Rocaton

INSIGHTS

2012 Year in Review: *The State of the Corporate Pension Market*

January 2013

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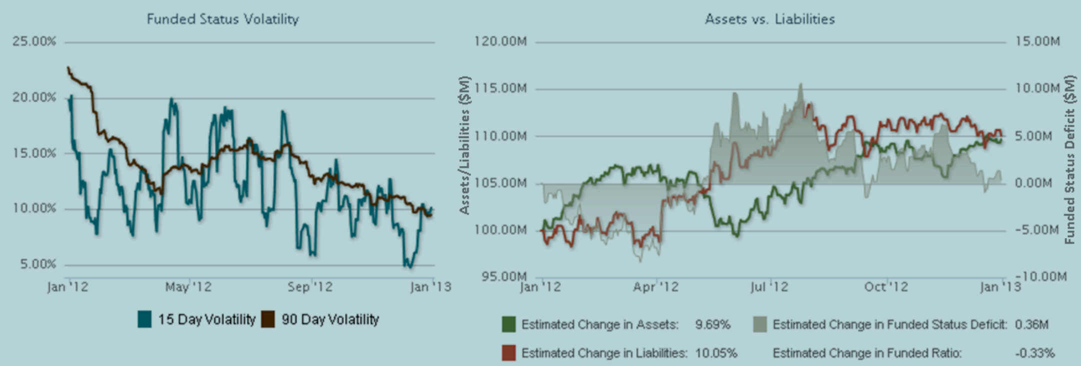
Recent years have been eventful in the world of pensions, and 2012 was no exception. While there is much to say about individual events and trends of the outgoing year, we wanted to take this opportunity to briefly summarize those which we believe were most significant:

* **Mark-to-Market Funding Levels Fall Modestly**: In spite of healthy (in many instances, double digit) asset returns for the typical U.S. corporate pension plan during 2012, a sharp rise in liability values kept funded positions relatively unchanged during the year. According to PlanRisk.com, Rocaton's recently released pension risk monitor, the funded status of a typical plan which started the year fully funded fell by approximately 0.33% by the end of the year *(see Figure 1 below)*.

Figure 1:
2012 Plan Performance

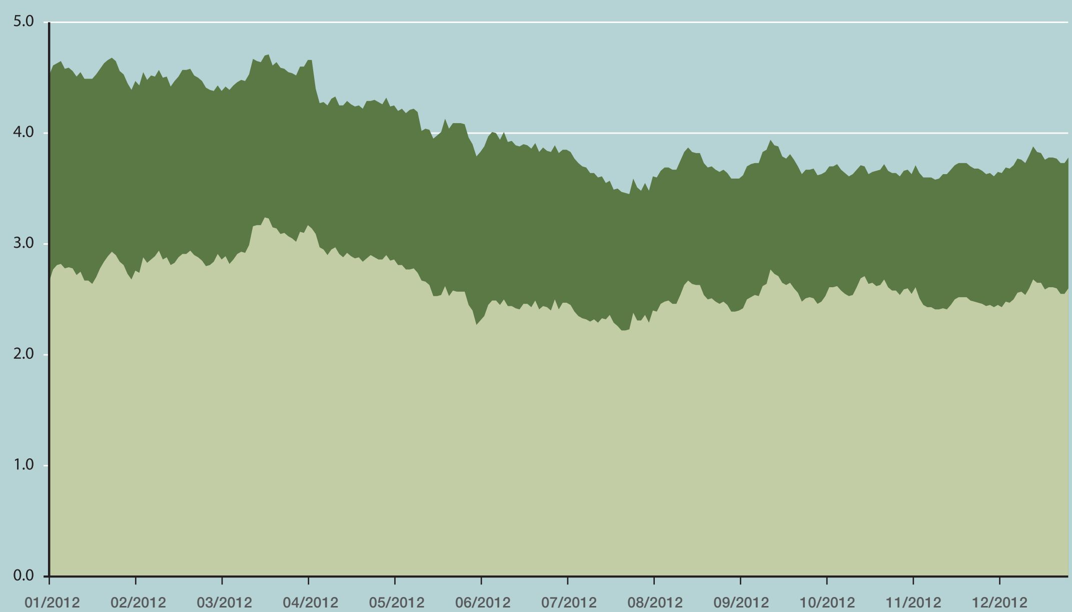


Source: PlanRisk.com (average plan). Market return on assets and liabilities estimated as 12.86% and 13.20%, respectively, during this period.

* **Liability Values Rise**: A meaningful decline in discount rates drove pension plan liability values up and funded positions down very modestly during 2012. The yield on the Barclays Long Aa Corporate Bond Index, a proxy for pension discount rates, declined by approximately 74 basis points during the year (see below for a further discussion of discount rates). A drop in both Treasury rates and, more significantly, corporate bond spreads contributed to this decline. A narrowing in spreads contributed almost 70 basis points to the overall decrease *(see Figure 2 below)*.

* **Funded Status Volatility Abates**: As funded positions moved back towards levels seen at the beginning of the year, markets also calmed considerably. An improving jobs picture, the start of a recovering housing market, and an unwavering commitment from the Fed to keep rates low drove investors' search for yield and increased risk appetites. Illustrated in Figure 1, PlanRisk.com shows that rolling 90-day funded status volatility (annualized) dropped from above 20% at the beginning of the year to below 10% by year-end.

Figure 2:
Long Aa Yield to Worst (%) During 2012



Legend:
Interest Rate Component
Credit Spread Component

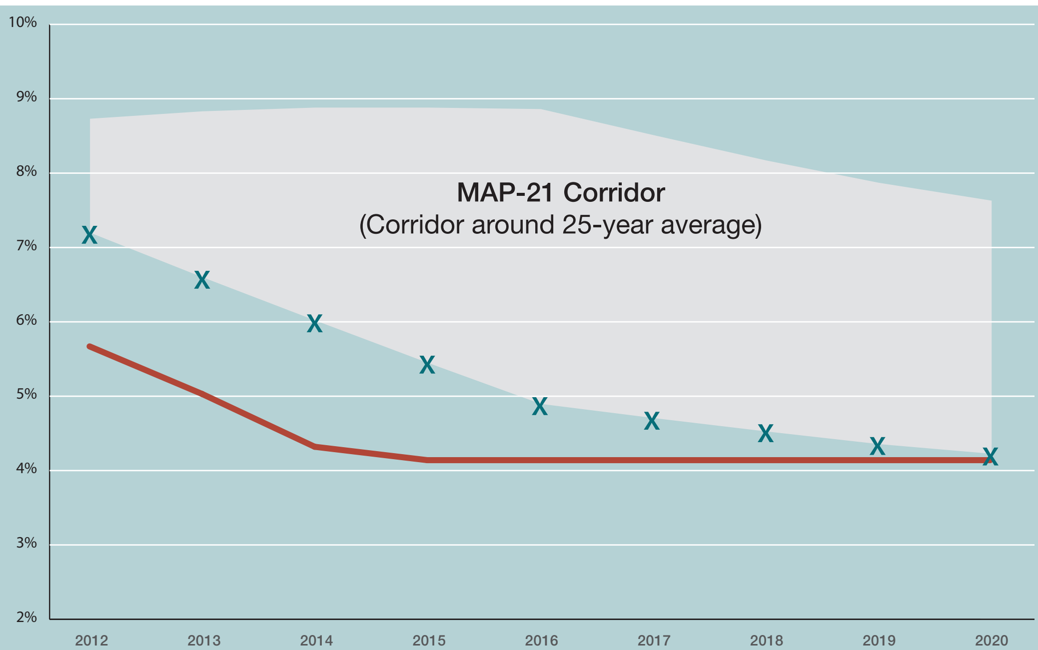
Source: Barclays

* **Changes in Discount Rate Composition Impacts Funded Position**: The spring and summer of 2012 highlighted the potential vagaries of the discount rate used to value pension plan liabilities and the resulting impact on funding levels. Notably, there were a number of ratings migrations, such as the downgrades to below Aa for GE Capital in April and for a number of banks such as J.P. Morgan, Credit Suisse, and UBS in June, which impacted discount rates and, in turn, pension plan funding levels. As discussed in Rocaton's May 2012 *Insights: Pension Liability Hedging—Concentration Risks in Long AA Corporate Bond Indexes*, we estimated that for a plan with a funded ratio of 75%, its funded position potentially dropped by approximately 2% due entirely to the GE Capital downgrade. Before the April downgrade, GE Capital bonds (which were higher yielding) represented 24% of the Barclays Long Aa Corporate Bond Index; after the downgrade, GE Capital was removed from the index,

resulting in a lower yield for the index, which serves as a proxy for the liability discount rate. Moreover, as discussed in our May 2012 *Insights*, these 2012 events provided a valuable lesson pointing to the limitations of the Aa corporate bond universe as the sole benchmark for the liability discount rate and the challenges plan sponsors face when trying to hedge liability interest rate- and credit spread-risk.

* **Funding Relief Granted**: On July 6, President Obama granted pension funding relief to certain corporate pension plans by signing the Moving Ahead for Progress in the 21st Century Act ("MAP-21") into law. Among other things, this legislation provides for increases in PBGC premiums over the next few years and for the use of a corridor (i.e. minimum and maximum) around a 25-year average of high quality corporate bond rates in determining minimum contribution requirements for most corporate pension plans. If the 24-month average rate used by most plans pre-MAP-21 falls below (or above) this corridor, then the bottom (or top) of the corridor is used. For the 2012 plan year, the corridor will be initially 90%-110% of the 25-year average of long duration high quality (rated A or better) bonds. By the 2016 plan year, the corridor will widen to 70%-130% of the same long duration high quality index. The funding relief will result in higher discount rates for the 2012 plan year because the rate at the bottom of the corridor (i.e., 90% of the 25-year average of long high quality bond yields) is higher than the rate that would have been used prior to the passing of the Act. The impact will differ by plan, but estimates suggest that discount rates could be 100-150 basis points higher, resulting in liability values that that could be 10-15% lower, assuming a liability duration of 10 years. As detailed in Rocaton's September 2012 *Insights: The Long & Short of It: LDI in a Low Rate Environment*, we encouraged plan sponsors to review the continued appropriateness of any existing liability-driven investing ("LDI") programs and transition plans into LDI due to this funding relief in combination with the prevailing low interest rate environment.

Figure 3:
Illustration of MAP-21 Discount Rate



Legend:

X = Estimated applicable interest rate after application of MAP-21 (Must lie within the MAP-21 Corridor)

24-month average Segment Rates = Applicable interest rate if smoothing was elected prior to introduction of MAP-21

Note: the figure above is illustrative and reflects the impact of MAP-21 if unaveraged PPA segment rates were to remain level during the timeframe shown.

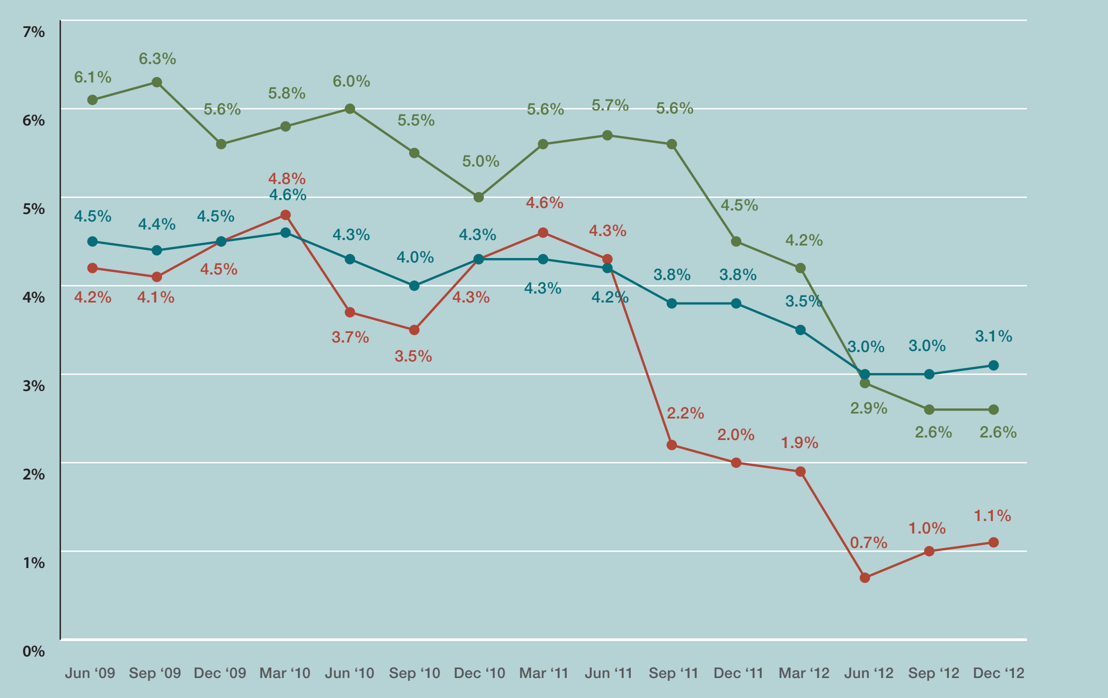
* **De-Risking Wave Continues**: In 2012, Rocaton and Pensions & Investments conducted our *2012 LDI Implementation Survey* of plan sponsors. We found that, in spite of a low interest rate environment (and, in many instances, severe underfunding), pension de-risking strategies continued to gain popularity. 66% of plan sponsors who responded to the survey indicated that they employ liability-driven investing strategies; the remaining 44% indicated that they were considering adopting such strategies in the next couple of years.

  While the use of more traditional LDI strategies continued on their growth trajectory, dynamic asset allocation strategies, lump sum payouts and pension annuity payouts all gained traction throughout the year. 2012 marked the first year in which the prescribed determination of lump sum payouts was based exclusively on corporate bond rates, which in comparison to the prior methodology removed the premium (relative to the liability "on the books") for sponsors of cashing out liabilities associated with uncertain future benefits. In response, a number of sponsors instituted programs to offer lump sums to terminated vested participants during the year, with some notable names including GM, Ford, Yum! Brands, Sears, and JC Penney. GM and Ford also set a precedent in the realm of lump sum windows by including retirees already receiving benefits in their lump sum offerings. In addition, during 2012 GM and Verizon announced that they would be executing annuity purchases for retiree liabilities – the two largest in U.S. history.

* **Low Yields = Low Expected Future Returns**: Finally, as reported in Rocaton's July 2012 *Insights: June 30, 2012 Capital Market Assumptions*, the second quarter of 2012 marked the first time in the past decade that Rocaton projected higher 10-year compound returns for core fixed income than for both long duration Treasury and long duration corporate bonds *(see Figure 4)*. This continued to hold for the two quarters that followed.

Notably, even though the cost of hedging interest rate risk is arguably at or near all-time highs, many plan sponsors have invested in long duration assets and explored new ways to mitigate pension liability risk. We believe this trend will persist. In the coming year, we look forward to proactively working with our clients to evaluate any new opportunities and to determine their appropriateness given each client's unique circumstances.

Figure 4:
Rocaton Next 10-Year Return Forecasts



Legend:
Long U.S. Corporate
U.S. Fixed Income
Long U.S. Treasuries

