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Q&A: **Pension Strategy in Today's Market Environment**

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First quarter 2016 began with dismal market performance, high volatility, and an overall decrease in pension funded status. Moreover, market predictions for 2016 bet on rising volatility as one of the year's most popular trading ideas. In turn, plan sponsors are left wondering how they should be reacting to the market chaos and whether or not they need to re-evaluate their current pension strategy to best protect their plan.

Tom Harvey, director of the Advisory Team within SEI's Institutional group, provides perspective on this topic in the following Q&A.

Q **Given the market volatility in Q1 and industry reports highlighting an overall decrease in funded status of corporate pensions, should plan sponsors be reacting by de-risking their pension plans?**

A The market volatility in the first quarter and subsequent impact on funding levels doesn't necessarily require immediate reaction. Late last year, the Bipartisan Budget Act of 2015 (BBA) extended the funding relief previously provided by MAP-21 in 2012. Funding relief, which appears to be approaching an indefinite delay status, has created an environment where plan sponsors can significantly reduce, and in many cases, eliminate contributions they would otherwise be required to make. This change has impacted the value of liability driven investing (LDI) and de-risking strategies for sponsors. The goal of de-risking strategies is to minimize volatility between the investment asset pool and the pension liabilities, based on how pension liabilities are calculated for accounting and funding purposes. Reducing the swing between these two measures creates more certainty for both the projected funding gap and required contributions. Currently, these two measures—generally accepted accounting principles (GAAP) and Employee Retirement Income Security Act (ERISA) funding—have diverged. This has created an environment for most plan sponsors where surplus volatility against the liability doesn't trigger additional contributions, thus reducing the value of the LDI strategy. This allows plan sponsors pursuing return-oriented strategies to continue those strategies without the near-term potential of being required to make funding contributions.

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Q Are there other contributing factors that make initiating a de-risking strategy not necessarily conducive to the current market environment?

A Under current economic conditions, the value of de-risking is somewhat diminished, as are other strategies for risk reduction, including annuitization. The low interest rate environment and flat yield curve make de-risking relatively expensive on a historical basis, requiring a larger pool of income assets to support future benefit streams. Long-duration fixed income is providing a limited-term premium relative to intermediate-duration bonds, while being subject to greater capital risk. There doesn't appear to be a near-term catalyst for reversing that, although the path of interest rates is notoriously difficult to predict.

Additionally, an underfunded plan with a high fixed-income portfolio and lower return expectation carries the risk of underperforming the liabilities. Without a funding strategy, this plan runs the risk of becoming increasingly underfunded over time. Implementing an aggressive LDI strategy, while taking advantage of funding relief, may be problematic for plan sponsors. In the current environment, a plan sponsor pursuing an LDI strategy most likely needs to make supporting discretionary contributions to the plan—and forego the benefits of deferred funding. For most plan sponsors, that may not be optimal, as there's likely a better use of their capital than pension plan contributions.

Q Are there certain scenarios where plans should be de-risking?

A Pension management is always dependent on the specific characteristics of the company and the plan relative to the plan sponsor. What is appropriate for a regulated utility in managing its liabilities and a cyclical industrial company is potentially going to be very different. Pensions should be managed on a case-by-case basis. Also, plan sponsors need to choose appropriate strategies for their plan and have a clear understanding of how those strategies impact the company. That said, there are some general examples where plan sponsors should still consider de-risking in the current environment.

For some plan sponsors, the pension management challenge requires a high risk management focus. In these situations, the pensions are very large relative to the plan sponsor. Pension benefit obligation (PBO) liabilities over 25% of market capitalization might be a useful threshold measure. A large plan coupled with other capital or cash flow constraints, for example high leverage or uncertain cash flows, may not have the financial flexibility to support pension volatility.

Well-funded plans benefit from aggressive LDI strategies by reducing asymmetric risk. Funded status can change rapidly, particularly in a rising or declining rate environment. At high funded ratios, companies have limited benefits associated with funded levels over 100%, but significant downside risk of reduced funded levels. Companies with funded levels of 90% to 95% have limited benefits associated with high return-oriented portfolios, and run the risk of a meaningful loss of funded status should the market or discount rates turn decline.

Finally, where a plan sponsor has already implemented a strategy to hedge liabilities, it's likely the plan sponsor has done so in pursuit of specific risk management goals. Re-risking without careful consideration and evaluation of the plan's current status, demographics and risk tolerance would be discouraged. If the risk profile encourages de-risking, that remains a favorable path. Switching might have larger consequences and be more costly down the road. Over time, when the majority of plans head to exit as they become fully funded, reacquiring long-duration fixed income may be expensive. Our recommendation would be for these plans to stay their current course.

Q **If a plan sponsor doesn't necessarily meet the profiles mentioned above, what strategies should they be considering in the current environment?**

A Sponsors who don't have the characteristics that would necessitate additional liability hedging should still be dynamically managing their pension strategy in the current investment environment.

For starters, it might make sense to defer annuitizing pension liabilities as a strategy until interest rates have risen and fewer assets are required to buy out the liabilities. In addition, sponsors might want to consider deferring contributions until they're either required to fund or until a discretionary contribution will allow for a very high level of hedging that truly minimizes market and interest rate volatility.

From an investment standpoint, asset allocations that are a reflection of higher returns, based on acceptable levels of volatility, continue to make sense. This includes diversified and optimized return-enhancing portfolios, and medium- to shorter-duration fixed-income allocations. Also, sponsors might reconsider glidepath trigger points, evaluating the trade-offs associated with higher funded level de-risking points that might not be adopted under "normalized" funding requirements.

Finally, plans should review their overall approach to investment management and determine if their current strategy is the optimal approach moving forward. Pensions continue to require constant attention and critical resources for effective dynamic plan management. Discretionary or outsourced investment managers are valuable partners in this process, as they take on a variety of decision-making responsibilities and provide pension committees with critical analysis to evaluate trade-offs associated with various strategies. This leaves plan sponsors with increased oversight and a more proactive approach in responding to the market volatility, which continues to persist in today's market environment.

About the author

Tom Harvey serves as a director for the Advice Team within SEI's Institutional Group. In his role, he is responsible for delivering ongoing strategic advice to SEI's institutional clients, which include corporations, healthcare organizations, multiemployer plans, public pension plans and nonprofit organizations.

An expert in corporate finance and a frequent speaker at industry events, Tom has more than 15 years of experience in the investment industry. Before joining SEI, Tom was a director with Wachovia Capital Markets for 10 years, providing mergers and acquisitions and capital raising advisory services to middle market corporate clients.

Tom earned his B.S. and MBA in finance from the University of Michigan. He maintains FINRA Series 7, 63, and 24 licenses. He also serves as an adjunct professor of finance at Penn State University.

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