Derisking—Is It a Good Idea?

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This article is based on the author's presentation at the 2017 Symposium.

Simply put, *derisking* is the process of reducing or eliminating risk. Derisking has been a buzzword in the pension industry for at least a decade now.

For plan sponsors that haven't yet derisked, is this a good idea? Well, the easy answer is that if you don't like risk, then derisking is probably the answer for you. If that answer sounds too easy, it really is. What I have found is that when plan sponsors do the hard thinking about the costs of derisking, they choose to continue along the path of what they consider risky but manageable investments—most commonly a mix of equities and bonds.

One of the problems with the generic buzzword *derisking* is that it can mean different things to different people. Some consider converting a pension plan from defined benefit to defined contribution a form of derisking. I am less convinced. Conversions typically don't eliminate risks; they just change who bears the risks.

A narrower definition of derisking would be investment derisking. The most common forms of investment derisking are selling equities in order to buy bonds and selling bonds in order to buy annuities, which not only relieve the plan of investment risk but eliminate mortality/longevity risk at the same time.

Those who are a little more adventurous can enter into a mortality swap contract with an insurer—exchanging a fixed set of payments based upon the life expectancy of your plan members for variable payments that depend on how long your members actually live. The result here is eliminating the mortality risk, which is completely out of the control of the sponsor, but allowing the sponsor to keep the investment risk and reward where the sponsor feels confident it can outperform bonds with more risky investments.

Armed with an understanding of what derisking is, do we think this is a good time to derisk? There is no easy answer. If I have learned anything over the past 30 years, it's that you can't time the market highs and lows to the nearest month—and, in fact, for most of us, it's hard to get it right to the nearest year. I had a client who, for a decade, starting in 2002, assured me that interest rates had hit bottom and would be going up soon. This view prevented them from derisking. I have a friend who was convinced the stock market was overheated more than two years ago and has been sitting in cash since. Clearly, even with a 10% or 20% correction, he would have been ahead had he stayed invested.

If we can't figure out the timing, how can we ever make the move? The answer is simple. Are you comfortable with the risks you are taking, and have you done some stress testing on the impact of a market decline on cash flow and your pension expense? If you are comfortable with the downside results you may face at some point in the future—maybe the near future—then you are OK taking those risks in the pursuit of greater rewards. If you are not comfortable with the negative outcomes, it might be time to derisk—not because it's the right time in the market but because it's the right time for your business strategy.