TOP 10 DEFINED BENEFIT AREAS OF FOCUS FOR 2019

Substantial contributions from plan sponsors, higher interest rates and volatile equity markets have left funded positions at a five-year high. As of late 2018 (when this paper was written), the average pension plan was 92% funded, up 8% over the past year. Plan sponsors continue to actively look at a wide range of opportunities across the pension balance sheet to increase returns, reduce the size of their liabilities and manage risk. Given this highly active but uncertain environment, Mercer's team of defined benefit (DB) experts present the key areas of focus for plan sponsors in 2019.

1. Time to bank on funded status improvements?

Most sponsors enjoyed significant funded status improvements in the first three quarters of 2018. The continued bull market, coupled with a significant rise in discount rates, drove up the aggregate funded ratio of pension plan sponsors in the S&P 1500 from 84% to 92% by the end of September — the highest level in the past five years. A record number of funded status de-risking triggers were hit in 2018, as plan sponsors with defined glide paths progressed along their de-risking journey. The beginning of the fourth quarter reminded plan sponsors of the potential equity volatility inherent to plan funded status performance and continued equity risk moving forward, including concerns of a potentially less accommodative Federal Reserve. This highlights the question: When is the right time to bank on funded status improvements?

Whether your plan has a formal glide path in place or not, take a fresh look at your current situation and risk posture and consider:

- Monitoring funded status more frequently to assess the progress and volatility of funded status, and to ensure opportunities are not missed
- Reviewing your situation to determine or reconfirm your ultimate destination and the conditions that should drive changes in the structure of your investment portfolio or initiate a transfer of plan obligations and risk off balance sheet (in part or in full)
- Putting the appropriate governance in place so you can move quickly to take advantage of market opportunities as they are presented.

We discuss these considerations further in the following topics.

2. What's your Journey Plan?

Developing a Journey Plan that outlines the strategic policy choices to move your plan to its ultimate destination is a step many plan sponsors have undertaken. The three primary elements of a Journey Plan are investment, funding and risk transfer strategies (for some plans, plan design may also be an option). It is important that these strategies are coordinated where appropriate, such as investment policy with risk transfer activity, to manage cost and risk. For example, where the Journey Plan calls for annuitizing a portion of the liability, adjusting the investment policy to account for financing the transaction by transferring assets-in-kind can reduce premium costs. This type of change requires planning ahead to generate the best economic results. When lump sums are being offered to terminated vested participants during a window period, it is also important to consider the investment implications. Once the interest rates used to determine the lump sum payments are locked in, the lowest-risk asset becomes cash, and coordinating liquidation of assets to support the payments and manage risk is a key element in a successful program.

3. Assess pension risk transfer strategies

Since 2012, plan sponsors have transferred more than $100 billion in pension liabilities from their balance sheets, through either lump sum payments to participants or annuity buyouts with insurers. Mercer survey data indicate that over 75% of plan sponsors have executed lump sum exercises, and the annuity buyout market has grown at a rate of 45% per year over the past five years.

Most sponsors who have executed lump sum programs or annuity buyouts are satisfied with the outcome, and are now looking at what's next to continue to reduce pension risk. Emerging solutions gaining increased interest for 2019 include:

- **Active lump sums.** "Why can't I get a lump sum also?" is a common refrain heard from employees of organizations that paid lump sums to terminated vested[1] participants. While slightly more complex, plan sponsors can structure a transaction[2] to offer lump sums to active employees with frozen benefits. Such an offer can shed liability, reduce PBGC premiums and make employees happy by allowing them to roll their pension lump sum into their defined contribution plan, though the cost may not always be attractive.
- **In-plan insurance solutions.** The majority of US insurance pension transactions to date have been structured as buyouts.[3] An increasing number of organizations are now looking at buy-in transactions as a potential way to better manage settlement charges and cash requirements. In a buy-in, the plan purchases an annuity as an asset that it holds and which provides cash flows to pay benefits.
- **Full plan termination.** As funded status improves, plan sponsors are more thoroughly exploring the full termination of their plans. This settles all liabilities through a combination of lump sums and annuity buyouts.

[1] A terminated vested participant is a former employee of the plan sponsor who has not yet begun receiving monthly retirement payments. To date, most lump sum activity has been focused on terminated vested participants.

[2] Such a transaction would generally involve spinning off some or all active participants to a separate plan that is subsequently terminated

[3] A buyout irrevocably transfers assets, liabilities and plan administration responsibility from the plan sponsor to an insurer. In a buy-in, the plan sponsor holds the insurance contract as a plan asset, mitigating financial risk but keeping the assets and liabilities in the plan. Although buy-ins are very common in the UK, US adoption to date has been low.

4. Is plan termination your goal?

The improved funded status has seen many plan sponsors approach the ultimate destination of the journey they set out on years ago (with peaks and valleys along the way). If you are currently navigating the regulatory maze of the plan termination process, it's time to focus on your investment risk hedging strategy and critical drivers of termination costs, such as the plan's lump sum stability and look-back periods and the impact that the lump sum rate-lock date will have on the total plan termination liability duration. Having a strategy in place to shorten the duration will be critical to avoid over-hedging interest rate risk. Since this outcome will depend on how many participants opt for a lump sum, which won't be known for a year after the lock date in many cases, consider amending the plan to adopt shorter stability periods (monthly or quarterly) for lump sum interest rates to enable better execution of the hedging strategy. Such an amendment requires a 12-month grandfathering period, which makes advance planning essential.

5. Rethink the structure of your liability hedging portfolio

The liability hedging portfolio (LHP) is generally composed of long-duration fixed income assets that have characteristics similar to your plan's liability. As funded status increases and more assets are allocated to the LHP, improving the match between the asset and liability interest rate and credit spread sensitivities becomes increasingly important to manage funded status risk.

The sensitivity to changes in credit spreads is generally more pronounced for investment grade corporate bonds that are lower on the quality spectrum. Because the liability is based on higher-quality corporate bond yields (that is, AA for accounting or A-AAA for funding calculations), an LHP that is invested primarily in corporate bonds might actually be more sensitive to changes in spreads than the liability. One way to adjust this is to revisit the relative policy allocation between corporate and Treasury bonds to improve the average quality of the portfolio. Alternatively, you could modify the corporate bond investment mandate to reflect a tilt toward higher credit quality (and update the benchmark to match). In addition to better aligning the LHP and liability, the timing might be right for this type of change.

The additional return from lower-quality corporate bonds has been attractive, but as rates rise and with the potential for lower-quality credit spreads to widen (relative to the liabilities) as we approach the end of the corporate credit cycle, the move may prove beneficial.

Another change to contemplate is better matching the key rate durations of the assets and liabilities. Most plan sponsors have extended duration by using standard long-duration fixed income benchmarks. These tend to have more interest rate exposure at the longer maturities, which may not align with the liability cash flows. In an environment where the level and shape of the yield curve are changing (the curve is relatively flat today compared to historical averages), this might produce unexpected results. Determining the key rate duration of the plans' liability and working with your fixed income manager to specifically target more points along the yield curve can provide more consistent interest rate hedging and reduced funded status volatility.

6. What's your bond capacity?

Plan sponsors looking to manage pension risk have often looked to long duration bonds as a means to control volatility. This is logical; a pension liability is a fixed stream of future payments, which is fundamentally the same economic transaction as a bond. Therefore, the value of pension liabilities and bonds with the same duration[4] are likely to move in tandem.

However, the supply of long-duration fixed income securities is finite. Interest rates at the long end of the curve are driven not just by macroeconomic factors, but by the number of buyers and sellers of long bonds in the marketplace. Many pension plans would like to de-risk further but are wary of buying too many long bonds when interest rates are "low." This creates an interesting supply-and-demand dynamic: If rates rise, pension funds look to buy more long bonds, putting downward pressure on rates. For this reason, many observers do not expect that a significant rise in long-duration rates could happen very quickly.

Although it may seem strange that a specific niche of bond buyers (pension funds) could have a meaningful impact on rates, a look at the size of the market provides some insight. Single-employer DB plans in the US make up roughly $3 trillion in assets, while high-quality, long-duration corporate bonds are only a $1.6 trillion market. Other long-duration bonds can play a role as well, but face similar capacity constraints. Insurers have become increasing buyers of long-duration bonds as well, especially as annuity buyout deals have proliferated. If this activity continues, early movers could have a distinct advantage, as plan sponsors de-risking their plans earlier (through either liability-driven investing or buyouts) could see more attractive bond pricing than late movers if appropriate bonds become scarce.

A related consideration is the suitability of the bond portfolio for a transfer in kind to an insurer. In some cases, insurers offer material discounts off annuity purchase premiums when transacting with in-kind assets. Sponsors should think about adjusting the composition of their hedging portfolios to include the types of assets that insurers find attractive in an in-kind transfer (typically high-quality corporate bonds). Although insurers will accept treasuries as an in-kind security, the scarcity of high-quality corporate bonds can actually result in a discount on the cost of the placement. Treasury bonds are much easier to buy and therefore won't warrant discounts, so these assets might be best suited for liquidation to pay lump sums to electing participants once rates are locked in, rather than held as part of the final hedging portfolio.

7. Re-evaluate your growth portfolio construction and alternatives

A public-equity-dominated growth portfolio has performed well since the global financial crisis. In fact, with the benefit of hindsight, investors would have been better off if their growth portfolios were dominated by US equities. This trend is unlikely to continue, and now, more than ever, pension plans need to ensure that their growth portfolios are well diversified and resistant to increased uncertainty and downside risks. This means having allocations to diversifying assets like real estate, infrastructure, private equity, emerging market debt, high yield, bank loans, private debt, hedge funds and others. Even "diversified" growth portfolios can be dominated by equity risk, and investors need to explicitly consider diversification of common risk factors, like equity market beta or inflation sensitivity, across their assets.

[4] Duration is a measure of interest rate sensitivity of a financial instrument. If a pension liability has a duration of 14, that means the value of the liability will increase by around 14% if interest rates fall by 100 basis points. If assets and liabilities have the same duration, the impact of changing interest rates is expected to impact both similarly.

8. Manage your growth portfolio's liquidity along your glide path

We have recommended that clients invest in less liquid assets since the financial crisis, but as funded status improves, it's time to develop a strategy for the plan's end state and calibrate illiquid assets to fit the ultimate strategy. If a plan intends to terminate, it should be planning to be out of illiquid investments well before the termination date. This means stopping new capital commitments and potentially looking for exit strategies from current investments. The cost and complexity of liquidating partnership interests prematurely can be significant. Alternatively, plans that are not seeking to terminate but only significantly de-risk may be well positioned to maintain their illiquid investments and benefit from the higher long-term returns. A de-risked plan will generally need some exposure to growth assets (depending on their funded position), and private investments, even as a relatively large proportion of the growth allocation, can still be appropriate and beneficial. Even with partial de-risking, plan in advance to avoid becoming too highly allocated to illiquid assets.

9. Use protection strategies wisely

As we look ahead to a likely turbulent, or at least uncertain, period for capital markets, consider how the plan's portfolio will perform if markets, or rates, decline. Although many strategies are presented as a way to have your cake and eat it too, by keeping your returns and avoiding downside, we believe many such strategies will leave investors with a feeling of empty calories. Such risk-reducing option strategies always reduce return as they reduce risk if the strategy is held for a long period. The key to options, and most protection strategies, is to use them when there is something in particular to protect against, and it can't be the same thing everyone else wants to protect against. An option strategy to protect a portfolio from a loss prior to a planned buyout or lump sum can be effective, as might an interest rate strategy that takes in a premium for accepting the risk of buying bonds after rates rise. The critical consideration is to know what you're paying and what you are receiving.

10. Assess opportunities to improve investment governance

Assets invested in delegated governance models (outsourced CIO, or OCIO) in the US have doubled over the past five years.[5] Although we never recommend blindly following the crowd, understanding why plan sponsors have made the decision to shift to the OCIO approach, and whether these decision drivers are applicable to your organization, is critical.

A majority of plan sponsors moving to OCIO models cited a lack of internal resources and improvement in governance processes among their top three reasons for the change (Cerulli Associates, 2017), and 55% of plan sponsors strongly agree/agree that they struggle to find time and expertise to meet obligations related to overseeing the investment strategy of their organization's pension plan.[6] If your organization has experienced turnover or a shift in roles and responsibilities, this often creates gaps in expertise, experience or governance. The OCIO approach provides an extension of remaining staff to enhance governance and reduce demand on internal resources. The potential for cost savings from manager fees, more nimble execution, improved performance and reduced fiduciary risk add to the OCIO value proposition. Ultimately, allowing sponsors to focus more on their core business may be the most significant reason for delegating pension investment management.

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[5] Cerulli Associates, 2017: US OCIO asset growth of 96% from 2013 through 2017.

[6] Mercer/CFO Magazine survey, 2017.

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