DEFINED BENEFIT TOP AREAS OF FOCUS FOR 2017

GET READY FOR CHANGE

Rising interest rates and equity markets have improved funding ratios, which does create opportunities for plan sponsors to take actions such as executing risk transfer actions, locking in gains and cutting risk or reducing contributions and expense. However, the proposed policies of the US President Elect could create a meaningfully different market environment than investors have faced since the financial crisis. As such, plan sponsors should carefully evaluate next steps to optimize outcomes for their plans.

Looking ahead, we believe that improved funding ratios and signs of global economy reflation requires actions to adjust your pension risk strategy.

1

HAVE YOU PREPARED A COMPREHENSIVE JOURNEY PLAN?

The most critical tool for managing risk in pension plans is a sound journey plan. A journey plan should be much more than a de-risking glide path; it should capture the full course of actions as the plan matures. A sponsor's goals for risk transfer, funding, closing/freezing and other activities, in addition to investment management actions, should be considered and evaluated. With ever-dynamic investment and insurance markets, opportunities for risk transfer activities can arise quickly, and funding opportunities may present themselves as the plan sponsor's cash flow and capital budgeting outlooks evolve. All this calls for both a well-thought-out and socialized game plan as well as nimble, execution-ready administration and governance with a blueprint for actions and an ultimate destination clearly laid out.

2

ARE YOU READY TO RESPOND TO GROWTH PORTFOLIO OPPORTUNITIES AND CHALLENGES?

There are ongoing changes in the environment for risk assets that may provide an opportunity for investors to improve their results. The evolution of the banking system since the financial crisis has pushed traditional credit providers, primarily banks, out of some lending segments, creating opportunities for sophisticated institutional investors to provide credit at attractive rates through private debt, structured credit and similar strategies. Since the recent US election, the growing potential for "reflation," an increase in inflation from low levels driven by both low rates and growth, has emerged. This could have significant effects across many assets, with low-yielding bonds expected to perform poorly, and some lower-growth equity areas, particularly yield-oriented areas, might struggle as well. Conversely, real assets, such as real estate, could hold their value if inflation is the primary driver of an increase in interest rates.

3

WHAT ABOUT RE-RISKING?

Most DB plans have an established de-risking glide path, but many have no formal procedure if their funded status declines. "Re-risking" involves moving back down the glide path and increasing the growth allocation. For some plans, increasing the certainty of plan costs and stabilizing the funding position are the most critical objectives, so re-risking might not be appropriate. For other plans, the assets are structured to help improve the funding position, and greater risk might be needed to accomplish this objective. Plans that adopt a policy on risk in advance of a funded status decline are able to react promptly and appropriately if a meaningful decline in funded status occurs.

4

ARE YOUR BONDS FIT FOR PURPOSE?

As pension plans de-risk and fixed income allocations increase, it becomes increasingly important to tailor the bond portfolio to each plan's specific liabilities and journey plan. It is also important to partner with a manager who can help execute your journey plan and be flexible and opportunistic. Some of the more customized needs of a de-risking plan include structuring the bond portfolio for immunization and/or transfer to an insurer. Opportunistic areas include dynamic interest rate hedging, where the level of interest rate exposure in the portfolio is adjusted to capture the benefits of rising interest rates on funded status.

5

DOES YOUR FUNDING POLICY INCLUDE BORROWING TO FUND?

The opportunity to capture the benefits of funding a plan through borrowing — such as increased tax deduction, decreased Pension Benefit Guaranty Corporation (PBGC) fees and stabilizing the pattern of contributions — is still available despite the recent rise in rates. PBGC variable-rate premiums (VRPs) are 3.4% of the plan's unfunded obligation for 2017 and increasing to 4.4%+ after 2019, making the case for increased contributions to close the gap very compelling. This, in effect, represents a substantial tax on pension deficits, amplifying the case for voluntary prefunding. Generally, borrowing to fund may be beneficial when the sponsor's after-tax borrowing rate does not exceed the pension discount rate plus the VRP tax. Issuing debt does not necessarily add to the total debt burden; rather, it can be viewed as a potentially favorable restructuring.

6

IS A 2017 CASH-OUT RIGHT FOR YOU?

The economics for a potential cash-out window remain potentially compelling. This has been a common project for many plan sponsors, with a focus on deferred vested participants, and the opportunity also exists for active employees with frozen benefits through a spinoff/termination arrangement. The economic cost of the plan's obligation should consider the maintenance costs of the plan not reflected in accounting liabilities — for example, PBGC fees, investment and operational expenses. When these frictional costs are considered, lump-sum cash-out programs can be executed at a substantial discount. Further, knowing that new mortality tables will likely be prescribed in 2018 makes for a time-sensitive window to review a potential cash-out in 2017. Reviewing the business case through four lenses — economic, HR and participant, portfolio and cash, and accounting implications — is important to understanding all aspects and the potential fit.

7

IS THERE AN OPPORTUNITY TO TRANSFER RISK TO AN INSURER?

Despite a stagnant interest rate environment for most of 2016, many pension sponsors are eager to either fully terminate their DB pension plans or simply reduce risk and "right size" the plans by purchasing a group annuity contract from an insurance company. We anticipate this trend will accelerate if markets and rates continue to rise. Understanding the plan sponsor's unique implications and impact on the pension journey will help determine the conditions that will define an opportunistic transaction. Market and plan dynamics will have an impact on relative pricing, and engaging the insurer marketplace early in the process will help bring clarity to the potential financial outcomes and pricing sensitivities. Articulating the business case, and working through many of the readiness steps in advance, will enable plan sponsors to move quickly to promote efficient execution of a transaction if and when a transaction is compelling. In some cases, larger plan sponsors are considering phased approaches with an initial focus on smaller benefit retirees, where the trade-offs are most compelling. With a vibrant insurance market underwriting both retiree-only and termination annuity contracts, many sponsors are seeing favorable pricing despite current interest rates. This trend is expected to continue in 2017, and new insurers are potentially looking to enter the space and further increase the competition.

8

ARE YOU EFFECTIVELY MANAGING ALTERNATIVE ASSET CLASSES?

Alternatives and private assets can add value to a long-term investor like a pension plan, since the plan can exchange liquidity for an expected long-term return premium relative to liquid investments. However, illiquidity can create challenges as plans move along a de-risking glide path or make substantial distributions. Although some alternative assets have reasonable liquidity, such as many hedge fund asset types and some real estate investments, others, such as private equity, offer very limited ability to redeem an investment. For truly private illiquid investments, trying to sell an interest to another investor is likely to result in a meaningful markdown in value. This means that plans should evaluate their illiquidity budgets (they may be larger than expected) and test those budgets throughout their strategic timelines.

Some particular considerations include:

- Investors should incorporate liquidity considerations into their plans for executing their glide paths.
- Sponsors whose long-term plans are to settle significant liabilities on a set schedule should plan ahead and begin reducing their commitments well before the settlement events are anticipated.
- Plans should develop "illiquidity budgets" to ensure they are utilizing their ability to invest in illiquid assets while also ensuring they are able to execute their long-term plans.

9

IS YOUR DATA READY?

Accurate pension plan data is a critical component for any pension de-risking project. Annuity placement, cash-out and plan termination projects can be executed only if participant data and benefits are complete and available electronically. Consider data quality and cleanup needs as early as possible so that the most efficient plan can be built to resolve issues. A data assessment will provide you with the necessary information to build a data readiness plan that is personalized to your needs, goals and timeline. With data gaps and challenges addressed early in the process, sponsors will be able to monitor the market and make quick decisions to begin de-risking projects. In addition, they will reap the benefits of a smoother administration process while awaiting the next steps in their journey plans.

10

DO YOU NEED A DELEGATED MANAGER?

A plan may benefit from delegating responsibility for some or all of the plan's investments to an overall manager who can oversee and direct both the fixed income and growth portfolios to achieve the journey plan objectives. Complex investment strategies, such as sophisticated liability hedging approaches, alternative asset classes and evolving risk transfer approaches, all highlight the benefits of an integrated pension governance model that allows an investment committee to delegate authority in certain areas to dedicated experts. This type of governance model allows the plan sponsor to focus on strategy — while the increasing complex dynamics of the journey can be managed day to day by experts with specialized resources and tools. More details on the services that a delegated investment manager, or an outsourced chief investment officer (OCIO), can provide can be found in our white paper, "A Blueprint for Defined Benefit OCIO Services."

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