$20 billion club strategy

The largest corporate DB plan sponsors make subtle shifts in strategy as funded status stagnates

The 20 members of the $20 billion club, which hold, collectively, over $700 billion in corporate defined benefit plan assets, encountered an environment of anemic asset returns and slightly increased discount rates in 2015. Their funded status stagnated during this period, past trends continued – and a few new trends emerged:

- In 2015, plan sponsor contributions were down more than 50% since 2013, with many sponsors taking full advantage of funding relief measures despite average funded status below 80%.
- Portfolio assets allocated to fixed income (mostly LDI) now exceed 40%, on average – an increase from 33% in 2010. Three of the 20 plan sponsors allocated more than 55% to LDI.
- Better than half of the members of this group have adopted an alternative approach to calculating pension cost, via either the “marked-to-market” or “full yield curve” approach.

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Strategic changes by the most sizeable corporate DB plan sponsors often cause ripple effects in the industry that linger for years. For this reason, we find it instructive to take a deep dive into the pension-related actions these companies are taking year-to-year.

The largest corporate DB plan sponsors tend to attract headlines when they make strategic changes, and they are often seen as “first movers” when it comes to implementing new strategies. Consider the massive annuity purchases GM and Verizon made in 2012, or Honeywell’s transition to mark-to-market accounting in 2010. Ford’s lump sum pension payout program and its public announcement of its dynamic shift to a 20/80 allocation as plan funded status improved were significant moves, both of which were later replicated by others.[1] These types of strategic changes by the most sizeable corporate DB plan sponsors often cause ripple effects in the industry that linger for years. For this reason, we find it instructive to take a deep dive into the pension-related actions these companies are taking year-to-year.

While no single story took center stage in 2015,[2] and as funded status remained fairly stagnant, some new strategies emerged while others continued the momentum that has been building over the last several years. Funding strategies have changed dramatically since 2012. Historically, contributions have generally been correlated with funded status, as the authors of the Pension Protection Act of 2006 (PPA) originally intended; and for several years after the global financial crisis of 2008, we saw a spike in DB plan contributions – peaking, for the $20 billion club, above $30 billion in 2012. Now, with the latest flavor of funding relief receiving its second booster shot via BBA 2015[3] legislation, contributions are down, despite the fact that high PBGC premiums give sponsors an incentive to fund. In fact, 2015 contributions were less than half what they were in 2013, and the 2016 forecast is that contributions will be just slightly higher.

The substantial losses to funded status in 2008 have not faded from memory. Sponsors are keying in on risk management, and in their efforts to avoid another catastrophic hit to their plans, a general shift toward liability-hedging assets has ensued. Seventeen of the 20 members of the $20 billion club specifically state investment objectives that account for liability-related risks.

In 2010, sponsors in the $20 billion club allocated, on average, 33% of DB plan assets to fixed income. Now the average is 40%, with a couple of companies having made significant shifts in that direction in 2015.

Other trends continued as well, such as risk transfers, adjustments to mortality assumptions and accounting method tweaks. Taking a closer look at these and other changes that affected these sponsors in 2015 can help us identify trends and understand strategic objectives for the industry as a whole.

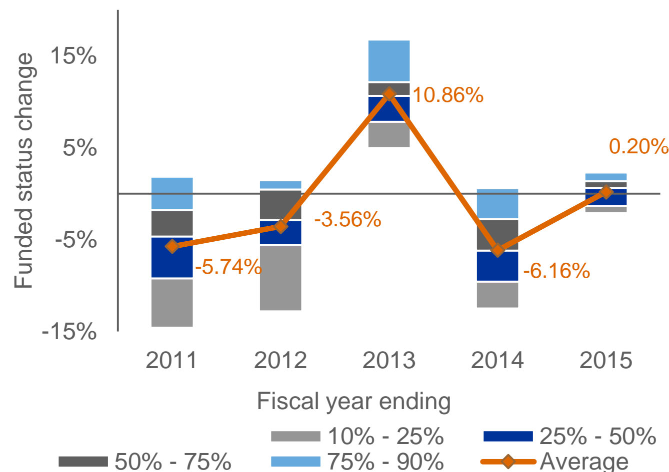
A closer look at funded status changes

To help put the 2015 funded status changes in context, let's look back one year. During 2014, we saw a wide disparity in funded status changes. It was a tough year in general for most pension plans as discount rates fell by more than 80 basis points, offsetting (and even overshadowing) a strong year for equity performance.[4] Only one member of the $20 billion club (Ford) improved funded status during that year, while for other members, funded status declined by as much as 13% (GE). Sponsors that fared best that year were either deeply into an LDI strategy (Ford, GM, Exxon) or making significant cash contributions (Verizon, Lockheed Martin).[5]

Unlike those in 2014, funded status changes in 2015 were small. Asset allocation had little bearing on overall funded status change, since the return difference between equities and fixed income was negligible. While 15 of the 20 corporations managed a positive asset return for 2015, the best return among those with fiscal year ending December 31 was just 2.3%. These anemic returns (the weakest overall since 2008) were offset with a rise in discount rates. This led to contributions – rather than returns or discount rates – being the key funded status differentiator. The four sponsors with the largest improvements in funded status were among those that contributed the most. The company that fared best (Pfizer) gained 3%, primarily due to a contribution worth 6% of liabilities. The sponsor whose funded status fell the most lost just 4%, primarily due to its fiscal year ending on a different date from the others. When we look at the 18 companies with FYE December 31, 2015, we see that the two companies that did worst (Boeing and Lockheed Martin) contributed very little. The average among all plans was a gain of 0.20% in funded status.[6]

In summary, 2014 was a better year for companies that had adopted an LDI strategy, while 2015 rewarded only those that had made discretionary contributions. This illustrates how investment and funding strategies can work in tandem to buoy a plan's funded status. Contributions always help to fill a funding gap, while LDI strategies can protect against interest rate risk, helping to preserve the contributions companies made. Exhibit 1 shows the range of funded-status-change percentages since 2011. In comparison to prior years, funded status changes were fairly uniform in 2015.

Exhibit 1: Range of funded status change, 2011-2015

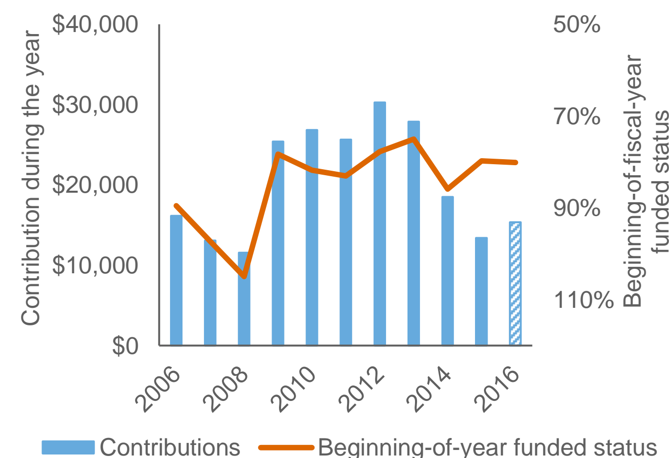


Source: Annual 10-K filings

Funding strategy: contributions too weak for treading water

In the past, a DB plan's funded status at the beginning of a year has been a reasonable indicator of how much sponsors will choose to contribute to the plan throughout the year. This was due to funding requirements under PPA, which generally require more contributions when larger funding shortfalls exist. For example, the average funded status of plans among the $20 billion club at the end of 2011 was 78%, the lowest recorded to that point. In 2012, DB plan sponsors responded by contributing, collectively, more than $30 billion, the highest contribution on record (see Exhibit 2). In fact, half of the 20 members of the club each contributed more than $1 billion during the year; five made contributions in excess of $3 billion.[7]

Exhibit 2: Contributions and average funded status, 2006-2016



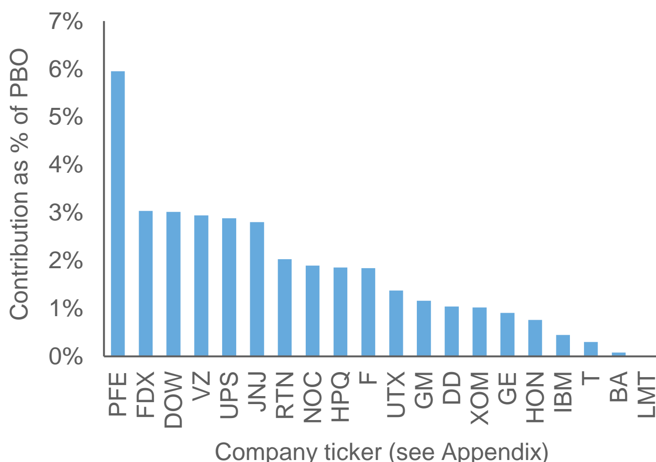
Source: Annual 10-K filings

In 2012, Congress passed the MAP-21 Act, which included pension-related provisions regarding funding methodology that offered much-desired funding relief for DB plan sponsors. While contributions did not decrease much that year, or in the year following, they significantly decreased in 2014 and 2015. The funding relief, which uses a discount rate bound by a corridor around historical discount rates, has led to most of these corporations having no U.S. contribution requirements of any kind, despite none being funded above 95% globally.[8]

Perhaps most striking: the $13 billion in 2015 contributions did not cover the $16 billion in new participant benefits earned that year.[9] In other words, on average, contributions were not sufficient to let sponsors tread water as regards funded status. Only one of these sponsors (Pfizer) chose to contribute more than 3% of plan liabilities toward its plan (see Exhibit 3).

While the funded status at the end of 2014 was about 80% (not much higher than 2011 funded status), contributions were less than half of 2012 levels, with just a few of the $20 billion club members contributing more than $1 billion. Notable among the latter was GM, which borrowed $2 billion to fund its plan, similarly to Ford's debt issuance in 2013.[10] Borrowing to fund a plan can hold significant advantages for plan sponsors, as current low interest rates make issuing debt historically inexpensive, and by funding a plan, sponsors can avoid escalating variable PBGC premiums.[11]

Exhibit 3: Fiscal year end contributions as percentage of PBO



Source: Annual 10-K filings

As we have noted previously,[12] using a minimum funding policy, or essentially taking full advantage of funding relief, could mean that a sponsor pays 25% to 30% of total contributions to the PBGC rather than to the funding of its own plan. While this scenario seems to be a compelling incentive for funding up the plan, few sponsors seem to be acting on an aggressive funding policy at this time.

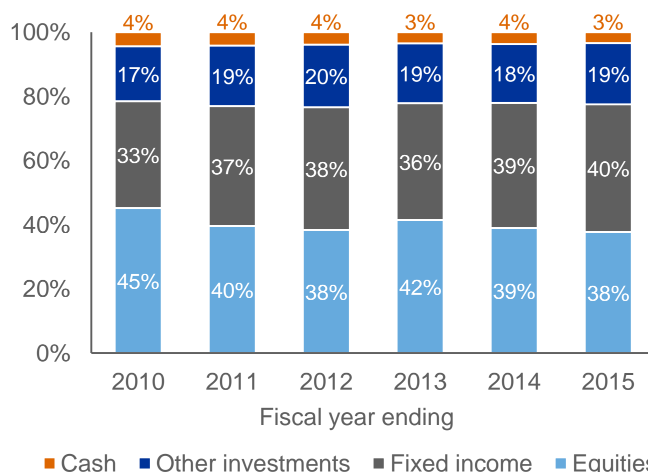
Investment strategy: slow but steady shift toward fixed income

At the end of FY 2010, only one member of this group allocated more than 45% of pension assets to fixed income, the most common liability-hedging tool. By the end of 2015, six companies had done so, with three (Exxon, Ford and GM) having allocated at least 55% of investment assets to fixed income. While a few sponsors have "re-risked" by shifting more into return-seeking investments, the majority have made notable shifts toward fixed income over the last several years, which, when coupled with the sponsors' stated asset/liability objectives, represents a clear shift toward asset/liability risk management.

The companies using the most aggressive LDI strategies over the last several years, each of which has shifted at least 10% toward fixed income since 2010, include Ford (added 27% to fixed income), GM (+23%), Exxon (+21%), Verizon (+17%) and IBM (+10%). During 2015, the two most notable shifts toward fixed income were made by Lockheed Martin (+9%, an apparent reversal from prior re-risking) and Verizon (+6%). No other sponsor in the group made a significant change in fixed income allocation.[13]

Exhibit 4 shows the broad asset classes to which, on average, these corporations are choosing to allocate global pension assets.[14] Some of these companies are certainly on de-risking glide paths that shift to fixed income as funded status improves.[15] As neither 2014 nor 2015 was a strong year for funded status improvement, we would not have expected many significant shifts toward fixed income during that time. However, if and when funded status improves, as it did in 2013, we expect the trend toward liability-hedging fixed income to accelerate.

Exhibit 4: Average asset allocation, 2010-2015



Source: Annual 10-K filings

Other observations: risk transfer continues; accounting methods are tweaked

Pension risk transfer has been an ongoing trend since 2012, and in 2015, we saw a few large transactions. Four companies cashed out former employees – Pfizer ($2.6B), Verizon ($2.3B), AT&T ($1.2B) and HP ($1.1B). No major annuity purchases occurred in 2015 among this group.[16]

The last major trend in pension accounting concerned the various forms of so-called "marked-to-market" (MTM) pension cost accounting. This is an approach to pension cost calculations wherein gains and losses are recognized immediately, rather than amortized. This impetus for this trend began in 2010, with Honeywell,[17] and since then five other members of the $20 billion club have followed suit – most recently Ford, in 2015. Notable here is that four of the firms have significant business rivals that have adopted this type of accounting.[18]

Another change to pension cost accounting began during fiscal year 2014, when AT&T adopted a new approach to calculating service cost and interest cost (components of pension cost), where rather than using a single rate to determine each value, a "full yield curve" (FYC) approach is employed.[19] The net result is typically a decrease in both interest and service cost, assuming the yield curve is upward-sloping. At least nine members of the $20 billion club have adopted the FYC approach since 2014. In total, 11 of 20 corporation have adopted the MTM approach, the FYC approach, or both.

Exhibit 5 denotes these 11 plans' adoption of new pension cost strategies.

Exhibit 5: Adoption of new pension cost strategies

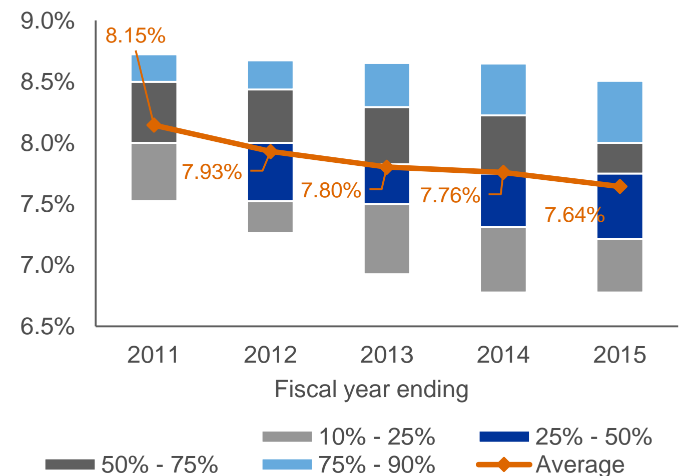
COMPANY	ADOPTED MTM	ADOPTED FYC
AT&T	Y	Y
Dow Chemical		Y
FedEx	Y	
DuPont		Y
Johnson & Johnson		Y
GM		Y
Ford	Y	Y
Honeywell	Y	Y
United Technologies		Y
UPS	Y	
Verizon	Y	Y

Source: Annual 10-K filings
MTM: marked-to-market; FYC: full yield curve

Assumptions: ELTRA moves steadily downward

The expected long-term return on assets (ELTRA) assumption used for pension cost calculations either stayed about the same[20] or decreased for all sponsors in the $20 billion club in 2015. Since 2011, the average ELTRA assumption has decreased by around 50 basis points to an average of 7.64%. This decrease is due to the combination of a generally lower-return environment and the general shift toward fixed income, discussed earlier. The decrease has been particularly significant among sponsors that have made significant allocations to fixed income, such as in the GM (6.38%) and Ford (6.75%) DB plans. Just six sponsors still maintain ELTRA assumptions at or above 8%, down from 16 in 2011.[21]

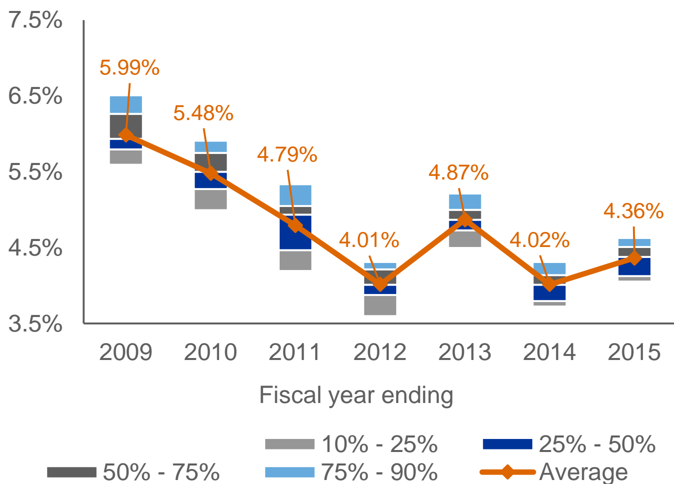
Exhibit 6: ELTRA assumption ranges, 2011-2015



Source: Annual 10-K filings

Discount rates have fluctuated significantly over the last several years, mostly moving farther down. While in 2015, as in 2013, we saw an increase in discounts rates, the increase was relatively small. In fact, as shown in Exhibit 7, it was the smallest overall change in discount rates in the last seven years. While the increase helped bring liabilities down, lackluster asset performance had an offsetting effect, leading most sponsors to simply maintain funded position throughout the year, as discussed above.

Exhibit 7: Discount rate assumption ranges, 2009-2015



Source: Annual 10-K filings

New mortality tables were a major headline for DB plans in 2014, with nearly all $20 billion club members adopting some version of the new Society of Actuaries (SOA) mortality tables.[22] In 2015, the SOA released updated versions of mortality improvement scales, and at least six members of this group used the new improvement scales, which generally decreased pension obligations.

Final thoughts

While we have noted the progress of several significant strategy changes over the last several years, this is only the beginning of the story. Even as strategies covered here will certainly continue, new methods and strategies will emerge, with members of the $20 billion club likely at the forefront. We will continue to monitor the status and strategies of these massive corporate DB plan sponsors, to help all of us keep a finger on the pulse of the corporate DB world at large.

Appendix

TICKER	COMPANY NAME
BA	Boeing
DD	E.I. DuPont de Nemours
DOW	Dow Chemical
F	Ford Motor
FDX	FedEx
GE	General Electric
GM	General Motors
HON	Honeywell International
HPQ	Hewlett-Packard
IBM	International Business Machines
JNJ	Johnson & Johnson
LMT	Lockheed Martin
NOC	Northrop Grumman
PFE	Pfizer
RTN	Raytheon
T	AT&T
UPS	United Parcel Service
UTX	United Technologies
VZ	Verizon Communications
XOM	Exxon Mobil

[1] Also known as "liability responsive asset allocation," first documented in 2009, by Russell Investments. See Gannon & Collie, "Liability Responsive Asset Allocation," 2009 Russell Investments Research.

[2] See Collie, "A lot going on behind the numbers for the $20 billion club in 2015," Russell Investments Research, 2016.

[3] The Bipartisan Budget Act of 2015, which extended funding relief passed in the Moving Ahead for Progress in the 21st Century Act (MAP-21) in 2012, and the Highway and Transportation Act of 2014 (HATFA).

[4] See Collie, "The pension world's $20 billion club stung by improving longevity," Russell Investments Research, 2015.

[5] See Owens, "Largest corporate DB plan sponsors tune up their strategies," Russell Investments Research, 2015.

[6] Company FY 2015 10-K filings.

[7] See Owens, "Members of the $20 billion club take action to address growing funding deficits," Russell Investments Research, 2015

[8] Based on FY 2015 10-K filings.

[9] First noted in Collie, "A lot going on behind the numbers for the $20 billion club in 2015," Russell Investments Research, 2016.

[10] "Ford sells $2 billion in 30-year bonds to help fund defined benefit plans," *Pensions & Investments*, January 3, 2013.

[11] See Gannon, "Borrow to fund: Do PBGC premiums incent sponsors to borrow to fund their pension plans?," Russell Investments Research Practice Note, November 2015 (update).

[12] See Owens, "Extended funding relief + higher PBGC premiums = a lethal combination," Russell Investments Fiduciary Matters Blog, December 9, 2015.

[13] Based on annual Form 10-K filings. Note that increased allocation to fixed income does not necessarily indicate a trend toward liability-hedging assets, as certain types of fixed income (e.g., high yield and emerging markets fixed income) are better categorized as return-seeking assets.

[14] Includes all global assets for pension plans. U.S. and non-U.S. plans are not always separated in the 10-K filings, making global comparisons the most consistent measure.

[15] According to 10-K filings, Ford, Verizon and United Technologies all have dynamic asset allocations tied to funded status.

[16] Based on FY 2015 10-K filings

[17] See Collie, Gannon, "Pre-empting FASB: mark-to-market pension cost accounting," Russell Investments Research, 2011.

[18] See Collie, "Ford switch to mark-to-market pension accounting: are more to follow?" Russell Investments Fiduciary Matters Blog,, January 7, 2016.

[19] See "Alternatives for pension cost recognition – issues and implications," American Academy of Actuaries, August 2015.

[20] Two sponsors increased the ELTRA assumption by very small amounts. Dow Chemical increased it from 7.82% to 7.85%, while Johnson & Johnson increased it from 8.46% to 8.53%.

[21] Based on annual 10-K filings.

[22] See Owens, "Largest corporate DB plan sponsors tune up their strategies," Russell Investments Research, 2015.

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