Investing for Health and Welfare, Apprenticeship Plans

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Overview

- Investment horizon
- Risk tolerance
  - Self-funded
  - Hybrid
  - Reserves and cash flows

Health and Welfare

Health and Welfare Investing

- Health and Welfare plans are inherently risk adverse
  - Conventionally require high levels of liquidity
  - Different plan types (insured vs. self-funded) necessitate different asset allocation mixes
- Healthcare costs are on the rise
  - An aging workforce, expensive pharmaceutical drugs and ACA provisions are impacting plan expenses
  - Pressure for plans to increase contribution or risk to meet funding requirements

Health and Welfare Investing

- The financial health of the plan will be the main determinant for risk tolerance
  - Restricted and unrestricted reserve levels can be calculated using a conventionally conservative approach or a more aggressive approach
- Diversification of unrestricted reserve assets should not only be tied to liquidity constraints but also to contributing risk factors
  - Relatively small allocations to equity can greatly impact the overall volatility of a plan assets

Plan Type

- Knowing plan type distinctions can play a role in asset allocation decisions

PLAN TYPE	CHARACTERISTICS
Insured	– Premiums paid over fixed time periods (i.e., monthly, yearly) – Less volatility to plan expenses and liabilities
Self-Funded	– Not covered by third-party insurer – Directly liable for all participant claims, admin costs, reform taxes – Higher volatility to plan expenses – More flexibility over health benefits offered

Reserves

- The collective pool of assets of a H&W plan are held as either liquid cash "restricted reserves" or investable "unrestricted reserves"

RESERVES	ASSETS
Restricted Reserves *Short Term (0-6 months)*	• Cash and liquidity – Operating expenses – Benefit costs
Unrestricted Reserves *Intermediate Term (6-24 months)*	• Bonds (core, short-duration) • Modest exposure to equity
Unrestricted Reserves *Long Term (more than 24 months)*	• Additional market and liquidity risk • Diversified bond exposure • Higher allocations to equity

Defining Risk Tolerance

- What are the primary risks?
  - Investment risk
    - A rising interest rate environment would be a significant drawdown to a core bond portfolio
    - Restricted reserve liquidity is necessary to cover outflows of benefit payments and insurance premiums
    - Volatility of expenses should be determinant of accepted level of unrestricted reserve investment volatility

Defining Risk Tolerance

- What are the primary risks?
  - Funding risk
    - Rising healthcare costs could necessitate an increase to contribution rate
  - Benefits risk
    - An aging workforce is increasing benefit claims and insurance premiums

Defining Risk Tolerance

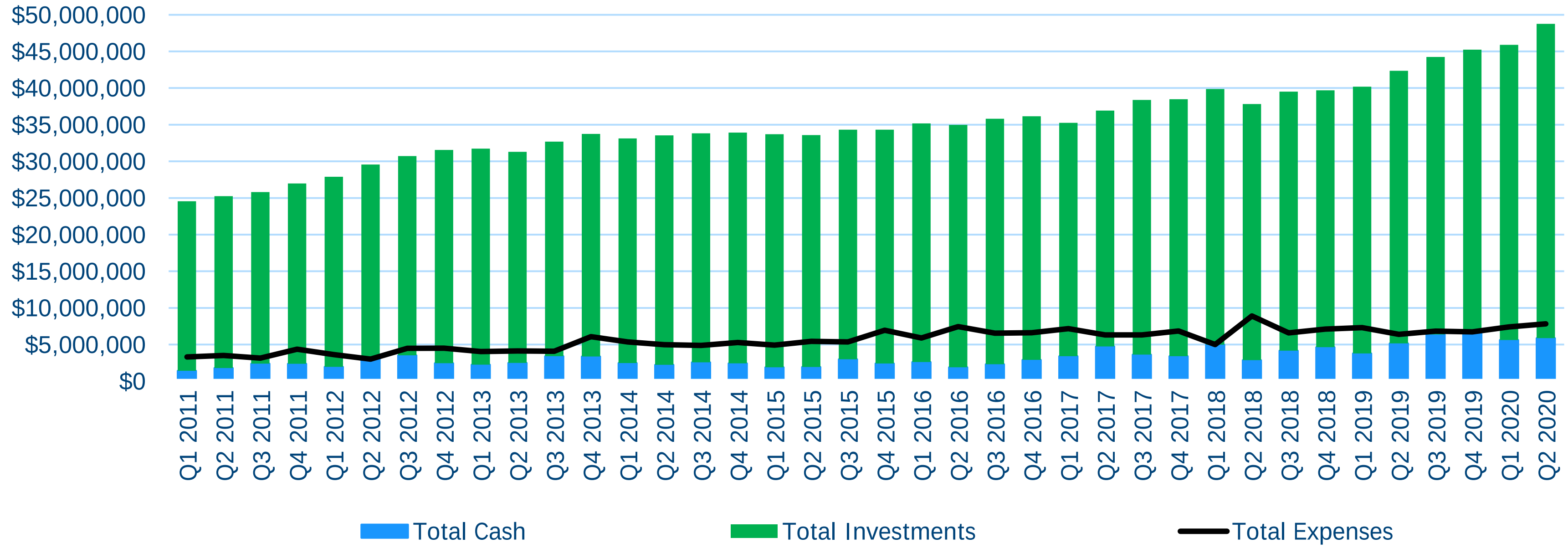
- What level of risk is acceptable?
  - A certain level of risk must be assumed by the unrestricted reserve assets in order to achieve a required return
- What are the plan goals?
  - De-risk portfolio to cover plan costs and maintain reserve levels
  - Introduce investment risk to grow plan reserve levels

Plan Review

- Assess the structure and characteristics of the Plan to determine risk tolerance, and with that, an appropriate asset allocation
- Conducted annually
  - A H&W plan is more susceptible to changes in risk tolerance
    - Investment results, hours/contributions, and expenses can all impact the risk tolerance year over year

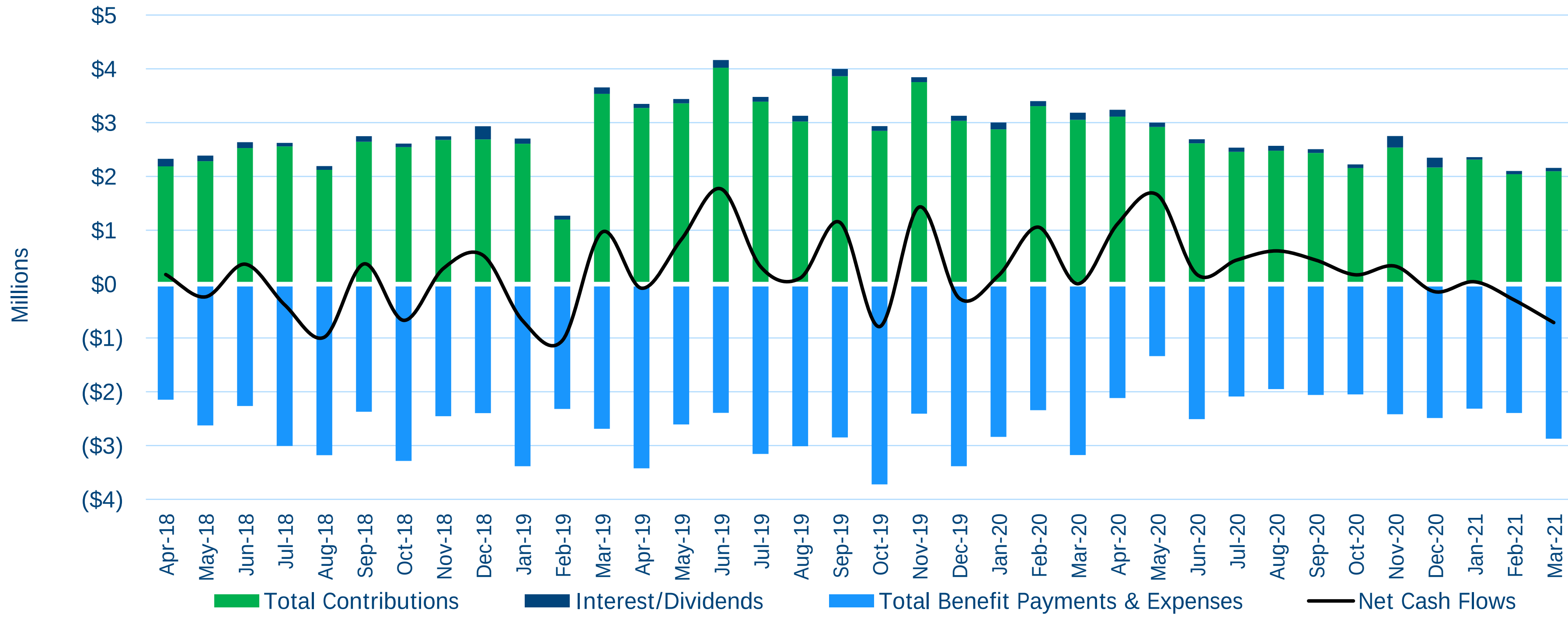
Plan Review—Plan Structure

- Enough cash to cover expenses

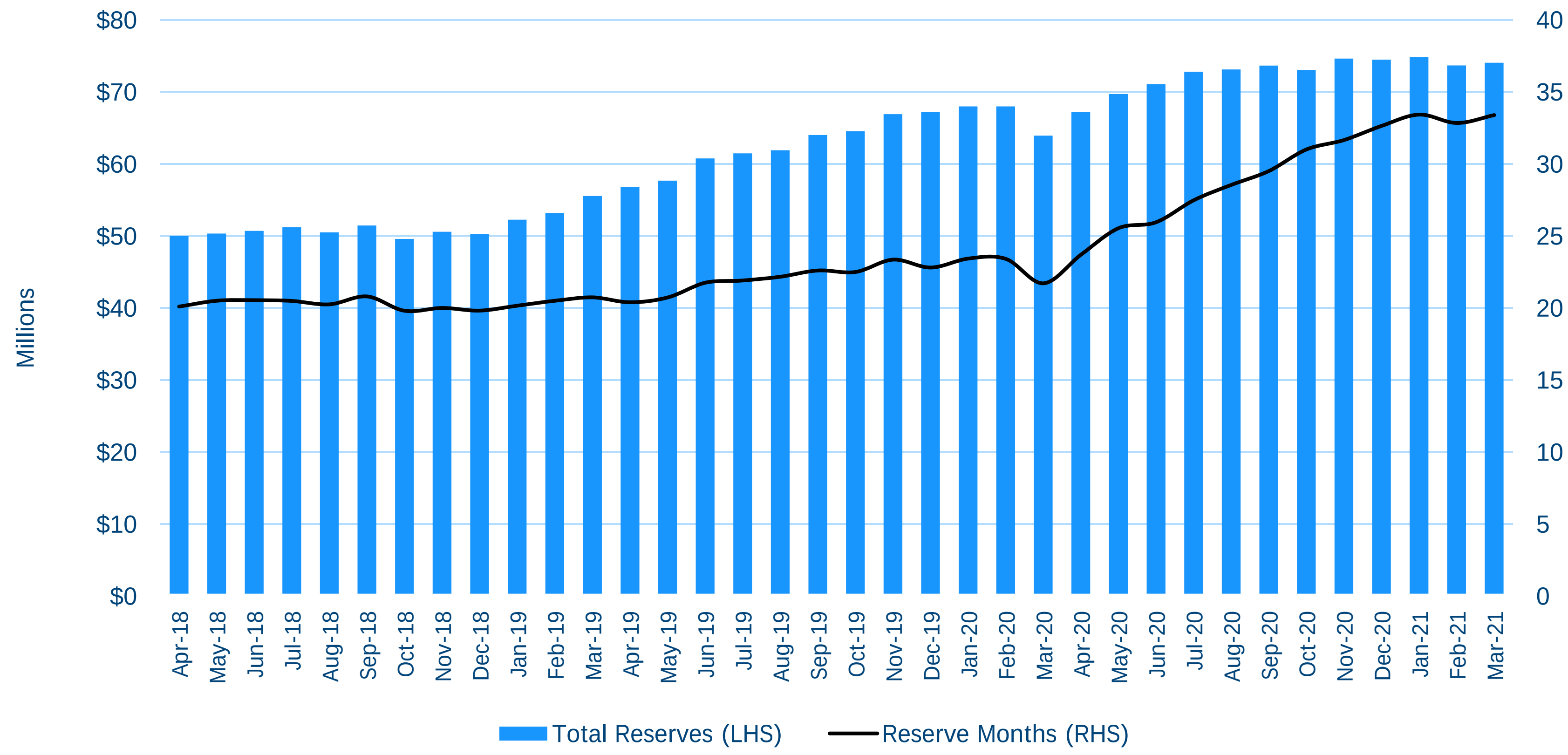


Plan Review—Cash Flows

- Positive/negative/trend

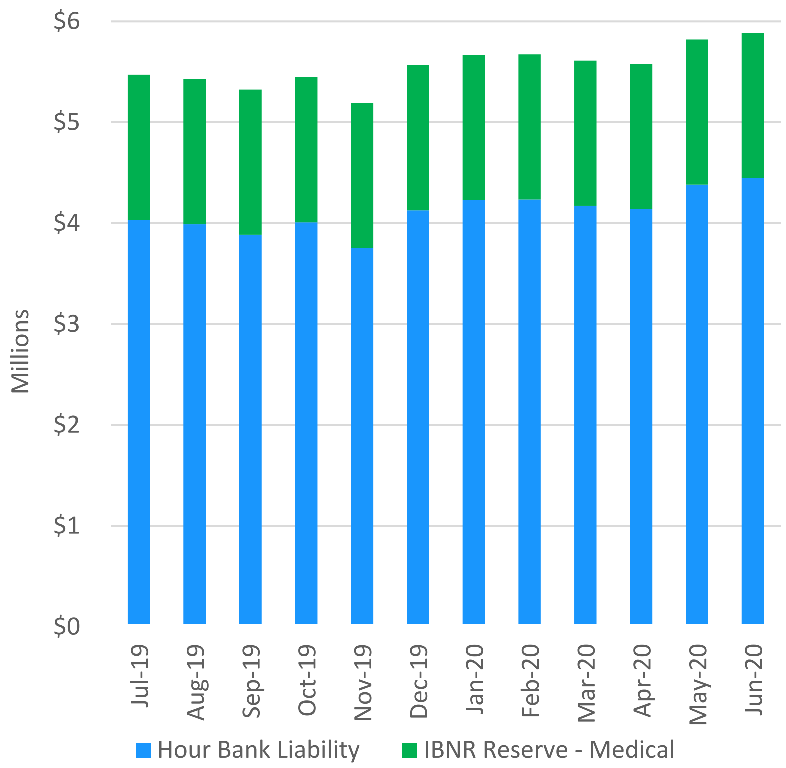


Plan Review—Reserves

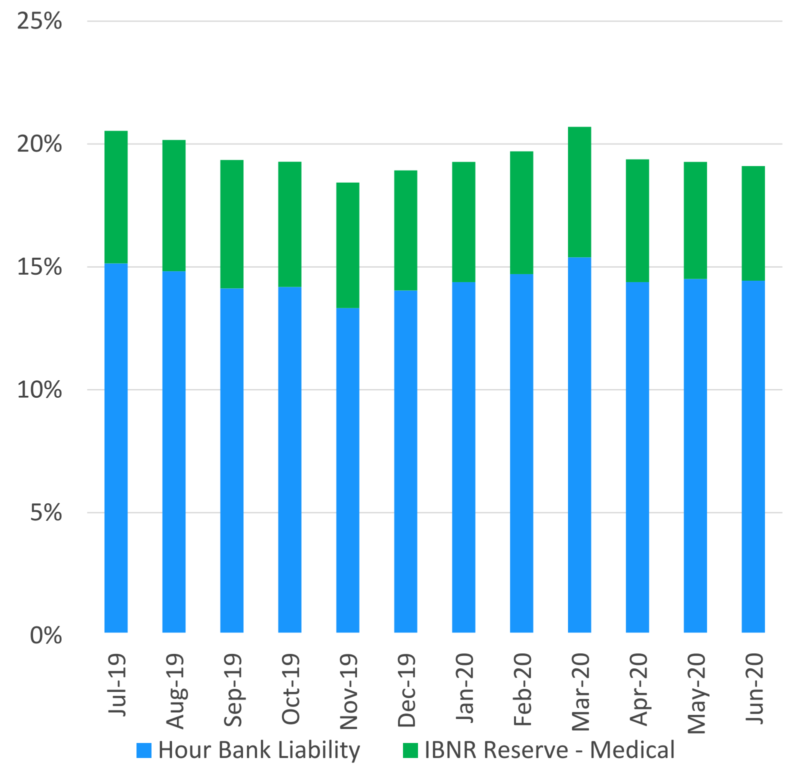


Plan Review—Liabilities

- Liability Components ($)

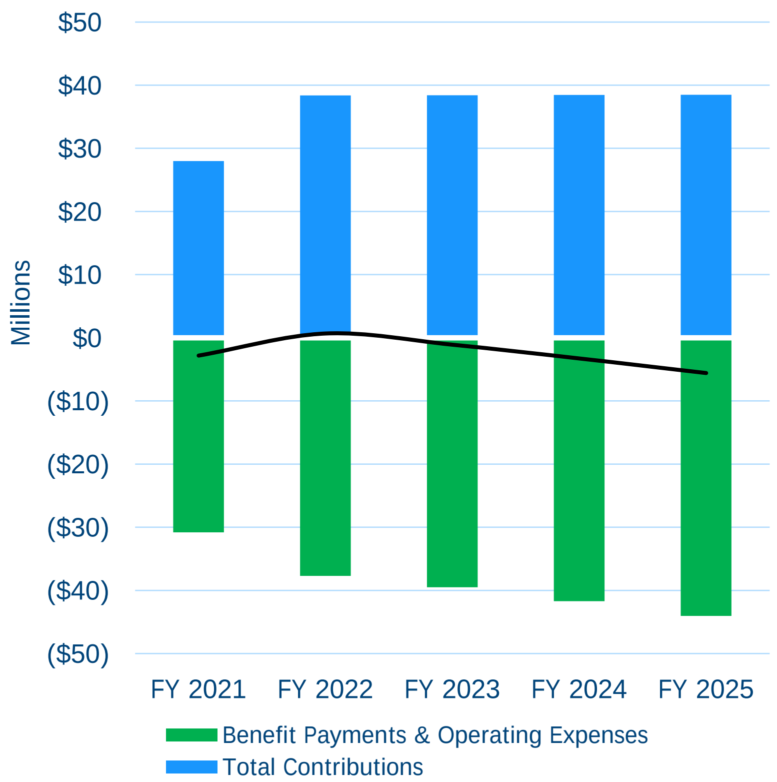


- Liabilities to Investable Assets (%)

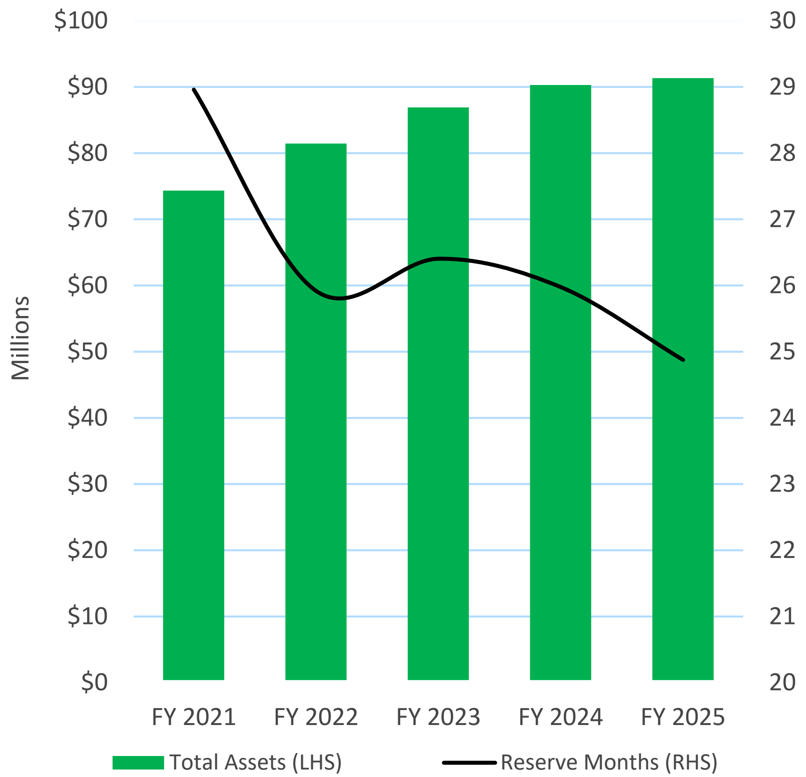


Plan Review—Projections

Cash Flows



Reserves



Structuring Allocations

Obligation	Allocation ($)	Allocation % Based on Liability	Appropriate Asset Class
Benefit and Operating Expenses — Normal cash outflows	$1.5M	5%	Cash
IBNR Reserve - Medical — Incurred But Not Reported medical expenses — A reserve liability estimating medical costs that have not been paid out yet	$3.0M	10%	Short-term fixed income
Hour Bank Liability — Additional hours over minimum threshold “banked” for future use — Allows participants to maintain insurance coverage during the time jobs are inactive; economically sensitive liability	$7.5M	25%	Core fixed income
Excess Reserves — Assets available for investment after accounting for the major obligations	$18.0M — Remainder of investable assets	60%	Diversified fixed income and equities

Fees and Expenses

- Fees can cause more erosion in a H&W plan
- Lower risk investments = Lower return expectations
- Investment fees should be minimized where possible

Apprenticeship and Training Plans

Apprenticeship and Training Plans

- Similar to Health and Welfare
  - Risk adverse
  - Preservation of principal
  - Understand cash flows
  - Diversified fixed income and cash

Key Takeaways

- H&W and Apprenticeship Plans are risk adverse
- Health determines risk tolerance, and this can change more frequently than a pension
- Annual plan reviews to review risk tolerance and asset allocation
- Minimize fees and expenses

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Session Evaluation