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perspective

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Rate of Return Assumptions Hounded by Market Changes

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In a recently released Issue Brief, the Academy of Actuaries discusses the interplay of the rate of return assumption and the investment mix. Focusing on the long-term return rate assumption for pension plans, a familiar idiom comes to mind: “Don’t let the tail wag the dog.” It’s not that simple, however, as plan sponsors and service providers sometimes lose perspective on which of them is the dog. The comfortable role of actuaries is to act as the tail.

When performing valuations and projections, actuaries use assumptions related to the expected future rate of return for the pension plan’s trust of assets. In doing so, they consult with the plan’s investment advisors to ascertain the trust’s investment policy and the portfolio’s current mix. Generally, plans that are heavily invested in fixed income securities will realize lower investment returns over time, but with lower volatility, compared to plans with more equity exposure. Plans with more equities will often experience higher investment returns over time, but also higher volatility. This information, along with consultation with the plan’s investment advisors, helps the actuary determine the appropriate rate of return assumption.

Adjusting to Changing Markets

However, markets change over time and a reasonable assumption in one year may not be reasonable in a subsequent year. Also, as market conditions fluctuate, the financial implications of the actuarial projections also change.

In the current market cycle, many capital market projections are lowering future investment return expectations. As a result, actuaries are reducing the expected rate of return assumptions based on the revised capital market models. If portfolios are expected to produce less investment returns in the future, plans sponsors are concerned that they must either make additional contributions or reduce future benefits. Neither option is favorable, which often puts pressure back onto the financial advisors to look for additional returns.

Wagging the Dog

As we know, investment returns are a function of risk, and therefore, in order to generate additional returns sponsors may end up taking increased risk. Plan sponsors and financial advisors will often reach for higher returns based on the actuarial assumption that produces the desired result, in other words, letting the tail wag the dog.

This is a problematic option, as the sponsors may unsuspectingly take on more financial risk than is appropriate for the situation.

Recognize Investment Risk

Actuaries should be reviewing the long-term rate of return assumptions at regular intervals and setting those assumptions based on the investment mix. This is especially true with multiemployer and public pension plans, but it also has implications with corporate plans as well. Plan sponsors should be comfortable with the investment risk they are taking and asking their actuaries to perform sensitivity analysis as part of their projections so that investment risks can be better understood.

Findley has many tools that can help plan sponsors understand the impact of investment-related volatility, as well as the impact of favorable or unfavorable investment results. If you have any questions please contact Keith Nichols at *keith.nichols@findley.com* or *724.933.0631*