

## PENSIONS

### Still waiting for pension reform after the PRPP

Just because **Canada's public retirement system** is regarded as having an exemplary funding model and high levels of protection for low-income citizens does not mean it doesn't require major reforms. In fact, it **ranks poorly among comparable high-income countries** on other aspects. Studies conducted by the World Bank indicate it **has a limited scope** and offers **a very low percentage of pre-retirement earnings to middle-income citizens**. Moreover, a significant portion of today's retirees' income comes from **private pension plans**, which **are currently in decline**. In 2010, 67% of Canada's workforce was not covered by a private pension plan and the numbers are still shrinking.

In conclusion, there is a crisis coming from both public and private sources of retirement income. According to a study by the University of Waterloo, **two-thirds of Canadians in the private sector** earning between \$30,000 and \$100,000 who are planning to retire in 2030 will likely **have insufficient retirement income to cover necessary living expenses**.

The Federal Government thinks it has found a solution with the Pooled Registered Pension Plan (PRPP) which is designed as a **large scale Defined Contribution (DC) plan**. Unfortunately, this arrangement does not take into account many **issues behind the pension crisis**:

- **Workers don't save** because they cannot afford to or because saving options are not attractive enough.
- **Private retirement savings programs** currently available to small and medium-sized enterprises **charge relatively high fees**.
- The current complex system of regulating workplace pensions **discourages employers from offering appropriate pension plans** and many plan sponsors have moved from Defined Benefit plans to DC plans.
- Retirement benefits from DC plans and RRSPs are affected by **lower returns on investments** and losses on the stock market.
- Soon-to-retire **baby boomers do not have enough savings** to pay for their upcoming retirement.
- Pension plans did not take into account the costs relative to **increased longevity**.

#### With the proposed PRPP:

- Self-employed workers and employees will have the **option of joining the program by contributing part of their income**. Since too few people currently take advantage of voluntary retirement options, it is not clear why PRPPs would be more popular than already-existing saving programs. In fact, PRPPs might be seen as less attractive than RRSPs as the funds are locked in.
- **Management fees will not be significantly lower** than current retirement saving programs. As PRPPs are optional, they will likely not reduce marketing costs for plan providers and might not create the expected economies of scale.
- **Plan participants will assume all the investment and longevity risks**. This does not solve the issue of income uncertainty for future retirees.
- **It is too late for baby boomers to benefit from the program**. The government and employers might need to create a supplemental program in the short term to share the financing of the boomers' retirement income.

*For these reasons we do not believe that PRPPs will be effective in solving the pension crisis on their own. In an upcoming newsletter, we will discuss the latest solutions presented by PBI pension experts to the government.*



## BENEFITS

### Be ready for biologics

For plan sponsors with drug plans, biologic drugs are an issue that can be expected to **create a growing number of claim predicaments** in the coming years.

Not so long ago biologics were still a blurry concept of high-tech drugs of the distant future. But now, in 2012, they are widely available to the public and are here to stay and grow.

**Biologics, also known as biotech, are drugs derived from living organisms and/or developed through special methodologies** such as recombinant DNA procedures.

**The most dramatic difference between traditional pharmaceuticals and biologics is in the price.** Biotech drugs to treat rheumatoid arthritis cost \$10,000 to \$20,000 per year to the patient. The manufacturing processes of biologics are complex, highly controlled and customized to each drug. The research, storing, and delivery costs are also significantly higher.

On the other hand, **biologics are a lot more effective with often fewer side effects and some can treat diseases for which no effective therapies are available.** All of this is fuelling their growing popularity. When looking at a sample of 56 million drug claims in Canada, biologics grew from 8.3% of drug spending in 2005/06 to 11.3% in 2009/10. At the same time, they accounted for 20% of the drug cost increases between 2005 and 2010. Within a few years, they could account for a third of all drug costs.

Pharmaceutical companies have realized the market potential of these drugs and, despite slow approval processes, **new biologics are now being tested and released at a growing rate.** In the U.S., clinical trials grew from 1,200 in 2000-2005 to 6,000 in the following five years.

The good news is that provincial governments too have noticed the rise of these high-cost therapies. **British Columbia, Ontario and Alberta have already introduced specialty drug programs** designed to provide financial support to patients requiring high-cost drug therapies for certain conditions such as rare genetic disorders and some cancers. Plan sponsors can design their drug plans to take such programs into account and should push for increased awareness about them.

For plan sponsors, getting ready for biologics means a clear understanding of new treatment opportunities and taking these into account by **incorporating clear rules within their drug plan.** Plan sponsors need to establish their benefits philosophy on biologics to ensure that the right person is getting the right treatment at the right time. What types of biologic drugs should be covered? For what disease severity? Where should the claim limits be set? **Establishing policies now and conducting annual reviews of the benefit plan could save sponsors from having to make decisions on a case-by-case basis, which could become personal and emotional.**

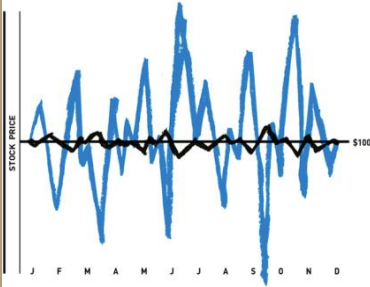
*PBI benefit consultants are experts in designing sustainable drug plans and are fully aware of the potential issues that could arise with biologics. We are also anticipating that our upcoming benefits survey will give participants some insight on who is currently doing what in terms of drug plan design among multiemployer benefits plans.*



# INVESTMENTS

## Low-Volatility Equities – Too good to be true?

It's a cheerful holiday time for those very few fortunate equity investors in Canada that bought into "Low Volatility" (LV) equity strategies, as they **have performed quite well during the recent equity crisis**. The average of several manager-sponsored LV funds produced one-year returns of 9% and partially simulated four-year returns of 4%; in comparison, the TSX lost -0.8% and -1.5% annualized, respectively.



The real **selling point of LV strategies was supposed to be – and still is – risk reduction**, something we are comfortable with. Recent strong performance is primarily explained by the very nature of LV products. **LV portfolios will generally outperform in periods of market distress and underperform in growth periods**. In the same way that the ocean protects Vancouver from the notorious Canadian winters and boiling summers, LV strategies protect returns from the stock market "seasons": **they never peak too high in the "summer" and never fall too low in the "winter."** A second contributing factor to strong performance has been due to **recent increased investor risk aversion**, which has created a sweet spot for LV managers.

**LV products are advertised as producing "equity-like" returns** (maybe even a little less) but **with approximately 70% of the market's (long term) volatility**. Advertising claims may be true as (partially simulated) performance history has shown. Canadian LV strategies were only about 70% as volatile as the TSX index and even less volatile more recently.

Where does this Shangri-La/Magic Kingdom effect of reduced volatility come from? The concept behind it is essentially quite simple. It takes root in the Finance 101 belief of not keeping all your eggs (equities) in one basket. **LV managers construct equity portfolios focusing on the best diversification and volatility characteristics first and worrying about returns after**. They believe that it's easier to predict a stock's volatility than its return and, as such, focus is on building the lowest risk portfolio and letting the return part of the portfolio take care of itself. The "free lunch" of portfolio diversification works because equity indices themselves are built with no consideration for good diversification.

**We believe that LV equity strategies are in fact good and true**, but the recent LV portfolios returns are likely outsized. Going forward, we expect that **LV investors will earn equity-like returns (likely less), but with much less volatility**.

*If you're striving to lower the volatility of your fund and can live with being different from the market, then low volatility equity strategies may have a place in your portfolio. PBI's investment team is ready to assist you with all the 'what', 'how much', 'when' and 'what if' questions you might have regarding these strategies.*

### ABOUT PBI

PBI Actuarial Consultants Ltd. is a dynamic and growing company uniquely focused on providing actuarial, administrative and investment consulting services for multiemployer pension and benefit plans, and other trust funds across Canada.

Visit our website at [www.pbiactuarial.ca](http://www.pbiactuarial.ca) for more articles and to learn about our services or connect with our experts for more information:

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