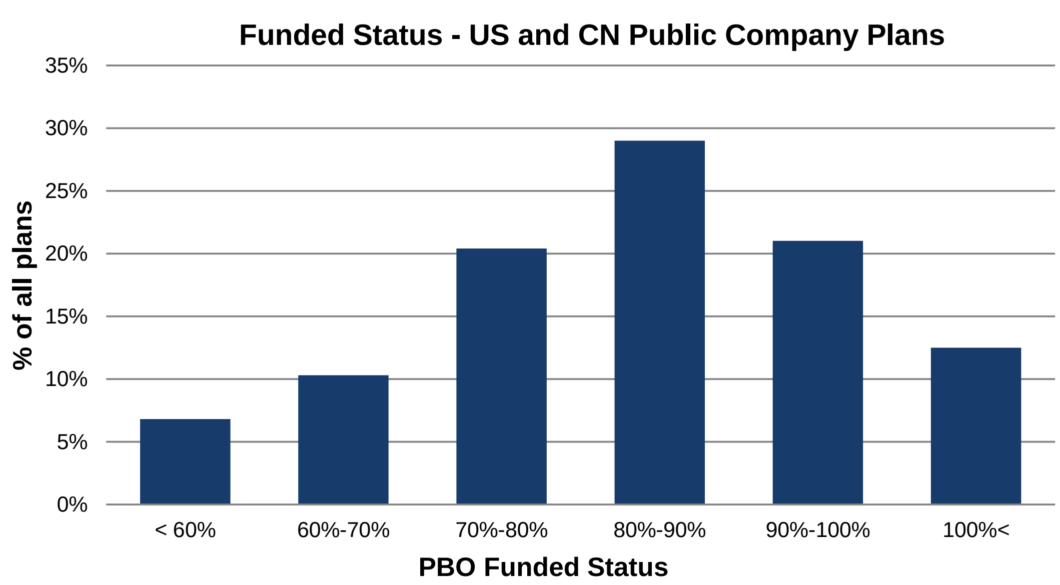
Institutional Group

De-risking Considerations for Pension Plan Sponsors

Pension funding is up but investment strategies remain unchanged

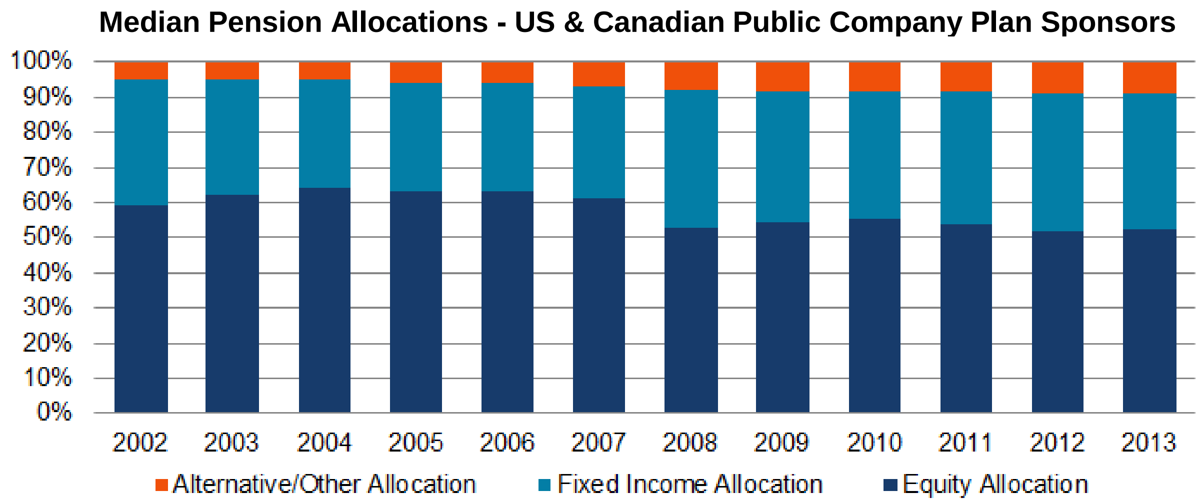
A review of corporate financial statements of public company pensions for year-end 2013 reveals that the funded status for the average plan has increased substantially, from 74% in 2012 to a median of 84% in 2013. A favorable year for asset returns, with the S&P 500 rising from 1428 to 1848, combined with an increase in the bond index rates increasing almost 90 bps, has provided an ideal environment for defined benefit plans. Twenty-one percent of plans have achieved a funding level of above 90%, with 12.5% over 100% funded on a PBO basis. Discussions for many plans sponsors have shifted rapidly from how best to improve funding to what to do next. Clearly, the situation for many plan sponsors has changed dramatically, but pension committees are struggling with how best to respond to both a changed funded status and a low interest rate, positive equity environment.



Note: Based on year-end 2013 financial results for 820 public companies with pension assets > $20 MM. Excludes financial firms
Source: SEC Filings, CapIQ.

Static asset allocations

Despite the increase in funded status, the investment strategy for plan sponsors has generally remained unchanged over the past six years.



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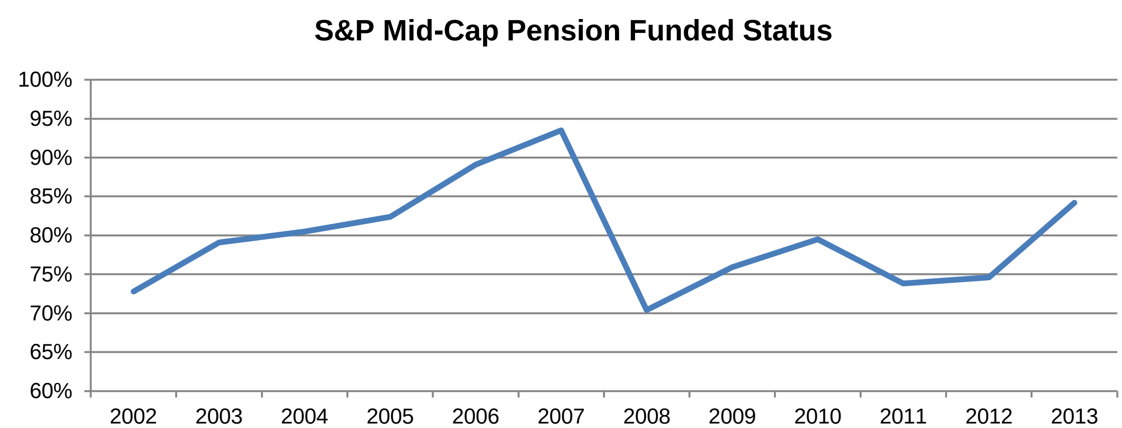
The median equity asset allocation remains at 52%, approximately the same as it was in 2012 at significantly lower funding levels. This is somewhat surprising, as there might be some reasonable expectation that plan sponsors might reduce their equity allocation as funded status improves. Only 11% of plans have implemented fixed income allocations above 60% of invested assets, indicating an aggressive liability hedging strategy. Perhaps more surprising is the relatively high equity allocations for well-funded and fully funded plans. Investment allocations for plans over 90% funded are substantially the same as the median strategies, and portfolios for plans over 100% funded are even more aggressive. While a large percentage of firms are now well positioned to almost fully hedge their legacy pension liabilities by reallocating their investment portfolios to a long-duration fixed income strategy, an overwhelming majority of companies are not executing that strategy. Corporate plan sponsors continue to prefer to pursue excess returns from their pension asset portfolios to reduce long-term funding, rather than use those assets to hedge the pension liabilities. Even those firms that have substantially achieved their required goal – funding their pension liabilities – are not de-risking their plans.

Despite the roller coaster ride plan sponsors have experienced over the past 12 years, from well-funded in 2007 to significantly underfunded in 2008, plan sponsors continue to execute portfolios that more closely resemble asset-optimized strategies rather than liability driven investing (LDI) ones.



Note: Based on year-end 2013 financial results for non S&P 500 companies public companies with sales over $1.0 Bn and pension assets > $20 MM. Excludes financial firms.
Source: SEC Filings, CapIQ.

Why are pension committees not reallocating their asset portfolios to better hedge their liabilities? Are pension committees positioning themselves for another 2013, or for another 2008? What are the concerns or considerations that might lead a plan sponsor to delay a more aggressive LDI implementation? Below are some potential reasons – and why they should be reconsidered.

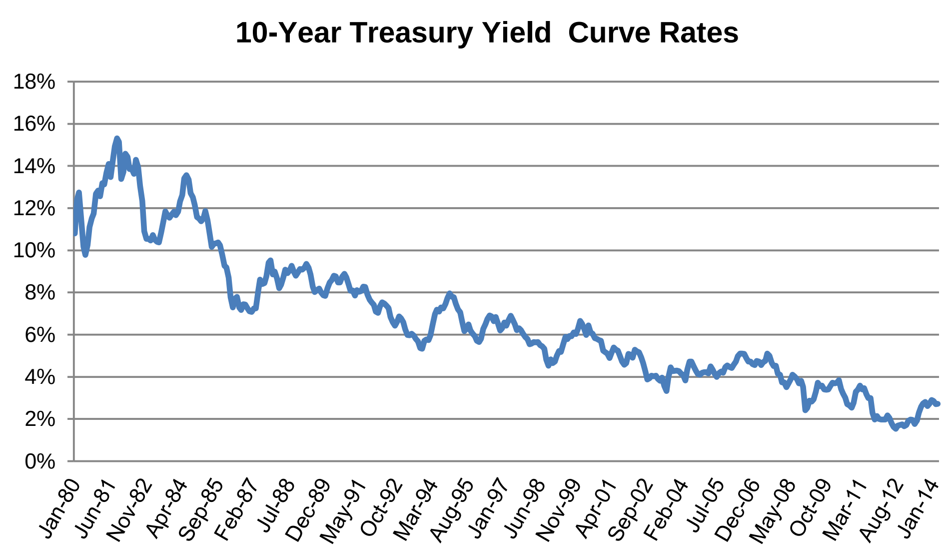
Equities provide greater long term returns

The traditional portfolio overweight to equities is grounded in the historically sound notion that over time equities perform better than bonds. Having a large equity allocation, with bonds to dampen portfolio volatility, provides the most favorable and efficient investment portfolio. This has been proven over long periods of time, perhaps 20-year market cycles. In the interim, portfolio volatility can have greater ramifications for pension plans than traditional investment pools. Funded status declines will drive funding demands, forcing plan sponsors to make increased cash contributions. At the same time, pension plans are forced to monetize assets in down market to pay for benefits – in effect reverse dollar cost averaging their investments. ERISA funding requirements may not allow for enough time for plan sponsors to wait for markets to rebound. While plan sponsors have experienced a remarkable rise in equity values since the market crisis of 2008, they've been required to make significant contributions during that time frame. Eventually the current bull market will reverse, and plans that remain asset-only optimized portfolios may find themselves back where they were in 2009.

Rates are going to rise

A consistent market theme coming off the unusually low interest rate environment of the last five years is that with rising rates bonds will perform poorly. Investors may be reluctant to reallocate their portfolios to long duration fixed income bonds, fearing that rising rates will negatively impact bond values and thus their funded status.

Certainly the aggressive action by the Fed drove interest rates down to unusually low levels. But much of the impact of those actions, particularly QE activity, has been unwound. Further, low interest rates are not a four-year phenomenon due to central bank activity, but a 20-year market trend. The belief that there may be some significant and rapid future rise in interest rates may well prove to be unfounded.



Source: Bloomberg

In addition, expectations of a rising rate environment are not unique, but rather widely shared by investors. The bond market should generally price in future rate expectations and an upwardly sloping yield curve, as reflected in the present environment view. Avoiding bond investments due to a fear of rising rates implies not that rates will rise, but that they will rise faster and more aggressively than the market currently anticipates.

Finally, bond prices are not the only asset class potentially impacted by rising rates. The Fed's activities over the past four years have been designed to push investors out of safe havens and into riskier assets. Throughout this period the stock market has shown it values cheap money almost as much as earnings growth. It may be unrealistic to expect that a sudden rise in rates will leave the equity markets unaffected.

Earnings per share impact

Modifying the pension portfolio and substituting fixed income assets for equities will likely necessitate a reduced expected return on assets (EROA) and negatively impact the plan sponsor's pension expense. This will reduce next year's corporate earnings and earnings per share, rarely a desirable outcome for any management team. The challenge for a pension committee is as assets grow through market returns and contributions, the positive EPS impact gets larger, effectively making the impact of de-risking and matching assets and liabilities more and more costly on an accounting basis. There is mixed academic research on the market impact the pension earnings and the degree to which the equity market "looks through" the accounting earnings associated with the pension. However, the negative consequences of the economic loss within the pension and increased additional cash contributions resulting from adverse market events are fairly clear. Trading non-core accounting earnings for what is in many cases significant value-at-risk may not be a desirable long-term strategy for plan sponsors. Corporate pension committees need to evaluate the trade-offs between an EPS-driven pension strategy and one designed to mitigate downside risk.

Ongoing plans

A number of well-funded plans with high equity allocations remain open, continuing to accrue benefits. These new benefit accruals, combined with interest on legacy obligations along with benefit payments, may cause plan sponsors to retain more aggressive investment strategies to achieve returns to offset these costs. This can be particularly challenging for plans with relatively high benefit payments, driving the desire for higher return portfolios. The question plan sponsors need to ask themselves is how much are they asking out of their assets – are they forced to fund to 100% of legacy liabilities? Is it a reasonable approach to invest more aggressively to offset current service costs? A more prudent approach may be to invest portfolio assets to match legacy liabilities, and contribute the current service costs as they are incurred. Investing previously contributed assets to offset new costs may require a level of return that exposes these plans to a significant risk of loss. The plan sponsor should consider funding these new expenses as incurred through contributions to the plan – or if too expensive consider options to close the plan and substitute a more affordable benefit.

Funding to termination

Many plan sponsors, having experienced enough of the challenges of managing a defined benefit plan, are seeking an exit – offloading the plan to a third-party insurer. This is usually at a premium to the existing PBO liabilities, usually in the 10-15% range. Rather than targeting 100% funding as required under ERISA, committees are at their own discretion moving the goal-posts back, and seeking to achieve premium funding to support a termination plan through market returns. While there are benefits associated with termination, for most plans this strategy will be no less costly than funding up to 100%

and immunizing the plan. Given that the two strategies are economically fairly similar, exposing the pension plan assets to significant market risk for the time it may take to achieve a premium funding is asymmetric risk – the plan sponsor bears significant downside in order to achieve a goal that has fairly discrete and limited upside. Should a plan sponsor determine termination is a favorable goal, they would likely be better off funding termination from cash or debt capacity rather than through favorable markets over time.

Conclusion

Corporate pension plans have proven extremely difficult to manage over the past ten years, with many pension committees actively seeking options to minimize their long-term risks and funding demands, including premium options to terminate their plan. For a well-funded plan, implementing an LDI strategy is a relatively low-risk approach to achieving many of those long-term goals, and a number of plans are in a favorable position to pursue that option. Plan sponsors should consider reevaluating their rationale for delaying implementation of an LDI strategy and evaluate the impact of their current strategy under a range of market scenarios.

PENSION MANAGEMENT
Research Panel

The Pension Management Research Panel, sponsored by SEI's Institutional Group, conducts industry research in an effort to provide members with current best practices and strategies for the investment management of pension plans.

To request SEI's paper on implementing a custom LDI strategy, please contact SEI at SEIResearch@seic.com or 1-866-680-8027.