of the entity itself is consistent with all government regulations affecting the Fund and this Policy Statement.

Derivative Investments

Derivative instruments such as options and forward contracts may be used by the managers or the Fund in the course of implementing the Fund's asset mix policy.

Securities Lending

The securities of the Pension Fund may be loaned to investment dealers and banks when it is deemed that such lending may add to the return on the Fund at minimal risk and provided the loan is secured by cash or readily marketable securities having a market value of at least 105% of the loan, maintained no less frequently than daily.

Compliance with Government Regulations

The managers of the Pension Fund, and the Trustee/Custodian, acting as agents of the Company shall ensure that all securities purchased for the Pension Fund are consistent with Ontario Regulation 708/87, Revenue Canada regulations and this Policy Statement.

Valuation of Private Placements & Other Non-traded Investments

The valuation of private placements and other infrequently traded securities shall be determined by the Trustee/Custodian of the Plan. In the case of investments in real estate and resource properties, the valuation shall be based on independent opinions of qualified appraisers.

Performance and Rate of Return Expectations

The managers of the Pension Fund are expected to achieve, over a four-year period, (i) an above-median position relative to other similar funds measured by a recognized performance measurement service, and (ii) an average annual total rate of return at least 300 basis points above the average increase in the Consumer Price Index.

Conflict of Interest Guidelines

Any employee of the Company directly or indirectly responsible for the investment activities of the Pension Funds, any employee of the external managers of the Pension Fund and any member to the Investment Committee shall immediately disclose to the Investment Committee any actual or perceived conflict of interest that could be reasonably expected to impair, or could be reasonably interpreted as impairing, his/her ability to render unbiased and objective advice or to fulfill his/her fiduciary responsibilities to act in the best interests of the beneficiaries of the Plan. A member of the Investment Committee required to make such a disclosure shall not participate in the discussion or vote on any resolution to approve a transaction in relation to which the disclosure is required.

Examples of a conflict of interest or perceived conflict of interest would include (i) the purchase of securities of a company or a fund in which the manager or his firm held a significant financial interest and (ii) the selection of a manager with whom a member of the Investment Committee had an independent business relationship.

Exercise of Proxies and Voting Rights

No proxy or other voting right associated with any of the Pension Fund investments may be exercised by the Trustee/Custodian or any of the managers without the express written consent of the Company.

Appointment of Investment Managers

The Vice-President, Administration of the Company shall appoint the manager or managers of the Fund upon the advice of the Investment Committee.

Review and Filing

This statement shall be reviewed at least once a year and either confirmed or amended as necessary. All amendments and confirmations shall be filed with the Pension Commission of Ontario within 90 days of the confirmation or amendment.

Vice-President, Administration