DEFINED BENEFIT

APRIL | 2020

PLAN SPONSOR UPDATE

DEFINED BENEFIT PENSION PLANS: EVALUATING THE LONG-TERM STRATEGY IN LIGHT OF SHORT-TERM VOLATILITY | *WHAT TO DO NOW!*

Virtually any institutional retirement plan is based on the foundation of a well-drafted investment policy statement (IPS). The IPS summarizes the long-term strategy, puts guardrails into place and provides oversight guidance to plan fiduciaries.

During times of duress and uncertainty – just like we see right now - the IPS also helps refocus on the strategic goals and helps turn emotional reactive thinking into rational action. Let's take a look how committees can prudently stay on course towards their goal despite the recent volatility.

A disciplined approach to asset allocation can enhance the probability of achieving longer-term goals. Since 1926, there have been 9 bear markets, including the current one. Market declines are difficult to predict as are market bottoms. During the month of March, we witnessed unprecedented market volatility, with the average daily moves in the market at 5%; something that has not been observed since the Great Depression. Never in its history has the stock market fallen by more than 30% in such a short period of time. Two of the five worst daily declines in U.S. market history occurred during March 2020, with the other dates occurring during the Great Depression and Black Monday in 1987. What caused this environment?

The outbreak and spread of COVID-19 put tremendous pressure on the capital markets. The spread of COVID-19 through China was made public by President Xi Jingping on January 20th and led to quarantine measures unseen in the post–war period. Despite the spread, U.S. and European capital markets continued their climb to new record highs by mid-February. By late-February, COVID-19 induced fear into the global capital markets as investors realized the risk wouldn't be geographically isolated to Asia. Worries about travel bans and the impact on economic growth weighed on capital markets and pushed them into correction territory. In early March, an oil price war compounded market and economic fears. Equity markets priced in a new level of risk and a vicious cycle of asset selling escalated.

It is difficult to overstate the effects that COVID-19 has had on our families, communities, businesses, the global financial markets and the global economy. Over 935,000 people worldwide were infected, including over 215,000 U.S. citizens and causing more than 5,100 U.S. casualties through April 1st. Many businesses enacted a self-imposed shut-down indefinitely, travel came to a halt, and education started to be conducted from home. Market stress tests under any scenario would not have forecasted our economy going from a 50-year low in unemployment to a record high of 3.3 million new applicants within one week, and then 6.6 million the following week. The longest economic expansion in modern history has come to an end and capital markets are trying to price the uncertainty. As a result, defined benefit (DB) plans are facing lower asset values and higher liabilities with interest rates falling significantly.

Many of our clients have avoided a market equivalent drawdown due to the utilization of a well-functioning liability hedge. Nonetheless, we are fielding many questions how to adjust the risk budget to the new reality of near-zero rates.

Well run DB plans have a pre-defined risk management strategy: *Which risks should be avoided? Which risks should be accepted? Which risks should be reduced? Which risks should be transferred?* An ongoing review of targeted risk and realized risks provides a valuable feedback mechanism. And while a long-term plan and the specified risk management strategy should not be changed in times of duress, the attractiveness of executed risk management strategies varies significantly over time and should be evaluated considering existing market environments. Below please find some considerations how actuaries and investment consultants need to work together to find the most appropriate solutions for DB Plans.

1. A key element of a pre-defined risk management strategy is clear contribution strategy. Plan sponsors need to work with their actuaries and investment advisor to develop a contribution plan that factors in realistic current market return expectations while accomplishing the sponsor funding goal in the appropriate time frame. Action item: review contribution policy.

2. Forward-looking return expectations have declined over the last several years. With interest rates continuing to decline, the return seeking as well as the risk diversifying component of fixed income is negligible. The recent volatility has also re-priced assets. With risk assets more reasonably priced and interest rates low, pension plans may want to re-evaluate the appropriateness of dividend-paying stocks with stronger balance sheets and stable cash flows compared to investment grade bonds. Action Item: review return expectations and risk budgets for most appropriate solution.

3. The eleven-year bull market has left us with significant performance dispersion among some asset classes. Growth has significantly outperformed value; large cap outpaced small cap; domestic stocks provided more than twice the return than developed international stocks and developed international markets in turn outpaced emerging markets. Recessions have typically marked the beginning of a new cycle (remember 2000/02 & 2008/09): Look for market leadership to shift and entertain active management in certain asset classes combined with a passive management in core asset classes to enhance portfolio performance. Action Item: review asset allocation. Be prepared for a change in leadership.

4. Across our DB clients, we see (so far) limited action of the asset allocation compared to previous bear markets. This makes sense: We are in unchartered territory and there is no model that could reliably predict how long the current crisis will last, so clients need to focus on items that are more important than the latest market moves. We also want to point out that in our view a rebalancing strategy is more of a prudent risk management tool and we do not consider this to be re-risking. Action item: review rebalancing policy and approach.

5. LDI: significantly wider bid/ask spreads in fixed income markets (particularly long corporate) have made transacting very costly (4–5 times normal levels). This may make rebalancing fixed income allocations impractical or too costly in the near-term. Nonetheless, plans should have a methodology in place to implement rebalancing actions over some period of time, even if that period of time ends up being longer than usual. Action item: review liability hedging approach.

6. Many smaller DB plans may not have governance structures in place to allow them to make tactical changes to their portfolios. Action items: consider discretionary investment consultant with actuarial experience and resources.

7. While the short-term future of markets is uncertain, one thing that is always certain: benefit payments that need to be made to retirees. With wild daily market swings, plans may have to liquidate assets (potentially at inopportune times) to fund distributions. Action items: review timing of contributions, review cash that portfolio generates (interest, dividends, coupon).

8. With lower return expectations, lower funded status and potentially less cash at hand to contribute to the Plan, cost management becomes crucial. Action item: review all plan expenses to identify any potential ways to reduce plan costs.

9. While the squeeze in interest rates has increased liabilities, it also provides the opportunity to refinance debt to fund the Plan. PBGC premiums on unfunded liabilities are expensive. Getting a plan fully funded could turn a variable liability into a fixed liability. Action item: find creative ways to take advantage of market dislocations.

There is no one-size-fits-all solution for pension plan management. Our client base is diverse in terms of objectives, constraints and financial strength and the aftermath of the current environment impacts DB plans very differently. For companies in certain sectors, COVID-19 is already an event much more severe than Black Swan simulations could have ever predicted. USI Consulting Group is actively working with these companies to manage through these incredibly challenging times. Given the event-driven nature of the current downturn, their concerns are more about maintaining liquidity to meet their liabilities. Considering paying plan expenses from the trust to help with near-term cash flow issues may be short-term solution at the cost of increasing the required funding with a year delay.

If you have any questions or would like more information, please contact your USI Consulting Group representative. We're here to help.

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