Pension Solution: Performance Measurement

Most pension assets are managed versus a market index as the objective or benchmark. However, **the true objective of a pension is to fund the pension liabilities (benefit payments) at the lowest cost to the plan with prudent risk.** No market index could ever represent the liability objective of any pension. Just like snowflakes, no two pension liabilities are alike due to each plan having a different labor force, salaries, mortality and plan amendments. As pensions have experienced too often, **given the wrong index objective … you will get the wrong risk/reward profile!**

This has been the pattern for most pension plans as their Funded Ratios have been on a roller coaster for several decades. Until the true liability objective of a pension plan (and any liability driven objective) is measured and monitored frequently and accurately, pension assets are in jeopardy of being managed to the wrong index objective(s). Until a ***Custom Liability Index*** is built and put in place as the proper benchmark, all asset decisions are in danger of being mismanaged. Given the wrong index objective(s), performance measurement will then provide inappropriate risk/reward measurements. It is rare that pension assets are ever compared to pension liabilities in performance measurement reports. It follows that if you **outperform the S&P 500 or any market index but lose to liability growth …the pension plan loses!**

Traditional generic bond indexes do a good job of measuring the risk/reward behavior of a market sector but have nothing to do with pension liabilities. Only a Custom Liability Index (CLI) could ever measure and monitor the risk/reward behavior of any pension liability cash flow schedule. Since contributions are the initial source to fund benefits, current assets fund net liabilities (benefits – contributions). Assets need to know what they are funding… net liabilities!

Solution: Performance Measurement

Once the Liability Beta Portfolio™ is installed to cash flow match net Retired Lives chronologically, you now need the Alpha assets to outgrow net residual liability growth (benefits – contributions of 10-year + Retired Lives and Active Lives)) to enhance the funded status. The CLI will provide the growth rate of net residual liabilities just like any index benchmark so performance measurement of Alpha assets versus net residual liabilities (as measured by the CLI) can be easily assessed. If Alpha assets can outgrow net residual liabilities, then the funded status will be enhanced and contribution costs should be reduced. The Ryan ALM Performance Attribution Report (PAR) will calculate:

eight measurements of risk
four measurements of reward
two measurements of risk-adjusted returns

"Common sense is not common… it requires preferred sense."
Ronald J. Ryan, CFA

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