

The DC Pension Plan Investment Wilderness

By: Mark Barnicutt, MBA, CFA

Over the past year, we've spent considerable time educating ourselves about the investment alternatives available to Canadians within Defined Contribution pension plans. Having spent 20 years in the private wealth management business, designing investment programs and working with investor clients, all I can say is "WOW" ... what a complete wilderness of confusion. Like so many things in the wealth management industry today, there's a massive proliferation of product available within DC pension plans but the important questions go unanswered:

- **Employer Question:** *Are we doing the right thing?* – Are we truly meeting our responsibilities in helping employees in my firm progress towards their retirement goals?
- **Employee Question:** *Will I be OK?* – How will my DC plan contribute to my overall retirement plan in meeting my retirement income needs?

How anyone responsible for a DC Pension Plan within a corporation can sort through the myriad of investment complexities in these plans and answer these questions is a complete mystery to us!!!! Here are our candid thoughts:

The DC Pension Plan Investment Landscape

- **CAP Guidelines**

We understand that the intent behind the transition from Defined Benefit to DC plans was to transfer the liability for future retirement benefit funding from the employer to the employee, but I don't believe (despite what gets positioned in the marketplace with employers) that this ultimately means that employers have no/limited responsibility for the oversight of DC plans in answering the two questions above.

To us, the CAP guidelines are a set of 'administrative' guidelines for operating Capital Accumulation Plans. They are a baseline set of operating standards, but do not address, at all, the two questions noted above ... which are they key questions that real *stewards of wealth* would ask.

- **Investment Product Shelf**

The range of investment product options available to plan participants varies widely. One of my partners at HighView, [Paul Rainford](#), who has been in the insurance and employee benefit sector for more than 30 years, confirms that there is an inverse relationship between plan size and the number of investment options available to plan participants. Specifically, it tends to be that the smaller the plan, the greater the number of investment options, and vice versa. In my view, too much investment product choice is just as dangerous as too limited choice. Like most things in life, it's a question of balance.

Based upon our collective experiences, I'd suggest that the number of investment products (or what I'll call 'investment mandates' – Canadian Equities, Canadian Bonds, etc.) required within a given DC plan would be somewhere between eight and 12 at most! Then, depending upon the type of plan, there may be one to three different investment managers per mandate (in order to provide employees with some choice), which translates into a total of eight to 36 investment managers in total. The reason I say this is that there are only so many investment mandates needed to construct a properly diversified portfolio and then, provided proper research and due diligence (both qualitative and quantitative assessments) is completed on each investment manager, you only need a few investment managers per mandate.

- **Managed Investment Programs**

There are many packaged programs, mostly in the Fund of Fund (FOF) category. The ones that I've seen have far too many sub-funds. One FOF structure I saw had 30 sub-funds. If each sub-fund had 60 underlying securities (stocks and/or bonds), that would be almost 2,000 securities in a given client portfolio

... *that's completely insane!* The other type of managed investment structure we saw were Target Date Funds (TDFs).

The idea behind Managed Investment Programs makes sense for DC Pension Plans – provide employees with a packaged program that provides ease, simplicity and professional asset management. However, the industry needs to *get back to the basics* and focus on simplicity ... complex structures with excessive diversification (di-worse-ification) and asset-liability mismatched portfolio designs serve the marketing department (the concepts sound great!), but are completely flawed in client reality!

- **Investor Profiling Tools**

Most of the software tools for DC pension plans that enable employees to determine their financial/retirement goals are faced with the same challenges as the general Investor Profiling tools in the wealth management industry. Specifically, they do not make an effective link between the employee's financial goal (which is effectively a future liability) and the most suitable portfolio structure that matches a combination of the goal, time horizon, and individual tolerance for risk. Most of the Investor Profiling tools that we've seen use a very rudimentary five to eight questions that just don't sufficiently capture an employee's true tolerance for risk (the ups-and-downs in the capital markets) in order to help them find a portfolio structure that balances their investment objectives against risk tolerances and timelines. These tools are typically two-dimensional – they capture risk and return – but not a third dimension which is an employee's desire to 'outperform or underperform.'

- **Portfolio Monitoring**

Once a given portfolio is established for an employee, we have not seen software tools that monitor an Employee's portfolio not only against (1) progression towards their retirement goals, but also (2) movements in their portfolio structures (ie: equities versus fixed income) when portfolio valuations shift. In other words, if I establish a portfolio today with a mix of 60 per cent fixed income and 40 per cent equities, I'll want to rebalance my portfolio when the composition of its valuations shifts beyond my initial mix, say when equities or fixed income change by more than 20 per cent of their target. These are important, yet basic, tools that should be made available to all participants in an DC pension plan.

- **Fee Transparency**

Upon reviewing many of these DC pension plans over the past year, it's very difficult to truly determine – from the employee investor perspective – what the TOTAL fees are in these various plans. In our view, there seem to be so many Fund of Fund (FOF) and Multiple Managed Fund structures, and there doesn't appear to be a consistent way of reporting fees/costs across all of the various types of plans. As a result, this has created much confusion in the DC pension plan marketplace.

- **Portfolio Reporting**

The traditional reporting that we've seen in the DC pension plan segment is the standard 'Position and Transaction' account reporting that happens in the retail wealth management industry. Although some plans have Performance Reporting, no plans that we've seen incorporate a goals-based approach to Portfolio Reporting that highlights how an employee is progressing towards their pre-determine retirement goals. As the whole objective of a pension plan is to ultimately provide for a retirement income stream, this would appear to me to be a Portfolio Reporting flaw with most existing DC pension plans.

In our view, it's time for a DC pension plan investment program that addresses the real needs of plan sponsors and plan members.

DC Pension Plan Investment Recommendations

- **Stewardship**

Don't only focus on the administratively oriented CAP Guidelines and ALSO institute proper fiduciary based investment governance practices (ie: stewardship) which answers the employer question (*Are we doing the right thing?*) and the employee question (*Will I be okay?*).

- **Goals-Based**

Make a better *asset liability matching* link between an employee's retirement goals (quantified) and the resulting portfolio structure that incorporates not only return expectations, but proper time horizon and risk tolerance.

- **Simplicity**

Get back to the basics of simple and straightforward portfolio construction – stop using highly complex multiple manager/fund of fund and target date fund programs. There are only really three asset classes – equities, fixed income, and cash. Everything else is normally a variation and/or derivative of one of these three asset classes.

- **Due Diligence and Objectivity**

All investment alternatives that are placed in these DC pension plans should be properly due diligenced/ researched and be absent of any conflicts (unless properly noted) from proprietary investment product providers.

- **Transparency**

All fees and costs (total costs to the end investor/employee) should be fully disclosed and consistently done across all types of DC pension plans.

- **Accountability and Shared Responsibility**

Whoever is providing the investment advice to the sponsor of a DC pension plan should not only be fully accountable, but also share in the responsibility for the investment decisions/recommendations that they make to a given plan.

With a looming pension crisis in Canada, we believe Canadian employees would be very well-served by having a DC pension plan structure that incorporated these features. ■

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