Insights
Liability-Driven Investing

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State Street Quarterly DB Insights

The Five Biggest Challenges Defined-Benefit Plans Face in 2021 — and How to Address Them

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We are excited to launch our quarterly defined-benefit commentary series. Each commentary will include our latest thinking on pension plan trends and a review of plans' funding status for the period. In this kickoff installment, we will discuss the five major challenges that defined-benefit plans face right now and how plan sponsors can begin to address them.

TK's Corner
Market Thoughts from Thomas Kennelly

In recent months, market observers in the media have sounded an increasingly strident alarm as equity markets have soared despite profound uncertainty. (" 'This Market Is Nuts': S&P 500 Hits Record, Defying Economic Devastation," an August 2020 headline from the New York Times, seems typical of the era.) There is real cause for concern: The risk-on mentality has led to tighter credit spreads and decreased equity premiums. This comes alongside real yields that have turned negative in the US and other markets, as global central banks have signaled a continuation of accommodative policies for the foreseeable future.

These circumstances create major challenges for defined-benefit (DB) pension plans, causing many to question whether hedging liabilities still makes any sense. Spoiler alert: We think it does, but effective liability management in 2021 and beyond may require greater creativity and more expansive thinking, customized for the goals and the funding status of each individual plan.

In general, given fast-moving news on the coronavirus and few opportunities for substantial interest income to buffer market declines, we believe that a deliberate risk management approach is preferable to banking on future risk-on markets. Instead, we prefer a more capital-efficient approach to managing fixed income and total plan duration. With return-seeking allocations tilting increasingly to risk efficient assets, and diversified growth assets that may include lower beta global equity allocations, plans could attain higher Sharpe-ratio strategies by taking advantage of the resilience of higher-quality assets. These strategies can provide incremental risk-adjusted return benefits for long-term investors.

Funded Status Review
Based on Representative DB Portfolios Using Different Equity/ Fixed Income Asset Allocations

	Benchmark Proxy	YTD Return (%)
Plan Liabilities	BBG Long AA US Credit	14.21
Plan Fixed Income Assets	BBG Long US Gov/Credit	16.12
Plan Equity Assets	MSCI ACWI	16.25

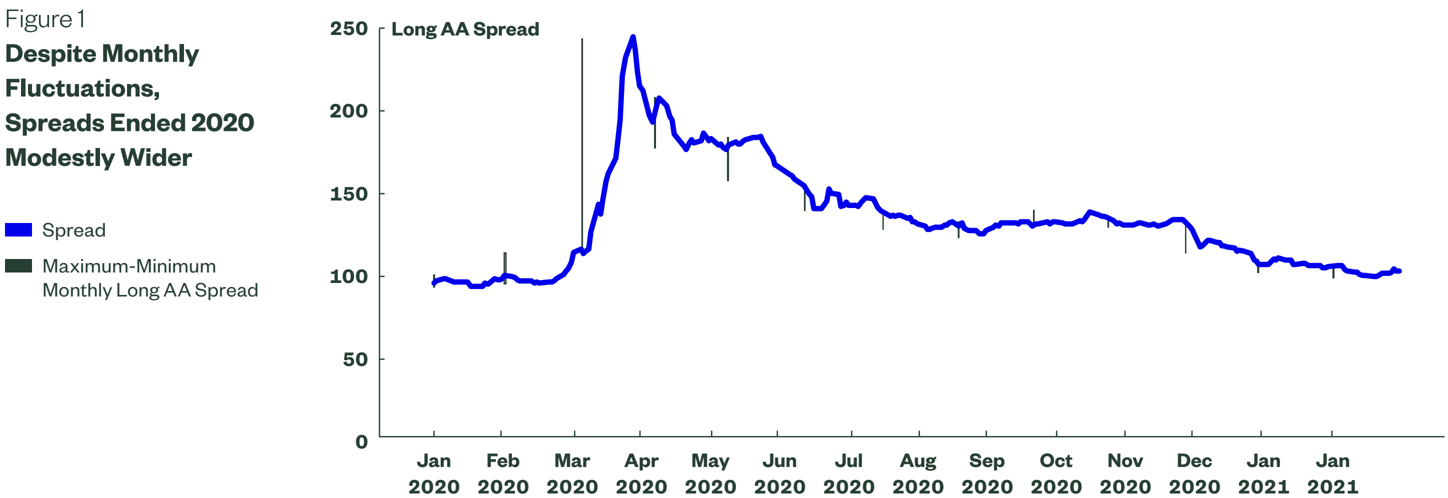
Source: Bloomberg Barclays, MSCI, as of December 31, 2020.

Funded Status as of 12/31/2019 (%)	12/31/2020 Estimated Funded Status Based on Equity/Bond Mix (%)			
	60/40	50/50	40/60	30/70
80	78.70	78.70	78.70	78.70
90	90.40	90.40	90.30	90.30
100	102.00	102.00	102.00	101.90

Source: Bloomberg Barclays, State Street Global Advisors, as of December 31, 2020. Calculations based on asset returns for 2020 from benchmark proxy equity and fixed income assets, including the BBG Barclays Long U.S. Gov/Credit Index and the MSCI ACWI Index.

Funded Status Was Little Changed in 2020 Despite healthy global equity and fixed-income returns in 2020, US corporate plan funding status was fairly flat for the year. Even though spreads on long-dated AA corporate bonds more than doubled from +91 bps to +191 bps in the first quarter of 2020, they ended the year largely unchanged at +103 bps (Figure 1). The plunge in long Treasuries, however, pulled long-dated AA corporate all-in yields down (with a commensurate drop in pension liability discount rates), resulting in returns on average plan liabilities of close to 15%. Global equities (as measured by the MSCI World Index) were up 15.9% for the calendar year.

Figure 1
Despite Monthly Fluctuations, Spreads Ended 2020 Modestly Wider



Source: Based on Option-Adjusted Spread for the Long AA Bloomberg Barclays U.S. Credit Index. As of January 31, 2021.

Fully Funded Plans Fared Better For these plans, a higher level of long-duration fixed income, including longer-dated Treasury exposure for liability duration management, helped to offset the lower discount rate and increased pension obligations.

Underfunded Plans Faced Modest Headwinds A greater bias to return-seeking assets and diversification of those assets outside of US equities hampered overall returns. While US equity returns were strong (Russell 3000 Index +20.9%), allocations to developed market equity ex-US lagged (MSCI EAFE Index +7.82%). In addition, lower overall asset-liability hedge ratios across underfunded plans created further funded-status drag.

Strategic Perspectives: Five Major Challenges

We see five prominent headwinds for pension plans in 2021. In this section, we'll outline those challenges and introduce some key approaches to manage them.

1 Challenge Low yields and tight investment grade credit spreads

Real yields on USD investment grade (IG) corporate bonds went negative in 2020 due to higher inflation expectations and a drop in nominal yields. Furthermore, with reduced expected return potential for long-duration fixed income, the opportunity cost of hedging liabilities has increased, making some pension executives question whether the price of hedging has become too steep.

We suggest that an effective liability duration management strategy is still possible and can be accomplished by seeking greater capital efficiency across fixed-income allocations. Sourcing Treasury duration via longer-dated Treasury STRIPS (as opposed to long Treasury or long government) or via synthetic duration overlays (utilizing Treasury bond and Ultra bond futures) can reduce the overall fixed-income allocation and open up more capital for higher-expected-return assets and increased credit spreads. For example, shifting an allocation of long US Treasury bonds to a synthetic solution would require a smaller outlay of capital but still provide the same hedge ratio. Our recent piece, **A Capital Efficient Approach for Managing DB Plan Assets**, discusses the mechanics in more detail.

2 Challenge High-flying equity valuations and elevated volatility

Record-high equity index prices (Figure 2) have generated concerns about funded-status downside risk and potential volatility. The VIX has fallen from its post-crisis peak in March 2020, but the markets still face a laundry list of worries including the COVID-19 vaccine distribution, the retail-driven market fluctuations, the rising global debt and the impact of the new US presidential administration on certain economic sectors.

Figure 2
Country PE Multiples Exceed Long-Term Averages

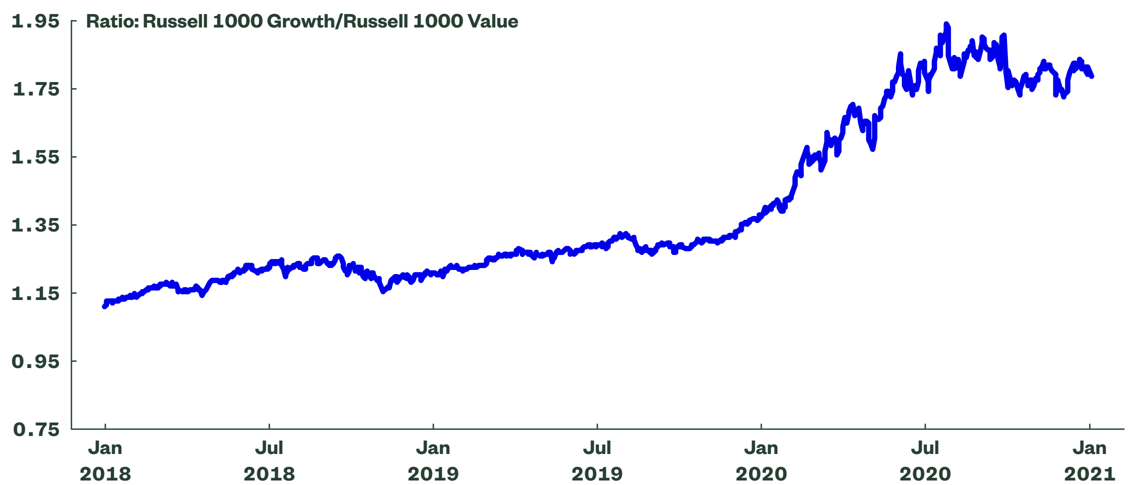
	December 2020 PE Multiple	December 2001–December 2020 PE Multiple Statistics		
		Average	Maximum	Minimum
US	23.03	15.73	23.03	11.19
UK	14.36	12.74	17.97	8.69
Europe ex UK	18.12	13.57	19.15	9.00
Japan	18.38	16.49	31.91	11.10
Australia	18.97	14.51	18.97	10.13
Canada	15.97	14.37	18.48	9.97
China	15.70	12.02	19.16	8.35
Brazil	12.65	10.45	14.14	6.62
India	24.23	16.35	24.23	10.30
Russia*	8.52	7.18	12.22	4.02

*Data available beginning December 2003.
Source: FactSet, MSCI, as of December 31, 2020. Based on annual year-end data for the MSCI US, UK, Europe ex-UK, Japan, Australia, Canada, China, Brazil, India and Russia Indices.

In our view, sourcing a diversified portfolio of growth assets with a lower correlation to equities (0–0.3 beta) can help to mitigate tail risks. These strategies can improve risk-adjusted returns by reducing risk while maintaining growth potential over the long term. Less-directional funds have reemerged due to rising return correlation between assets and lower volatility, but future moves may provide opportunities for managed futures or other directional strategies.

In May, we wrote that low-volatility strategies such as minimum/managed volatility or defensive equities can benefit investors by providing more resilience against economic weakness. While the ratio of growth to value has risen steadily in recent years due partly to pricing in stocks such as Tesla and Amazon, the ratio has leveled in recent months (Figure 3), and large value funds modestly outperformed large growth funds in the fourth quarter of 2020.

Figure 3
Value Had Flickers of Life in 4Q2020



Source: Yahoo Finance, State Street Global Advisors, as of February 17, 2021.

In addition, private credit or long/short solutions may be advantageous. Synthetic risk overlays such as collars may also be useful here, as they can offer low-cost protection and improve the probability of future outcomes for underlying holdings (see **Alternatives Allocation: Market Volatility and the Denominator Effect**).

3 **Challenge** Inflation exposure

Recent decades were marked by disinflationary forces across much of the world and global financial markets. Is this situation poised to change? Breakevens have risen strongly since mid-2020 (Figure 4), as investors are pricing in economic improvement alongside a double whammy of fiscal stimulus and accommodative central banks. These forces may be paving the way for a regime shift toward higher inflation.

First, based on the experiences of the global financial crisis, policymakers have moved to a flexible framework that allows for an overshoot of the Federal Reserve's 2% inflation target. The Fed has also redefined its employment mandate from full to maximum employment, which may spawn a new landscape for both monetary and fiscal policy. Fed Chair Jay Powell has called maximum employment a more "broad-based and inclusive goal."

Second, increased fiscal stimulus through large-scale government transfers to low- and middle-income households (to address inequality) may contribute to a more reflationary environment.

Third, high central bank deficit spending could also keep rates low. The Fed also stated that it will continue buying assets at a $120 billion monthly pace until there has been "substantial further progress" on its employment and inflation goals. Core personal consumption expenditures (PCE) for December increased 1.5% year-over-year, still well below the Fed's 2% target; however, PCE inflation of 1.3% was above expectations.

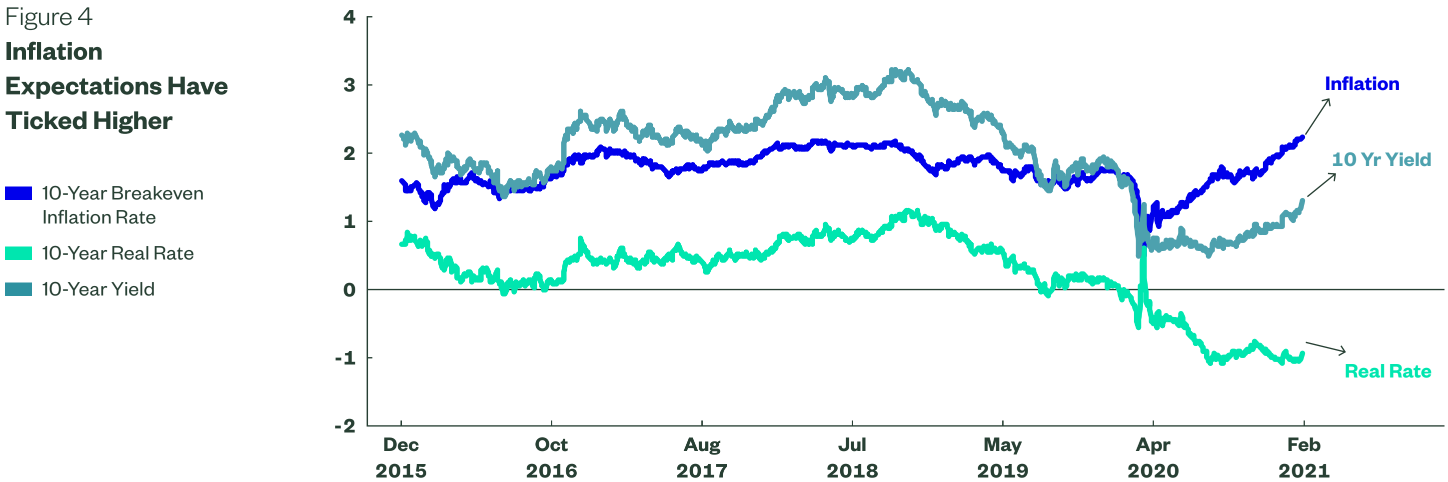
Finally, State Street Global Advisors Senior Economist Simona Mocuta points out recent price expansion in the ISM Non-Manufacturing Index and notes that the recent move lower in the US dollar, along with potential supply bottlenecks in some service areas, could put upward pressure on inflation. This combination of monetary and fiscal stimulus, economic reopening with increased success of vaccine rollouts, and pent-up demand will likely propel growth in 2021. We expect the US economy to grow by 4.1% in 2021 (see **Forecasts Quarter 1, 2021**).

Pension plans are exposed to inflation in different ways, both in assets and liabilities:

Closed/frozen plans Long-term nominal high-quality corporate rates drive liability valuations, particularly for closed and frozen corporate plans. A steeper curve and rising long rates caused by a rise in inflation expectations will be a welcome tailwind to improved funded status, provided growth-oriented assets do not fall victim to an inflationary shock scenario. While fixed-income, LDI-oriented assets will fall in value when rates rise, the majority of plans are underfunded and not yet fully hedged from an asset-liability standpoint (i.e., they carry a hedge ratio of 50%–70%). In this scenario, plans will be well served to consider options to manage and add duration and increase their hedge ratio via long-dated Treasuries, STRIPS, futures and certain investment-grade corporate bonds.

Open/active plans For plans with open and active participants, or a cash balance feature, inflation may boost projected future payout projections and increase service costs and accruals. Here, a growth-oriented allocation that provides a level of inflation exposure — such as an allocation to broad-based real assets — is one option for managing inflation risks. While these assets have been performance laggards, a new inflationary regime and strong recovery may improve their return prospects and asset allocation inflows. Pockets of other asset classes that can mitigate inflation risks should also be explored.

Figure 4
Inflation Expectations Have Ticked Higher



Source: FactSet, as of February 16, 2021.

4 Challenge Funding uncertainty and increased plan expense

Liability management has become a more significant focus as many plans have aimed to generate returns and increase their asset bases to source ongoing benefit payments. In addition, all eyes are on potential legislative relief to pension funding requirements. In January, Ways and Means Chairman Richard Neal introduced the **Emergency Pension Plan Relief Act (EPPRA)**, which could be an important part of the COVID stimulus package. EPPRA could give troubled plans enough financial assistance to remain well-funded for the next thirty years, with no cuts to benefits for plan participants. In return, plans would have to meet certain conditions and file regular comprehensive update reports to the PBGC and Congress. Some components of the bill include:

- For single employer plans, the bill would allow funding shortfalls to be amortized over 15 years, rather than 7 years. Per Wolfe Research, this could slash required annual cash contributions by about half.
- The bill would also delay the phaseout of the 5% corridor[1] until 2026, at which point the corridor would begin to move higher until it reaches 30% in 2030. A 5% floor would then be placed on the long-term average rate to protect from extremely low rates in future periods.
- For multiemployer plans, the bill would also increase PBGC guarantees to participants.

The legislation is an ongoing debate in Washington. In the meantime, the hurdle rates of liability accruals and increased projected benefit obligation values continue to drive sponsors towards discrete liability management solutions. Plans continue to focus on lump-sum offerings and annuitizing bulk low-balance participants (i.e., those who receive low monthly payments) to reduce per-participant-based PBGC[2] fees.

While pension-risk-transfer activity was muted in 2020, some corporate DB plans have bounced back to solid funding status and may have the economic incentive to now consider a pension risk transfer (PRT). Discussions around PRT feasibility have increased notably. If a reflationary environment were to unfold, and as mentioned above, a rise and steepening of the pension liability discount rate curve were to result in improved funded status for a plan, that plan should be ready to engage in further pension de-risking activities. To position for a PRT, sourcing long-duration investment credit with a focus on scale, liquidity and cost of entry will be paramount. Investors should seek investment partners that can manage credit quality, issuer risk, and downgrade and default migration in an arena with many other market participants seeking long-duration credit vehicles. The need for duration in a rising rate environment will likely increase, and therefore the use of long-dated Treasuries, STRIPS and futures provide a liquid access point for dollar-duration exposure to increase a pension's overall hedge ratio.

Clients who are moving along the de-risking glidepath and are challenged by the low expected returns of fixed income and other asset classes may seek to combine long-duration Treasury exposure with diversified sources of income and yield. This can be accomplished via a spread product that complements their investment grade exposure. Spread assets accessed in a diversified, multi-asset credit framework (loans, high yield, emerging market debt, securitized credit and, in some cases, private credit) can offer de-risking benefits (moving from equity beta risk to multi-asset credit) due to lower expected volatility. At the same time, multi-asset credit frameworks can offer yield and income to meet or beat liability spread exposure. The key is that de-risking can be achieved through other methods — not just long-duration fixed income.

> “The key is that de-risking can be achieved through other methods — not just long-duration fixed income.”

5 **Challenge** Achieving benefits of scale

Low expected returns and compressed yields require plan sponsors to look more closely at their fee structures as well and evaluate what they're receiving for the fees levied. High fees across a broad scope of services can be a significant drag when starting from such an extremely low basis for forward-looking returns. In some cases, active management may well provide value. For example, it's important for plan sponsors to consider the value of active credit management as idiosyncratic risks take shape at this point in the credit cycle. But in asset classes that require less oversight and exhibit less value from active management, where beta exposure is more efficient overall, it may make sense for clients to consider indexed rather than active mandates, freeing up capital and fee budgets to seek alternative sources of alpha.

Tying It All Together: Harmonizing Advisors and Partners

More and more, clients want fewer strategic partnerships and advisory teams rather than a "supermarket" of asset manager relationships that contribute to different needs. This trend has dovetailed into client demand for strong investment advice and guidance accompanied by a bundling of services and a cross-functional team of subject matter experts. It's important for DB plans to find a global partner with a commitment to strong governance and operational efficiencies. With the challenges facing pension plans this year, a capable, innovative partner can help plan sponsors to navigate and improve risk-adjusted returns.

Endnotes

1 As part of interest rate stabilization efforts, Congress in 2012 put forth a law limiting the interest rates used to discount pension plans to be at most 10% different from long-term averages.

2 Pension Benefit Guaranty Corporation.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 31 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $3.47 trillion* under our care.

* This figure is presented as of December 31, 2020 and includes approximately $75.17 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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