WHITE PAPER

A MULTI-ASSET APPROACH TO THE MULTIEMPLOYER PENSION CHALLENGE

Structural and Other Challenges for MEPs

At more than $500 billion in assets, the country's Taft-Hartley multiemployer defined benefit (DB) plans represent a stark microcosm of the bleak future of the DB pension plan model for the next generation of workers. The unique nature and characteristics of these plans have for years made their problems more pressing than the challenges of the much larger corporate or public DB plans. Recently, however, the plight of multiemployer plans has come into sharp focus with the approval by the U.S. Treasury Department in late 2016 of the first benefit reductions for a specific plan's active and retired participants under the Kline-Miller Multiemployer Pension Reform Act of 2014 (MPRA).

Multiemployer DB plans, or MEPs, are codified under Taft-Hartley (i.e., Labor-Management Relations Act of 1947), where two or more employers under collective bargaining fund retirement plans for participants in a particular union or trade—often organized by region. About 1,400 MEP DB plans currently fund benefits to more than 10 million people, both actively working and retired. (MEPs also exist for health and welfare benefits in the form of defined contribution plans; however, DB plans are currently the largest type of MEP.)

MEPs, like many other types of pension plans, suffered substantial losses in the 2008–2009 global financial crisis, but, unlike other plans, they continue to experience their own long-term challenges of declining union membership and contributions and participating employers exercising their rights to opt out of the structure. Although the average funded status of MEPs is in the mid-70% range, there are dozens of substantial plans in "critical or declining status," the so-called red zone, with extremely low levels of assets compared to plan liabilities. Additionally, the government backstop for single and multiemployer DB plans, the Pension Benefit Guarantee Corporation (PBGC), has said that its multiemployer fund, designed to pay benefits in the event of a plan insolvency, will be insolvent itself by 2025. PBGC paid $113 million to 65 insolvent plans in its fiscal year 2016, compared to $103 million it paid to 57 plans during the previous year, according to the latest PBGC annual report.

Summary

The current situation for multiemployer plans (MEPs) is acute and demands immediate action. Declining MEPs need a specialized investment and asset allocation approach to their portfolios. The first benefits reductions for an individual plan were approved by the U.S. Treasury Department in late 2016. With the decline of multiemployer plans, the investments and particularly the costs incurred by plans are coming under increased scrutiny. Cerulli argues that not only should asset managers working with Taft-Hartley clients be aware of impacts of the Kline-Miller Multiemployer Pension Reform Act of 2014 (MPRA), but also that institutional multi-asset-class strategies may, from an investment standpoint, help the significant investment challenges of multiemployer defined benefit (DB) plans.

Key Points

- Multiemployer DB plans suffered substantial losses in the 2008–2009 global financial crisis and they continue to experience unique long-term structural challenges.
- Several plans in critical and declining status have applied to reduce benefits, and late last year, one plan—Iron Workers Local 17 Pension Fund—gained approval to reduce benefits for active and retired participants.
- Developments in the multiemployer space will likely bring renewed pressure on investment management fees and the suitability of certain investments overseen by asset managers working with Taft-Hartley DB plans.
- Cerulli asserts there is an opportunity for certain institutional asset managers to work with multiemployer clients and their consultants to adopt institutional multi-asset-class solutions (MACS) strategies—specifically risk mitigation strategies—for plan investment portfolios.

First Benefit Cuts Under MPRA

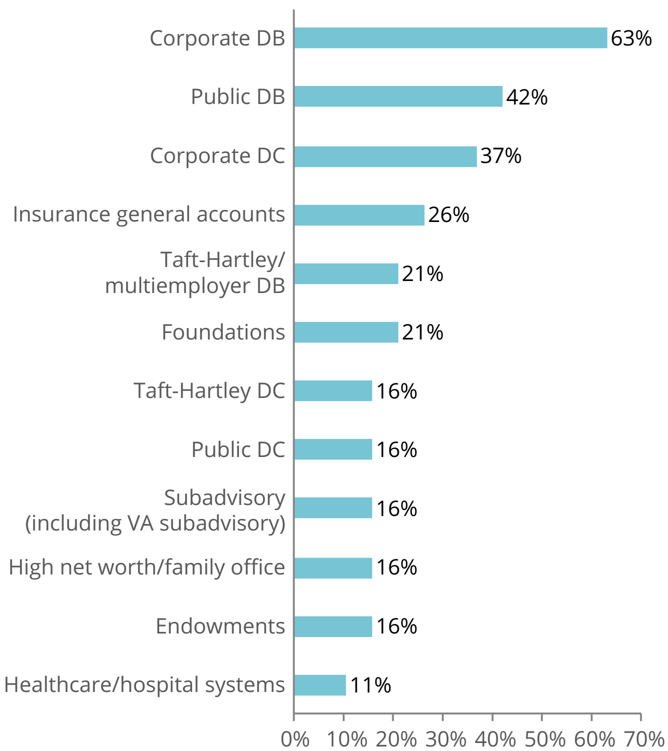
Enter the MPRA. The trade organization representing MEPs, the National Coordinating Committee for Multiemployer Plans, was a vocal proponent of the 2014 MPRA. The most notable implication of the legislation is that it enables troubled plans to enact benefit cuts within certain limits. The legislation also allows for PBGC assistance in facilitating the merger of MEPs, for which the agency issued a proposed rule in June 2016; the partitioning of a distressed MEP, where PBGC provides financial assistance for a portion of the plan's liabilities; and increasing the premiums MEPs pay to the PBGC from the current $27 yearly per participant premium today.

Several plans in critical and declining status have applied to reduce benefits. Late last year, the much smaller ($90 million) Iron Workers Local 17 Pension Fund based in Cleveland, which had a 39% funded ratio according to its last government filings, gained approval from the Treasury to reduce benefits within certain parameters for both active and retired participants. (In January 2017, participants voted to accept current and retiree benefit cuts.) However, some have had their applications rejected— including the large $17.8 billion Teamsters Central States, Southeast & Southwest Areas Pension Fund—for not meeting the specific criteria.

Another distressed MEP with its application for benefit cuts under MPRA still under review, New York State Teamsters Conference Pension and Retirement Fund, which expects to be insolvent in 19 years, opened another front on this topic. A report in The New York Times (December 30, 2016) took issue with the investment costs incurred by the plan and plan trustees' approval of adding alternatives investments to the portfolio following market losses in 2008–2009 noting, "other pernicious forces…illiquid, opaque and high-cost investments." Additionally, it was reported that a plan participant group had hired the firm Benchmark Financial Services to conduct a "forensic study" on the investments and costs of the plan.

Exhibit 1: Client Types with Most Expected Asset Growth in Customized Multi-Asset Strategies in the Next 12-24 Months, 2016

Although Taft-Hartley multiemployer DB plans constitute a small segment of customized institutional multi-asset-class solutions today, institutional asset managers surveyed by Cerulli believe MEPs will be among the client types seeking these strategies in the near future.



Source: Cerulli Associates, The Cerulli Report – U.S. Institutional Custom Solutions 2016: The Rising Demand for Outcome-Oriented Client Strategies

A Multi-Asset Investment Approach to Rapidly Depleting Portfolio Assets

Cerulli expects that these developments in the multiemployer space will bring renewed pressure on investment management fees and the suitability of certain investments overseen by asset managers working with Taft-Hartley DB plans. This is not surprising as pressure on fees in the much larger public plan space continues, as does the questioning of the performance of alternative investments added by public plans before and after the global financial crisis. Much like their public plan brethren, MEPs took a "swing for the fences" approach with alternatives after 2007–2008 drawdowns in order to grab risk-adjusted returns, especially with liquid alternatives such as hedge funds, only to be disappointed when many of these investments didn't deliver.

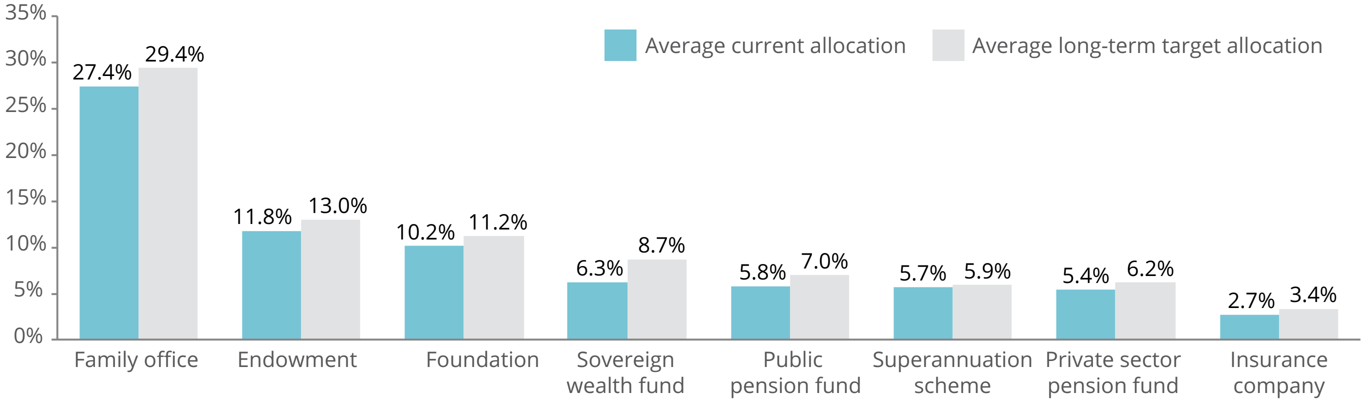
But the current situation for MEPs is much more serious than with other types of institutions and it demands immediate action. Certainly, unfavorable demographics point to a much faster depletion of assets compared to other types of DB pensions. Additionally, it is likely that a finite number of smaller plans will get relief under MPRA, leaving larger MEPs to fend for themselves. Much like a derisking corporate DB plan, or a smaller endowment or a foundation charged with paying out assets in a specific time period, declining MEPs need a specialized investment and asset allocation approach to their portfolios.

Applications of MACS

Cerulli recommends institutional asset managers already managing assets for Taft-Hartley DB plans work with clients and their consultants to adopt institutional multi-asset-class solutions (MACS) strategies for multiemployer

Exhibit 2: Average Allocation to Private Equity by Investor Type, January 2016

Taft-Hartley multiemployer DB plans, as seen through the category of private sector pension funds, generally have relatively small allocations to more illiquid alternative investments.



Source: Preqin

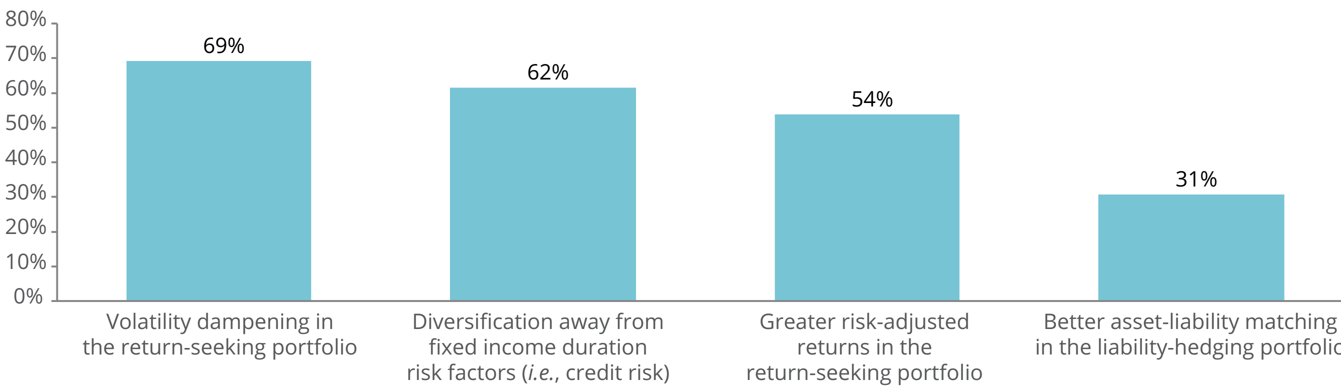
investment portfolios. MACS are about the combination of sometimes many different institutional strategies—often tactically via modern asset allocation practices—for the objective of lowering asset volatility, capturing investments with low or no correlation in returns, raising risk-adjusted returns, and protecting an institution from debilitating large-scale losses (*i.e.*, asset drawdowns) that may hamper the institution from meeting its ultimate goals.

Strategies can range from derivatives-oriented managed volatility overlay to the most sophisticated volatility or income targeting, and can include alternative and absolute return investments. Asset managers and institutional investors tell Cerulli that a specific focus on investment risk factors is leading to a multi-asset approach that combines MACS strategies with a "core" of smart beta, risk parity, and other risk mitigation strategies—essentially the combination of passive beta and active management strategies. This is becoming prevalent with institutions that, according to several managers and consultants, are seeking to use MACS for "engineering specific exposures."

A number of factors would presume to favor a handful of larger asset managers offering MACS to MEP clients. First, these managers are more likely to be able to be flexible in an environment of greater fee scrutiny. Second, these firms are more likely to have the resources to devise a multi-asset solution for a client. The scale of these firms does not just apply to investment expertise. Ultimately, this effort is about better downside risk mitigation, and that requires sophisticated analytical tools to break down both intended and unintended exposures in portfolios.

Exhibit 3: Reasons for the Inclusion of Alternative Investments in Corporate Pension Derisking Strategies, 2016

Much like a derisking corporate DB plan, MEPs need to account for managing a declining asset base. Corporate plans will often employ alternative investments for needed volatility dampening and diversification on the return-seeking side of their investment portfolios.

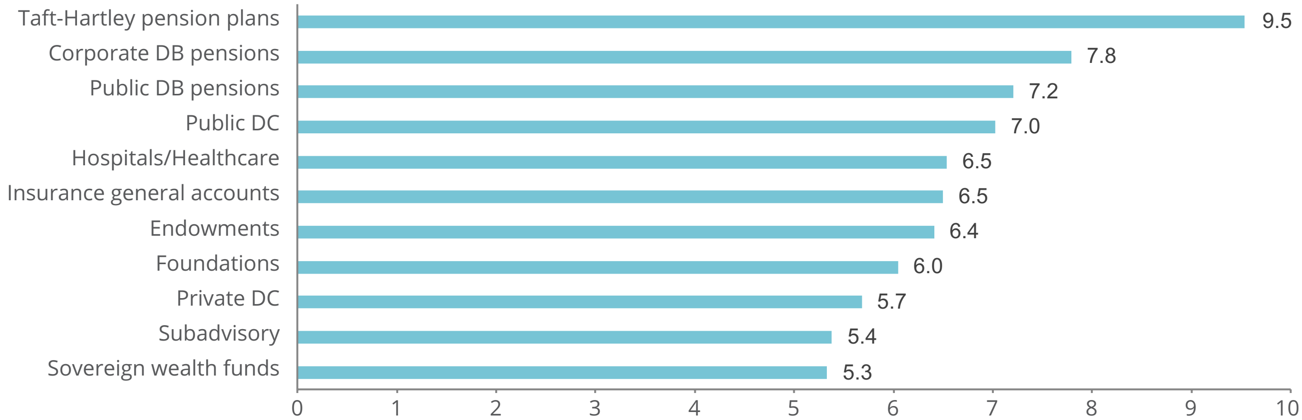


Analyst Note: This data only includes respondents who are managing alternative investment strategies for plans that are adhering to a derisking glidepath.

Source: Cerulli Associates, The Cerulli Report – U.S. Alternative Products and Strategies 2016: The Multiple Roles of Alternative Investments

Exhibit 4: Average Client Relationship Timeframe by Institutional Client Type, 2016

Although they can be much smaller than corporate or public DB pensions, Taft-Hartley plans tend to have the longest client relationships with their asset managers.



Analyst Note: Figures shown are in years.

Source: Cerulli Associates, The Cerulli Report – U.S. Institutional Markets 2016: Reassessing Opportunities for Growth Across Multiple Institutional Asset Pools

Although a number of factors favor large asset managers with significant capabilities, union-based plans are an area known for strong long-time relationships among clients and their consultants and asset managers. Certain asset managers and consultants often have specialists dedicated to Taft-Hartley plans with intimate knowledge of unions, their members, and their decision-making process. Although these relationships will remain important for some time to come, the changes in the MEP world threaten to upend the business of providing investment services to these plans.

Cerulli recommends that institutional asset managers evaluate their investment capabilities and resources to determine whether they can provide more customized, outcome-oriented strategies—including inflation-hedged, absolute return, or portfolios designed to target a specified level of volatility and plan asset drawdown.

Additionally, asset managers should train client relations staff to initiate and make high-level recommendations on more customized MACS engagements for MEP clients, and employ pension and actuarial resources to help the client map the client's unique circumstances with potential investment solutions. Cerulli also envisions a market for outsourced chief investment officer (OCIO) services in the MEP space, though OCIO opportunities continue to be largely in the single-employer corporate DB and in the nonprofit (endowment, foundation) areas.

Risk mitigation and the protection from major asset drawdowns from MACS will clearly be key for MEPs in the future from an investment standpoint, although it won't allow these groups to avoid its significant structural and plan design challenges over time. Nevertheless, Cerulli encourages managers to offer cost-effective MACS and risk mitigation strategies for this cohort of pension institutions that will still need to pay out benefits for years to come. ◆