



## BEST PRACTICE

### **Asset Allocation Guidance for Defined Benefit Plans (1999 and 2009) (CORBA)**

**Background.** The ultimate goal of a defined benefit (DB) plan is to provide the retirement benefits promised to retirees in state and local government public employee retirement systems, and in order to accomplish this goal sufficient investment returns must be generated. Asset allocation – the practice of dividing an investment portfolio among the major asset categories of equities, fixed income, cash equivalents, and alternatives – is a fundamental principle of sound investing. Diversifying the investment portfolio by including asset categories with investment returns that increase or decrease under different market conditions can protect a DB plan against significant investment losses. That is because historically, the returns of the major asset categories have not all experienced investment gains and losses at the same time. A portfolio should be diversified not only among asset categories, but also within asset categories. The key is to identify investments in segments of each asset category that may perform differently under different market conditions (for example, equity investments would be divided among large-cap, midcap and small-cap stocks, and those investments would be further divided between growth and value). (See GFOA Best Practice *Pension Investment Policies* and accompanying checklist, *Investment Policy Checklist for Pension Fund Assets*.)

Determining the appropriate asset allocation model for a DB plan is a complicated task. No single asset allocation model is right for every plan. The challenge is to pick the mix of assets that has the highest probability of meeting the plan's goals, at an acceptable level of risk. (Many plans also implement a short-term tactical policy that is more responsive to changes in the financial markets).

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that state and local government retirement systems establish, within their overall investment policy, an asset allocation plan that is based on the following best practices:

1. Prior to developing an asset allocation plan, review and evaluate the following issues: legal framework and fiduciary standards; actuarial return and risk expectations; need for growth of principal; need for income; need for liquidity (the ability to convert an asset to cash quickly); tolerance for risk; tolerance for volatility (the amount of uncertainty or risk about changes in the value of a security); investment time horizons (the length of time over which an investment is made or held before it is sold); monitoring guidelines; and compliance procedures.
2. Work closely with actuaries and other advisors to determine the plan's expected rate of return (estimated long-term investment yield for the plan, net of fees, with consideration given to the nature and mix of current and expected plan investments), the expected variation or level of volatility of returns, cash needs for several years out, and the expected time horizon for achieving return objectives.
3. Develop a long-term strategic asset allocation policy that identifies the broad mix of assets (equities, fixed income, cash equivalents and alternatives) necessary to achieve the plan's investment return and risk objectives. Evaluate all investments in light of the system's time horizon, which will help determine the proper balance between equity and fixed-income investments. When determining the number of investments to be chosen, and their complexity, consider the ability of plan decision makers to properly monitor the strategies.

4. Review the portfolio performance, at least annually (preferably quarterly), to ensure compliance with the strategic and annual investment targets. Avoid market timing (buying and selling securities based on an attempt to predict the future direction of the market). Report the findings of the review to the Board of Trustees.

**References.**

- *Investing in Public Funds, Second Edition*, Girard Miller with M. Corrine Larson and W. Paul Zorn, GFOA, 1998.
- *An Elected Official's Guide to Defined Benefit and Defined Contribution Retirement Plans*, Nicholas Greifer, GFOA, 1999.
- GFOA Best Practice, *Pension Investment Policies*, 2003.
- GFOA Checklist, *Investment Policy Checklist for Pension Fund Assets*.

Approved by the GFOA's Executive Board, October, 2009.