NO RAIN, NO RAINBOW

To help raise their funded-status ratios after a stormy period, corporate defined-benefit plan sponsors are considering near-term direct contributions. Proposed changes to the corporate tax code and other issues could make the timing opportune.

Implemented by most corporate defined-benefit pension plans, liability-driven investing (LDI) manages current assets to match future liabilities. Typically, a plan's assets are separated into return-seeking and liability-hedging allocations, and a glide path is established to de-risk the portfolio—reallocating return-seeking assets, usually equities, to liability-hedging fixed income strategies. Such reallocations are triggered as the plan achieves predetermined levels of funded status—the percentage of future liabilities the plan is able to cover. The Milliman 100 Pension Funding Index, a measure of the funded status of the 100 largest pension funds, stood at 81.5 percent at the end of February 2017. A decade ago, the average was 105.3 percent—a surplus that has been eroded by low interest rates and volatile equity markets.

Many plans have paused de-risking following the most recent drawdown in funded ratios since the end of 2013, when they were on average around 88 percent. "Plans with de-risking-only glide paths still need to wait until funded ratios get back to those prior peaks, before they resume de-risking," says Amy Morse, Director of Pension Strategies at Wellington Management. This could require discount rates to increase about 25 bps and equity returns in the mid-single digits.

Outside of the markets, plans can improve funded ratios through company contributions, and this could be an opportune time. "There could be reasons for plans to consider making near-term contributions," says Bill Cole, Fixed Income Investment Director at Wellington Management. If corporate tax rates go lower, a plan sponsor could write off deductions at the previously higher tax rate if made before new legislation is enacted. Another incentive is to mitigate premium increases to the Pension Benefit Guaranty Corporation, which provides pension liability insurance.

Another consideration, which could further encourage contributions, is the future availability of long-duration, high-quality corporate bonds. "The supply could be reduced in the coming years," says Cole. If corporate taxes are lowered, the ability to write off interest is not as valuable. There also could be an opportunity for issuers to repatriate overseas cash at a reduced rate, especially technology and pharmaceutical companies. Moving their substantial cash holdings to the U.S. could dampen future investment grade issuance.

Investment Strategies

LDI requires a delicate balance of allocations to growth assets and income assets, and thoughtful management of each. On the return-seeking side of the portfolio, plans are looking to alternative strategies to reduce overall risk and generate more balanced returns across a variety of economic environments. On the liability-hedging side, the question is how precisely to match the liability cash flow profile. "Plans need to target a few key risks—credit risk, interest rate risk, and curve risk," says Cole, noting that most plans can do this by blending standard market indices to reflect their liability profiles. "A little customization can go a long way, but too much can lead to issuer concentration, less liquidity, more complexity, and increased cost," he says.

Furthermore, many plans remain under-hedged relative to their liabilities. De-risking is on hold as sponsors wait for rates, and thus funding ratios, to rise. "There is a significant cost to this if rates don't rise significantly," says Morse. "Plans can respond to short-term rate movements by incrementally lengthening duration to protect the resulting funded ratio gains," she says. Otherwise, if rates don't continue to march upward, gains could erode over time as the liability out-yields the plan's liability-hedging assets.

"Systematic, predetermined glide path allocations make sense," says Cole. It works best when strategies have been well thought out, well communicated, and well vetted by an investment staff, so everyone knows the plan of action through different market environments.

—Howard Moore

WEATHERPROOFING A PLAN'S RETURN-SEEKING ASSETS

By Amy Trainor, FSA, EA, Multi-Asset Strategist, Wellington Management

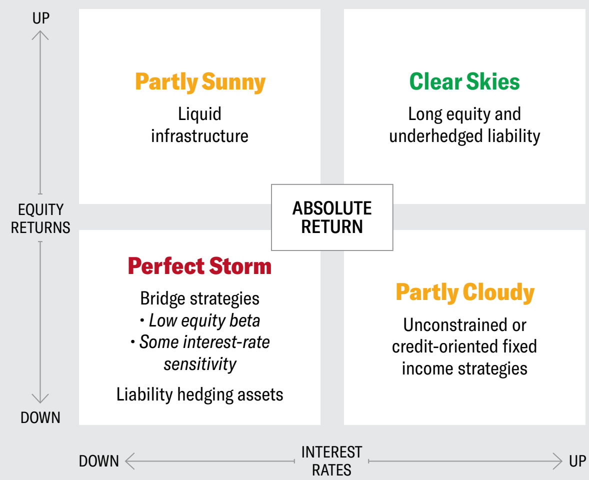
For corporate DB plans, return-seeking assets are often synonymous with traditional equities. That's fine if market conditions are just right, but it leaves plans vulnerable in many environments, including one marked by weak equity returns and falling interest rates—what came to be known as a "perfect storm" scenario amid the funded-ratio devastation of 2000–2002. We think the solution is for plans to consider diversifying their return-seeking allocations with assets that may perform well in a variety of conditions.

Fair weather or foul? Rate and return scenarios

Many DB plans concentrate their risk in two positions: They are long equities and significantly underhedged versus their liabilities. As a result, the key market forces that affect their funded status are equity returns and interest rates. We used those two variables to define the four economic scenarios shown in Figure 1. *Clear Skies* is the optimal scenario: With equity returns and rates rising, both risk positions would be expected to pay off.

The polar opposite of that scenario is a *Perfect Storm*, where falling equity returns and falling rates can threaten major funded status drawdowns. Ideally, plans would eliminate equity exposure and fully hedge their liabilities in this environment, but that's unrealistic for those that desire some return to help offset costs and improve funded status.

Figure 1: Better Balance for Changing Market Conditions



For illustrative purposes only. Not investment advice.

Instead, we think plans can help mitigate the risk of this scenario by diversifying their return-seeking portfolio with "bridge strategies"—investments that combine return-seeking and liability-matching characteristics, and that may offer low equity beta and moderate interest-rate sensitivity. Examples include strategies focused on liquid infrastructure investments (e.g., companies with long-lived physical assets and earnings set by regulation or long-term contract, creating potential for "bond-like" earnings streams) and unconstrained or credit-oriented fixed income strategies.

We advocate holding a mix of bridge strategies that encompass varying levels of equity beta and rate sensitivity. This provides diversification and better balances the portfolio across the *Partly Sunny/Cloudy* scenarios, in which equity returns and interest rates move in opposite directions. In these environments, the effect on funded status depends on which of the two variables dominates. Our research confirms that during periods when equity returns and interest rates have moved in opposite directions, traditional equity exposure has been about equally as likely to harm plan funded ratios as to improve them.[1]

It is this uncertainty about what will work best in a *Partly Sunny/Cloudy* scenario that argues for a mix of bridge strategies. For example, in *Partly Sunny* scenarios, liquid infrastructure investments may have enough market beta to participate in rising equity returns, and may benefit from falling rates given their interest-rate sensitivity. In *Partly Cloudy* scenarios, unconstrained or credit-oriented fixed income strategies may be attractive for their low equity beta, even with modest rate sensitivity.

Absolute return strategies may also help plans navigate different environments. Whether using stand-alone or portable alpha strategies, the key is ensuring that the returns are truly market neutral.

While these approaches might give up some upside relative to traditional equities in *Clear Skies*, we expect they would still outperform the liability. Regardless of the specific strategies selected, the key is to begin taking a more holistic approach to return-seeking assets that doesn't count on ideal conditions for its success. ●

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[1]March 1973 – December 2016. Equities: S&P 500. Liabilities: 75% Bloomberg Barclays US Long Corporate Bond/25% Bloomberg Barclays US Long Government Bond | Equities up/down identified by direction of monthly return on S&P 500; up/(down) rates defined as months where yield on US 10-year Treasury rose/(fell) by over 5 bps | PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS AND AN INVESTMENT CAN LOSE VALUE | Sources: S&P, Bloomberg Barclays, US Treasury, Wellington Management