HEALTH WEALTH CAREER

PENSION INVESTING FOR THE LONG TERM

AN ALTERNATIVE TO RISK TRANSFER

MAKE TOMORROW, TODAY

MERCER

THE UPCOMING PENSION SHAKEOUT

Following a flurry of investment de-risking activity after the global financial crisis, plan sponsors have recently turned to pension transactions — such as voluntary lump-sum and bulk annuity buyouts — as cost-effective ways to reduce or eliminate legacy pension obligations. Much of this activity has involved liabilities easily transferred to a receptive and vibrant insurance market.

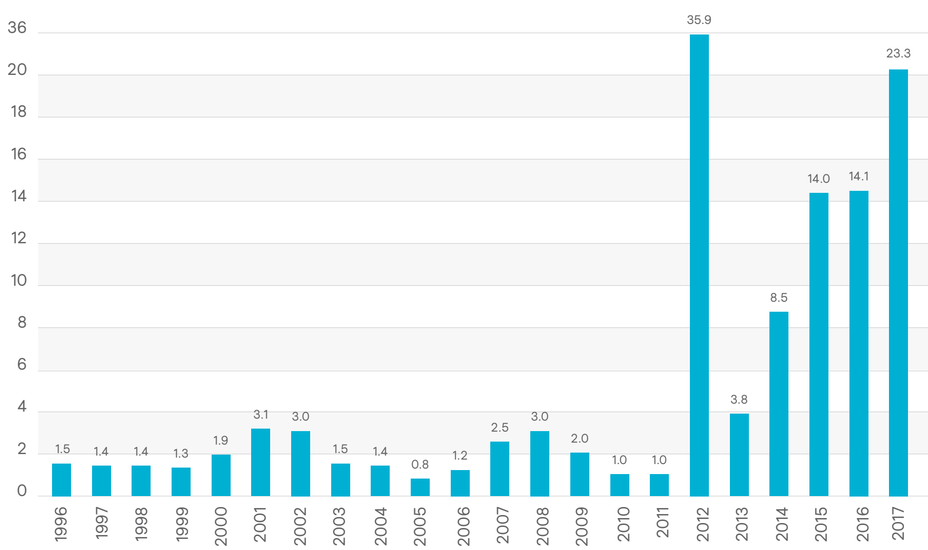
In our 2017 paper "DB Pensions and the Emergence of the Big Bang Strategy,"[1] we described a confluence of factors that may drive many plan sponsors to accelerate these de-risking changes, with many terminating their plans entirely. As a result of this acceleration, bulk annuity capacity — capital, corporate bonds and people — will take more time to adjust, and we saw some strains based on current demand as we neared the end of 2017. The insurance market for deferred benefits in particular is feeling pressure, and we see this challenge becoming more widespread in the near future.

Although we anticipate that a near-term upswing in plan terminations will put pressure on capacity, we also foresee a parallel growth in those fully funding and winding down their plans on balance sheets over time. In addition, as more marketable obligations — such as those for in-pay retirees — are transferred to insurers, residual defined benefit (DB) plans will have unusual and idiosyncratic features that make them more difficult to manage. This latter challenge of steady-state pension management will drive pension investing to a "hibernation" focus for many, which is the focus of this paper.

A BULK BUYOUT GLUT IN THE MAKING?

Robust bulk buyout activity led to an increase in deal flow of $23.3 billion for 2017, composed mostly of retiree-only buyouts. Even with the substantial increases of recent years, current deal volume represents less than 1% of the $3 trillion dollars of estimated total annual pension obligations for the private sector in the US. We foresee a continued upward trend that is substantiated by our 2017 Mercer/CFO survey,[2] which indicated that 55% of sponsors are likely or very likely to annuitize some or all of their obligations in the next five years.

ANNUITY BUYOUT DEAL VOLUME 1996–2017*



2012: GM and Verizon

2014: Motorola and BMS

2015: Kimberly Clark, Philips and JCPenney

2016: PPG and WestRock

2017: Accenture, The Hartford, International Paper

*Graph not to scale

Source: LIMRA

1 Mercer. "DB Pensions and the Emergence of the Big Bang Strategy," 2017, available at https://www.mercer.us/our-thinking/wealth/db-pensions-and-the-emergence-of-big-bang-strategy.html.

2 Mercer. "Adventures in Pension Risk Management," 2017, available at https://www.mercer.com/our-thinking/wealth/adventures-in-pension-risk-management.html.

In addition to the retiree buyouts we outlined in our "Big Bang" paper, we anticipate a substantial increase in demand for full-plan terminations, especially now that tax reform for corporate rates has become a reality. With lowered tax deductions, many sponsors are incentivized to fund up their plans now. In particular, many frozen plans could be fully funded overnight, causing a huge number of plan sponsors to rush for the exit through full-plan termination. This could in turn overwhelm the pension risk transfer insurance market.

BIFURCATING PENSION OBLIGATIONS

Should this buyout glut eventuate, insurers' low appetite for plan terminations that include longer and less predictable deferred obligations (see call out below) will become more of a challenge. Given the amount of more marketable risks (the "easy stuff") on the table, insurers will become more fickle, turning down the "harder stuff." Throughout 2017, we saw early signals of this trend with significant pressure already emerging in the pension transfer market.

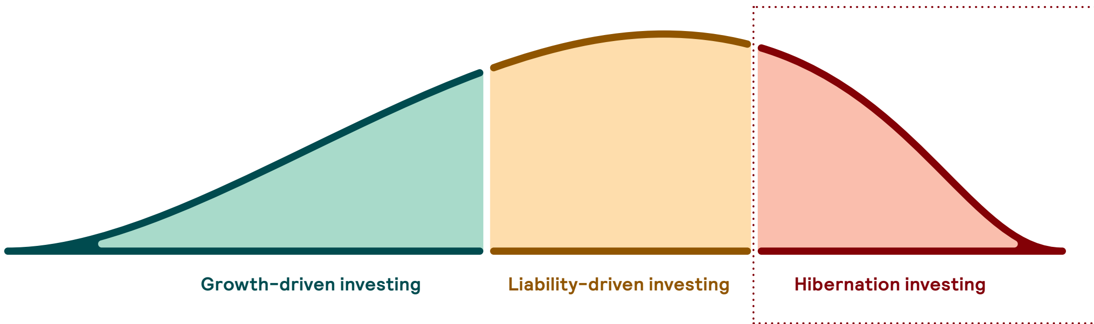
Many frozen plan sponsors of more marketable plans will fully fund and terminate their plans now. As supply becomes more challenging, we foresee other sponsors adopting self-insurance approaches in winding down their pension obligations gradually on the balance sheet. A growing number will also transfer retired lives to insurers and retain less marketable deferred lives on the balance sheet. So growth in these end-state solutions is not always a question of whether to transfer risk or self-insure — instead we anticipate a substantial growth in both.

WHICH LIABILITIES ARE MARKETABLE?

Insurers generally prefer relatively short-duration lives — such as retirees — and favor benefits without material optionality — such as lump sums and subsidized benefits. Shorter-duration liabilities are desirable because these liabilities are easier to hedge with assets that yield a spread, and the re-investment risk is lower than for longer-duration liabilities. In addition, the longevity risk is lower over shorter periods since we cannot know the improvements in life expectancy from medical advances many decades in the future. Benefits without material optionality are desirable because insurers can confidently price and hedge these liabilities. Regarding plans for which future participant choices significantly impact the underlying plan benefit and cash-flow profile, insurers will hold greater capital for the increased uncertainty, leading to higher relative premiums.

THE EMERGENCE OF HIBERNATION INVESTING

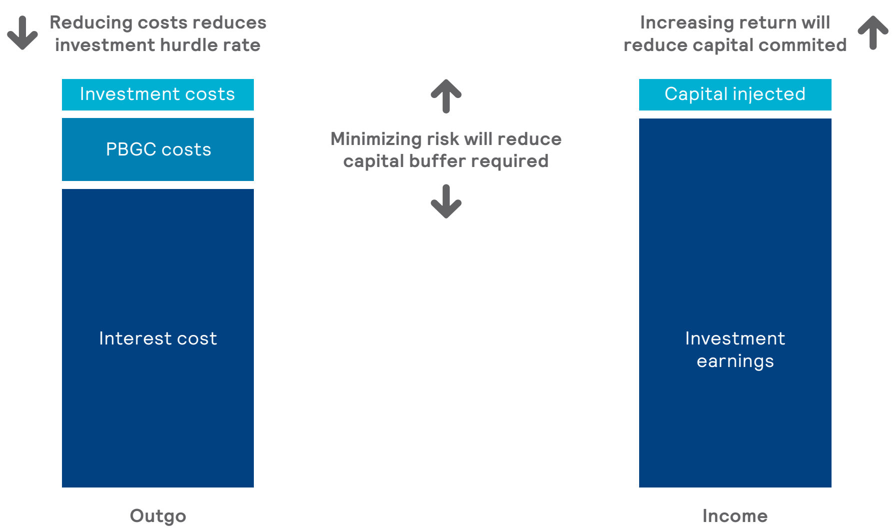
Pension sponsors historically focused on managing their financial commitment to the plan — both the cost of deficits and of future accruals — through **growth-driven investing**. The main purpose of this approach was earning asset returns in excess of liabilities. As more plans were frozen over time, this was coupled with a focus on **liability-driven investing** (LDI) to reduce pension balance-sheet volatility.



Pension sponsors should now focus on the shakeout that lies ahead, with the potential bifurcation between liabilities sold to insurers and the hard stuff kept on pension balance sheets. As more sponsors look to self-insure their obligations, hibernation investing will begin to dominate the pension investment landscape. Hibernation investing involves putting plans in a steady state while winding them down over time and/or gradually preparing for pension risk transfer over a longer period of time. Although very similar to traditional LDI, as we discuss below, hibernation investing will not be as simple — it brings its own set of challenges and risk-management opportunities.

SUCCESS FACTORS FOR HIBERNATION

We see the specifics of a tailored investment strategy fit within a broader self-insurance framework. This is driven by interlinked success factors that will guide pension sponsors to an optimal steady state. We lay out below how these various factors intertwine to provide a low-risk balanced outcome for asset and liability management, staying aligned in a way that minimizes costs, volatility and capital commitments to the plan.



For a plan entering a hibernation period, four key priorities come to the fore. Sponsors will want to:

1. **Minimize residual expenses**, whether investment, PBGC or other administrative costs.

2. **Maximize their asset returns** in a low-risk state through active management and diversified sources of return where appropriate.

3. **Minimize residual risk** in the end state through a tailored investment strategy by keeping asset and liability returns as closely aligned as possible, as well as focusing on demographic risks.

4. Ultimately, **minimize the capital deployed** in excess of pension obligations to keep the plan self-sufficient in a low-volatility state, accounting for the plan's residual costs and risks.

These priorities involve several trade-offs that will lead to different outcomes for different sponsors. The higher the net investment return generated, the lower the need for capital. Similarly, the tighter the hedge in the investment strategy, the lower the downside risk and, therefore, the lower the need for excess returns and/or capital commitments. So the first steps in a successful hibernation strategy are to determine the target parameters around these factors and then manage to the resulting benchmarks effectively.

We explore below considerations for sponsors in managing some of these implementation priorities as effectively as possible.

MANAGING EXPENSES

Ongoing expenses, especially PBGC premiums, can cause a significant drag on portfolios, requiring extra capital or additional return. In order to minimize maintenance costs and the resulting capital tied up in the pension plan, sponsors can undertake a variety of measures — such as lump sums and buyouts — to reduce these expenses in the most cost-effective manner.

Management of investment expenses can also lower the amount of capital deployed to the plan above the accounting liability. In our analyses of pension portfolio expenses, we often see investment expenses that are excessive by 20–30 basis points, which could translate to excess capital deployed over time in a hibernation portfolio of 2%–3% of liabilities.

ENHANCING RETURNS

When plans are fully funded, plan sponsors need pension assets to keep pace with liabilities, including expenses, and counteract certain headwinds, such as defaults and downgrades on bonds. The investment strategy can respond by having a portion of growth assets, using active management and, in particular, having active management of credit bonds. In addition, using some diversified sources of return in any residual-growth portfolio will enhance the end-state balance of cost and risk. Many of these measures are used by insurers in managing pension obligations, and pension sponsors electing to self-insure could use much of the same playbook.

TAILORING THE HEDGE

Self-insurance might be thought of as a 100% long-bond strategy, under which the plan has fully hedged its liabilities. Unfortunately, the traditional LDI model will be insufficient and even sub-optimal for most self-insured plans. Bond downgrades and defaults deteriorate bond portfolios over time, whereas the same factors do not affect their corresponding liability benchmarks. This effect is more acute with long-dated liabilities, requiring careful consideration and management of these dynamics. In addition, many self-insured plans will be left with complex benefits, including cash balance and other hybrid benefits, and there are often no hedging assets that will match the particular nuances of these liabilities. Some of these considerations are outlined below.

PLAN TYPES	KEY ISSUE	POTENTIAL FUTURE INVESTMENT STRATEGY TO HIBERNATE
Deferred annuity benefit	Many plans will be left with liabilities for deferred lives (those who have yet to commence pension benefits). The time horizon until their benefits are fully distributed, and the corresponding duration of the liability, tends to be long. There are also residual liability risk factors, including when benefits will commence and the choice of payment form, that can't be hedged.	The investment strategy will likely require the use of derivatives to extend duration beyond the typical long-duration fixed-income benchmarks, though this will need to be assessed against the resulting drag on returns. And based on the level of capital deployed, the steady state may also require a higher allocation to growth assets to compensate for the "unhedgable" liability risks.
Defined lump-sum benefits	Lump-sum plans can be broken into two primary types: those, like cash balance plans, for which the benefit is defined as a lump sum, and those for which the underlying benefit is an annuity but which provide a lump-sum payment option. When the benefit is defined as a lump sum that grows at an interest-crediting rate, hedging can be challenging.	When the objective is to hedge the liability, determining how the interest-crediting rate assumption will change as the discount rate changes is essential to determining the appropriate hedge. In a situation when the desire is to hedge the account balance, a total-return strategy may be more relevant than a duration-matching strategy.
Annuity benefits with lump-sum option	The duration of this type of benefit tends to be similar to the traditional annuity-only benefit. However, the actual timing of the distribution will likely happen much sooner.	Using long-duration fixed-income aligned with the underlying duration of the annuity payments will help offset interest-rate risk. Ensuring the portfolio has sufficient liquidity will also be important, and managing the desired asset exposure with an overlay strategy may be beneficial.

MINIMIZING CAPITAL DEPLOYED

Focusing on the objectives described above can have a significant impact on the capital deployed to hibernating plans. This will also reduce the “premium” required to self-insure obligations and provide a better (often lower) benchmark for sponsors in deciding whether to keep or transfer some or all of their pension obligations. Finally, sponsors also have the option to wait and see how any residual risk can work in their favor in enhancing funded status so that the capital hurdle does not need to be made up entirely with contributions. If, for example, a sponsor does not wish to fund any more than its GAAP liability but will tolerate some manageable level or residual risk, the ultimate contributions paid into the plan could be considerably less than the cost of risk transfer.

CONCLUSION

Bulk-annuity bottlenecks may eventually unwind the favorable economics of risk transfer for many. And for those seeking an alternative, the standard off-the-shelf LDI model of mostly long bonds is unlikely to suffice. Hibernation investing involves a finely tuned balance of assets and liabilities in the end-state, with a keen eye on expense, return and risk management. For many, the more marketable obligations will have been transferred, and the remaining plans will be full of wrinkles with unusual and individual requirements. When managed and coordinated carefully, the self-insurance path will be a cost-effective alternative to risk transfer for many, especially as the insurance market becomes more challenged. Ultimately, the need for close integration between asset and liability management will be more acute than ever, as DB obligations navigate to their many destinations.

ABOUT THE AUTHOR

Richard McEvoy is a partner and leads Mercer’s Financial Strategy Group (FSG) and pension buyout advice and solutions in the US. He is a CFA charterholder, fellow of the Institute of Actuaries (London), fellow of the Society of Actuaries, member of the American Academy of Actuaries and an enrolled actuary under ERISA.

richard.mcevoy@mercer.com
+1 212 345 3194

IMPORTANT NOTICES

References to Mercer shall be construed to include Mercer LLC and/or its associated companies.

Mercer does not provide tax or legal advice. You should contact your tax advisor, accountant and/or attorney before making any decisions with tax or legal implications.

This does not constitute an offer to purchase or sell any securities.

For Mercer's conflict of interest disclosures, contact your Mercer representative or visit www.mercer.com/conflictsofinterest.

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances.

Investment management services provided by Mercer Investment Management, Inc. (MIM). Investment advisory services provided by Mercer Investment Consulting LLC (MIC). MIM and MIC are federally registered investment advisors under the Investment Advisers Act of 1940, as amended, providing nondiscretionary and discretionary investment advice to their clients on an individual basis.

6005954A-WE

MARSH & McLENNAN
COMPANIES