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FLIGHT PATHS – A DYNAMIC INVESTMENT STRATEGY

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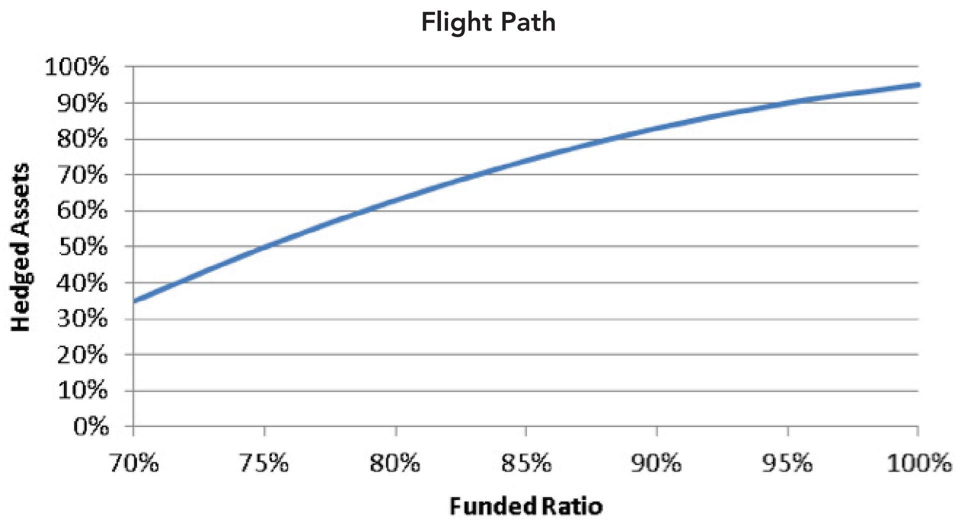
A flight path is a dynamic investment strategy for defined benefit pension funds to de-risk the plan. The asset mix is changed based on the funded ratio. As the funded ratio improves, the allocation to return seeking assets such as equities is gradually decreased and the allocation to hedged assets such as bonds and interest rate derivatives is gradually increased. The reallocation strategy is continued until the target funded ratio is reached.

Factors to consider when de-risking a plan include plan maturity, the plan sponsor's risk tolerance, and the funded ratio. Plan maturity impacts the duration of the liabilities and the cash flow needs. Mature plans have shorter durations and greater cash flow needs, and more of a need to de-risk than plans that are less mature. Plan maturity and the sponsor's risk tolerance are relatively stable compared to the funded ratio, which can be very volatile.

A flight path is built to fully fund the plan either on an ongoing plan basis or on a plan termination basis and that determines the liabilities that will be used for the funded ratio. The assets to be used are either the market value or a smoothed actuarial value. Because a surplus is of little use to the plan sponsor, the advantages of overfunding are not as great as the disadvantages of underfunding. There will be no exact match to completely de-risk the plan. The asset mix along the flight path will represent a balance between return and volatility. The plan sponsor should choose if the strategy will be to reallocate for funded ratio increases only, or to reallocate in both directions.

For the hedged portion, the duration could be increased as the funded ratio improves. Changes in interest rates can be used as opportunities to decrease risk. As the funded ratio improves and when the interest rates reach the desired level, the sponsor could look for ways to settle some of the liabilities with lump sums and annuity purchases. ■



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