2023 defined benefit planning checklist.

Considerations for a new reality.

Defined benefit plan sponsors faced several challenges in 2022, creating a new set of factors to consider when setting strategy. As you think about your pension approach, keep our list of top considerations in mind:

☐ PBO vs. FTAP: Make sure you understand the difference

For plans with significant liability-driven investment (LDI) allocations, 2022 saw little volatility in projected benefit obligations (PBO) because LDI more closely matched the change in discount rates. However, we saw a significant reduction in funding target attainment percentage (FTAP) funded status because that discount rate is not market-based. The reduction in FTAP was attributed to market-value losses, including losses in the LDI strategy due to rising rates.

The market recovery toward year-end helped avoid accelerating the timing of contributions even further. Had 2022 ended with an FTAP ratio below 100%, contribution calculations could have been immediately triggered.

Key takeaway: Understanding the difference between these two measures should be considered when making any changes to your plan.

☐ Be clear on your asset allocation goals

Ultimately, your key plan goals and objectives determine the appropriate strategy in two ways:

1. Limit accounting and funding volatility.
2. Support a return expectation high enough to fund plan liabilities and maintain the plan's financial health.

Clearly, asset allocation strategies to manage accounting risks don't always manage contribution risks. Ask whether your plan's asset allocation is based on accounting measures or cash contributions. In our opinion, the current rate environment and its impact on funded status warrants a review and may require shifts in strategy moving forward.

Key takeaway: Check your asset allocation strategy. It's important to prioritize your goals when setting the allocation.

Does LDI still have a role?

LDI's primary role is to help manage accounting volatility. Unless a full yield curve for FTAP is used, LDI does not manage contribution risks. Simply, discount rates reset to market, while rates for FTAP are set to longer-term averages. Hedging a long-term average is just not feasible. So, the allocation to LDI needs to be set at levels that help manage accounting variability but do not negatively impact asset returns for contribution calculations.

Key takeaway: If your allocation to LDI is focused solely on accounting, in the absence of a committed contribution policy, you may need to reassess the future contribution impacts of significant moves in interest rates. A fresh asset liability study could help determine appropriate levels of hedging that could balance impacts on both PBO and FTAP funded ratios.

Decide what's next: Re-risk, de-risk?

Given the high carry cost of liabilities driven by higher interest costs, the expected return for a program with significant LDI is not likely going to provide enough returns to meet that hurdle. And, given the custom rates that are developed by actuarial firms, that hurdle becomes even higher and more difficult to manage.

While most plan sponsors are avoiding equities because of the economy's uncertainty, we believe there is still a need for them in this environment. Investment vehicles such as managed volatility and and low beta funds, which strive for lower volatility without sacrificing returns, can provide that return while tempering volatility. As an early adopter of these vehicles, we combine these strategies with LDI allocations to re-risk in a way that seeks to manage volatility of return. This can be a way to manage PBO volatility while still sourcing return to help manage FTAP risks.

Key takeaway: Consider incorporating new investment vehicles that can provide return while tempering volatility.

Moving forward confidently

Regardless of your goal, you should take a holistic approach since all of these issues matter at different times. If you are not thinking holistically, it may be too late to fix problems that arise. And, if your provider is not having these conversations and helping you prioritize, it may be time to take a second look.

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