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INSIGHTS

Pension Funded Status Levels on the Rise

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Executive Summary

- Pension funded status levels have likely increased in recent months due to a sharp rise in interest rates along with continued gains in public equity markets.
- Based on our estimates, funded status levels have likely improved between 2-5% since the election depending on a plan's asset allocation, liability duration, and starting funded status.
- Investors with glide path allocations should review their current funded status to determine if a change in asset allocation in warranted.
- We recommend adhering to glide path plans and not waiting for interest rates to go higher before hedging liabilities unless this was part of a pre-established plan.

Examining the Recent Rise in Funded Status

Since the U.S. election on November 8, most defined benefit plan sponsors should have experienced a material increase in funded status. There are several reasons for the increase in funded status:

- Interest rates, particularly at the long end of the yield curve, have risen sharply. From November 8th through December 7th, the 30-Year U.S. Treasury yield increased 41 basis points.
- Taking a slightly longer view, 30-year yields are 85 basis points higher since their July 2016 low.
- Long AA corporate bond yields, a proxy for pension liability discount rates, are higher by 32 basis points post-election and are 75 basis points higher since July lows. However, it is worth noting that long AA yields and liability discount rates (for accounting purposes) remain below levels seen at the end of 2015.
- Global equity markets (as defined by the MSCI ACWI in USD terms) are up 3.1% since the election and 7.9% since early July.

Given the rise in interest rates and strong performance in equity markets, we estimate that funded status levels have risen materially over a short period of time. For a plan with an 85% funded ratio and an allocation of 60% global equity, 40% core U.S. fixed income, we estimate a 4.3% rise in funded status since the election. A plan with long duration fixed income exposure likely experienced a 3.3% gain in funded status over the same time period. Plans with more fixed income exposure likely saw more modest gains in funded status on the order of 1-2%. If we extend the time horizon to early July when rates reached their intra-year low and equity markets were at lower levels, the subsequent gain in funded status should have been materially better. The 60/40 portfolio (with core fixed income) likely saw a nearly 10% gain in funded status from early-July through early-December. A more hedged portfolio (80% long duration fixed income) should have experienced a more modest funded status gain of 2-3%.

Conclusion

While the recent gains in funded status are certainly welcome, it is worth pointing out that funded status levels for many plans had deteriorated through the first six months of 2016 with interest rates declining and risk markets delivering mixed results. Given the recent rise in interest rates and the gains in public equity markets, we believe now is a prudent time to review glide path triggers or review the idea of incorporating a glide path in the management of a plan's asset allocation. Further, we believe that defined benefit plans which are interested in hedging liabilities should take advantage of recent market movements by continuing to de-risk their plans. Plan sponsors considering accelerating contributions should evaluate funded ratio and risk tolerance levels in consideration of the asset allocation policy. Too often we have seen plan sponsors wait for further increases in interest rates based on interest rate forecasts before hedging liabilities, only to experience significant decreases in funded status. Plans which are interested in acting quickly could potentially get duration exposure through the derivative market before transitioning physical assets. Long duration exposures are also available in liquid vehicles, such as mutual funds, which could be bought in a timely manner as well. Regardless of the exposure, we believe plan sponsors should review their current risk positioning closely and determine if a change in asset allocation is warranted.

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Performance Information and Return Expectations

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