



Applying LDI in CAPs

PLAN SPONSORS SHOULD FOCUS ON MANAGING MEMBERS' EXPECTATIONS, NOT JUST ON BENEFITS ADEQUACY. BY CHRISTOPHER CARTWRIGHT

Whether liability driven investing (LDI) is a new idea or an old one dressed up in new jargon, it's usually associated with defined benefit (DB) plans. Does LDI make sense for capital accumulation plans (CAPs)? If so, what does it mean?

In the simplest terms, LDI means managing the assets holistically (i.e., with an eye on the liabilities). This sounds straightforward enough for a DB plan, but in a CAP, it's not always clear who is managing the assets or what the full scope of the liabilities might be. CAP members may think that HR, the fund manager or the service provider is looking after everything, but usually, the responsibility to manage the assets is shared between the plan sponsor and the member. The plan sponsor typically hires the plan's investment managers and constructs a menu of choices, including a default option. It's then up to each member to choose investments and manage them going forward.

At the member level, is LDI nothing more than setting an age-appropriate asset mix? Let's consider the ultimate liability: how much is "due" to plan members at retirement. In a DB plan, the sponsor knows exactly what is promised and what is payable at the member's retirement date. The costs may fluctuate, but they can be tracked through periodic actuarial valuations.

The promise in a CAP, however, is that a specified amount will be contributed today and set aside for the future. The amount going in is promised, not the benefits coming out. Regardless of the final outcome for the plan member, the plan sponsor fulfills this promise every pay period by depositing contributions into the member's CAP account.

But the plan's performance will also be measured against the members' expectations. Consciously or otherwise, participating employees have expectations about what the CAP will ultimately provide. These ideas may be nurtured by advertising promoting the dream retirement on a sunny beach somewhere, through repeated messages about the company's competitive retirement program, through recollections of previous DB promises or through retirement planning tools that project the best-case scenario. Regardless of how they come to be, these are real entitlements

in the minds of plan members, and they'll have a powerful impact on how well the plan's eventual payouts will be perceived.

Essentially, managing the assets holistically applies to the CAP world in two ways. For plan members, it's about matching the risks to an appropriate investment time horizon. For plan sponsors, it means balancing the plan's financial performance with the outcomes that members are expecting.

Today, most industry efforts are focused on making the investment process more effective. Improved default options and manufactured solutions, such as target date funds, are designed to avoid the disaster scenarios that would arise if contributions were left in a GIC or a money market fund for 25 or 30 years. And while taking action to improve the rate of return is a smart move, it only addresses the asset side.

Unless we also consider member expectations, we don't know much about the size of the unmanaged liabilities. And the best way to manage expectations is with knowledge. Many employees, lacking a formal financial education, don't have a good grasp of what is realistic and believe that the onus is on the employer to provide retirement savings. Employers can help by broadening their educational efforts beyond the company plan in isolation, explaining the "three-legged stool" of retirement savings—the employer, the government and the individual—and how these sources combine to create a decent retirement income.

While benefits adequacy is important, pursuing LDI in a CAP means more than just optimizing investment returns to help ensure that the CAP delivers benefits according to the plan design. The smart CAP sponsor will also use the LDI approach to proactively manage employee expectations, taking steps to bring those expectations in line with what the CAP is designed to deliver.

By managing both sides of the equation, the plan sponsor minimizes any potential gap between what is expected and what actually occurs. It may even be possible to manage expectations to the extent that the CAP over-delivers—and how satisfying it would be to receive a thank-you card, instead of a subpoena. **BC**

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