Derisking DB Plans in Flux

Substantial volatility in late 2018 and early 2019 highlight the challenges and risks many corporate defined benefit plan sponsors face

Cerulli White Paper | April 2019

Summary

Corporate (private, single-employer) defined benefit (DB) plans have traditionally chosen to derisk liabilities, in part because of volatility concerns. Recent financial market volatility cast a spotlight on these concerns and other issues, as the results of a Cerulli survey of mid-sized plans show. In this context, Cerulli offers several recommendations to asset managers and investment consultants helping derisking plans implement a liability-driven investing solution.

Key Points

- After tens of billions of contributions and higher discount rates improving funded status for much of 2018, volatility negatively affected corporate DB plans in the last days of the year.
- Despite an improvement in conditions in the first months of 2019, mid-sized plans surveyed in the first quarter express a greater focus on investment risks and on the fees paid to third-party asset managers.
- Respondents generally hold investment risk analytics in high regard when choosing among various non-investment-management services provided by managers: more than half (56%) rank strategic asset allocation advice and risk analytics as "very important."
- Cerulli suggests managers help corporate plans take a more holistic view of investment performance and risk in their portfolios, particularly in the case of asset-liability management.

U.S. corporate defined benefit (DB) plans probably would rather forget this past winter. Significant volatility in financial assets and interest rates whipsawed these institutions just as underfunding concerns were beginning to ease early in the fourth quarter of 2018. As the pension industry weathered these challenging conditions, Cerulli sought to gauge the sentiment of mid-sized corporate DB plans—a cohort in the midst of the liability derisking trend, but without the resources of large plans—to assess how these institutions were managing through the volatile period. In general, Cerulli found that surveyed corporate plans held fast in the face of an unusually rapidly changing environment. Cerulli believes asset managers and investment consultants working with corporate plans should continue to counsel clients on the benefits of securing funded status improvements through liability-driven investing, or LDI.

Unusual Volatility

Through the first three quarters of 2018, the funded status of the average corporate DB plan steadily improved from a more than 85% funded ratio to the low-to-mid 90s in September. Many plans, especially larger ones, had taken steps to derisk pension liabilities by freezing benefit accruals and/or closing to new participants after facing significant pressure to immunize the volatility of liabilities on corporate balance sheets and income statements. Not surprisingly, corporate pension contributions skyrocketed in part because of a September 2018 tax deduction deadline following the 2017 changes in the U.S. tax code that reduced corporate tax rates and lowered the tax deductibility of pension contributions.

Tens of billions of dollars of contributions accounted for more than a three-percentage-point improvement in funded ratios in 2018, per Goldman Sachs Asset Management. Record levels of termination and pension risk transfer (PRT) activity occurred, fueled by the notable PRT deals of several large plans.

Financial market volatility in late 2018 brought on largely by concerns of slowing global growth changed the game seemingly overnight. Investment drawdowns in equities and fixed income overwhelmed higher contributions as well as any increase in long-term discount rates used to value pension liabilities. According to the Milliman Pension Funding Index, November to December was the largest percentage-point decline for the year, in many cases wiping out 2018 percentage point improvements in funded ratios in one month. Then, in the first few months of 2019, as the U.S. Federal Reserve Board appeared to change track and hold off on further increases in short-term interest rates, financial assets rebounded, and volatility largely became a positive.

Despite the bounce back, one can't fault a corporate DB CIO for feeling shell-shocked. Recalling the 2007–2008 global financial crisis losses (which, on the eve of the crisis, was the last time corporate pension plans were fully funded), CIOs tell Cerulli that their companies cannot stomach such volatility again.

Indeed, a majority (63%) of mid-sized corporate DB plans responding to the Cerulli Corporate DB Derisking Survey (those between $2 billion and $10 billion of plan assets) say both funded status volatility and uncertainty of pension contribution levels were what encouraged them to derisk in the first place.

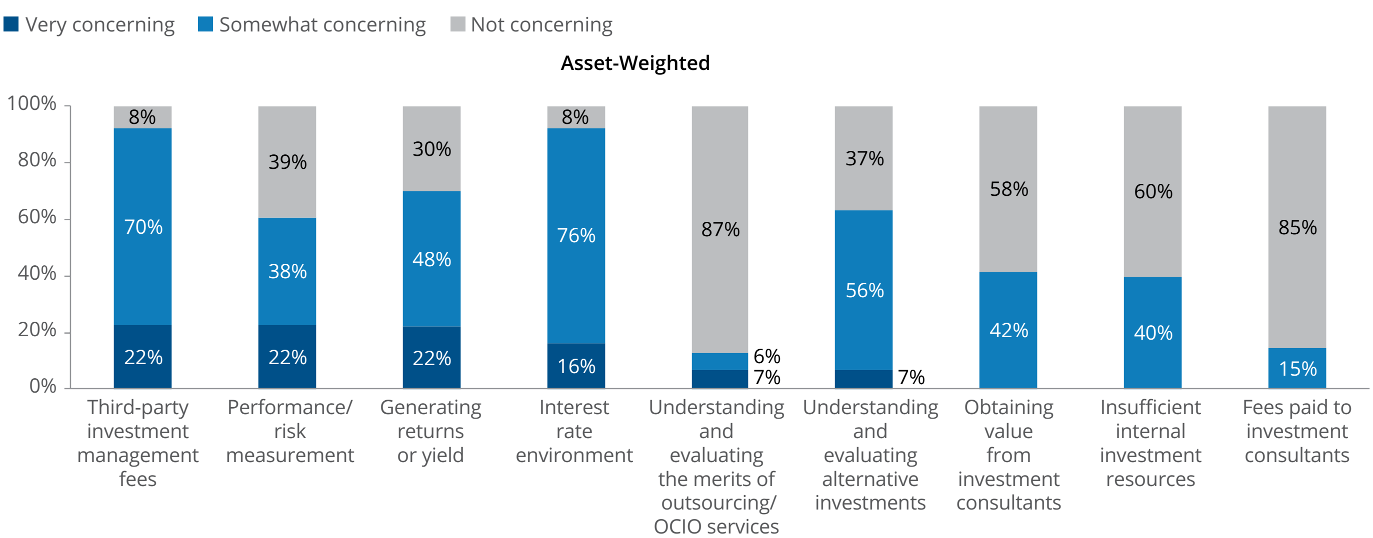
So, what are mid-sized DB plans thinking after this latest bout of volatility? For one thing, after years of low discount rates negatively reflecting the present value of future liabilities, followed by rates rising for much of 2018 (providing some relief), the current environment has now muddied the waters of plans' interest rate outlook. On an asset-weighted basis, almost half (42%) of respondents are concerned about rates while 37% report being relatively not concerned. Had the survey been taken in September of last year, it's likely many more would have been "not concerned" about rising rates.

Greater Focus on Investment Risks

In today's context, however, it appears costs and risks are coming to the fore from an investment standpoint. Indeed, mid-sized plans, again on an asset-weighted basis, rate investment management fees paid to third-party managers, performance and risk measurement, and generating risk-adjusted returns and yield equally (22%) "very concerning" on a sliding scale.

EXHIBIT 1

Mid-Sized Corporate DB Plans' Level of Investment-Related Concerns, 2019



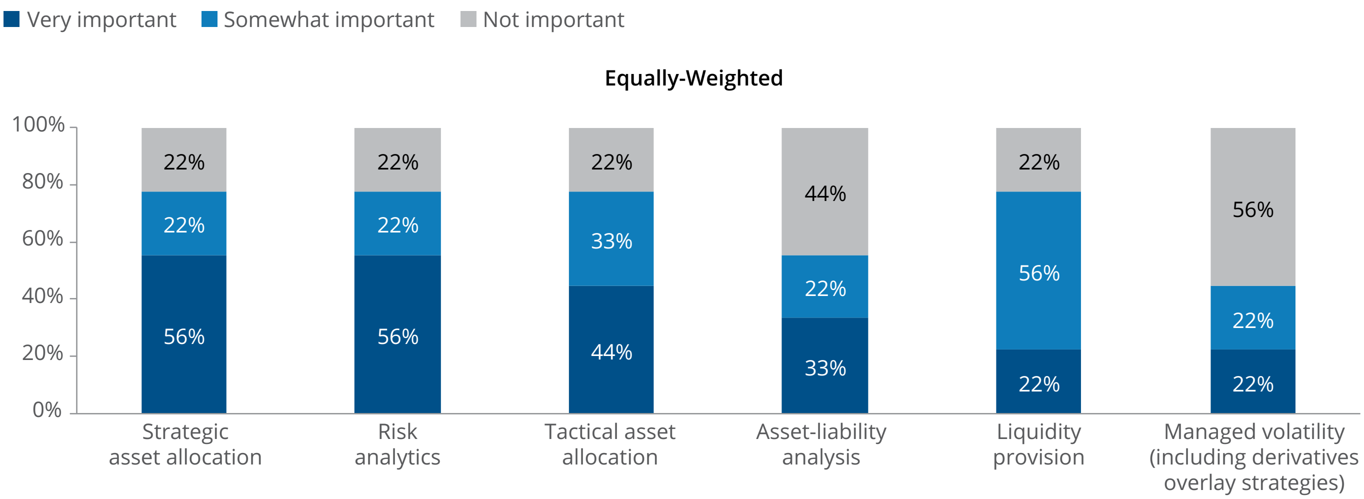
Source: Cerulli Associates

Furthermore, when asked to rate the importance of non-investment services provided by their asset managers, plan respondents generally hold investment risk analytics in high regard. More than half (56%) rank strategic asset allocation advice and risk analytics as well as tactical asset allocation (44%) as "very important." Interestingly, these types of services have traditionally been provided by investment consultants, but Cerulli finds that the larger the plan, the less likely they will be dependent on consultants: asset-weighted, less than half (47%) report using an investment consultant.

When corporate DB plan sponsors commit to some form of derisking, they generally separate their investment portfolio between liability-hedging assets and risk-seeking assets. The mid-sized plans responding to the Cerulli survey all appear to be at some point along the derisking curve, with the average respondent reporting 53% of their assets in liability-hedging strategies (*i.e.*, long-duration fixed income, various derivatives, and other instruments). In general, as the liability-hedging side grows, the risk-seeking side gets smaller. The smaller risk-seeking portfolio therefore becomes more susceptible to volatility and asset drawdowns, even as the plan must still seek risk-adjusted returns.

EXHIBIT 2

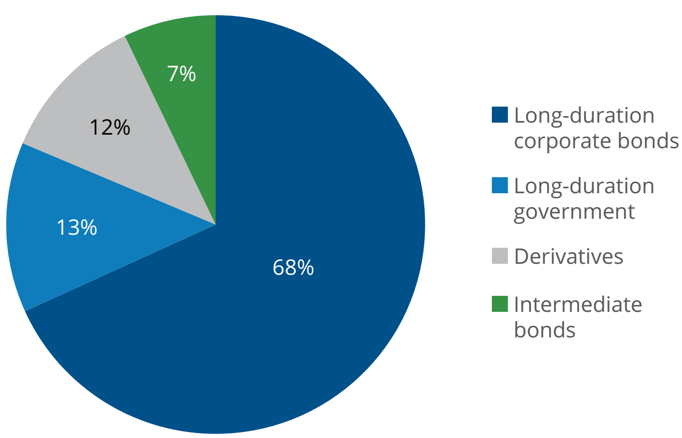
Importance of Various Non-Investment Services, 2019



Source: Cerulli Associates

EXHIBIT 3

Average LDI Allocation, 2019



Source: Cerulli Associates

Thus, when mid-sized DB institutions were asked about near-term (next 12 months) plans for asset management search activity (new and replacement searches), their answers reflect the desire for better risk-adjusted returns. Private equity, real estate, and hedge funds are among the among the strategies or asset classes cited for "high" or "moderate" future searches.

Cerulli suggests asset managers help corporate DB plans take a more holistic view of investment performance and investment risk in their portfolios, particularly when it comes to asset-liability management. No two plans' liabilities are the same; however, managers can assist clients by:

- Helping corporate DB plans finalize derisking goals and milestones and educating plans' investment committees about the differences of an LDI approach compared to typical institutional investment strategies (assuming the company is in the early stages of derisking);
- Running scenario and holdings-based risk analysis for corporate DB plans in an asset-liability framework, including the impact of changes to the risk-seeking side of the portfolio;
- Providing thought leadership on long-duration fixed-income liquidity and the use of various types of derivatives in an LDI portfolio;
- Educating plans on the differences in performance reporting and analysis in an LDI context compared to the traditional quarterly reporting they may be used to;
- Explaining the benefits to the client of custom liability glidepaths compared to market index glidepaths;
- Offering a vision of the future and companies' options if the ultimate goal is plan termination.

Volatile investment environments such as the most recent period highlight the risks companies face in meeting their benefit promises in traditional pension plans. It's clear that plan sponsors are reaching out to trusted asset managers (and consultants, in some cases) for guidance. The question is whether or not the asset management industry will be ready, willing, and able to listen.

About the Survey

The 2019 Cerulli Corporate DB Derisking Survey of chief investment officers and other internal investment professionals at mid-sized plans—defined by plans with assets between $2 billion and $10 billion—was conducted in 1Q 2019. Plans surveyed represented more than $43 billion in assets as of December 31, 2018.