Five Best Practices for Pension Plan Sponsors

As we move across an unprecedented year, it would be advisable for pension plan sponsors to revisit strategies for the future of their investment programs. With this in mind, we have put together a few timely best practices that can help you continue to navigate the current environment.

1. Keep focus on the liabilities

Pension plan investing should be approached by considering a plan's assets relative to the liabilities they support. The current extremely low interest rate environment may lead to the question of whether long duration investment still makes sense. As the markets continue to prove, interest rate risk is one of the key risks for corporate pension plans; we have observed double-digit growth in liabilities this year due to declining rates. Holding fixed income assets that are aligned with the longer duration of the plan's pension liabilities may be the way to manage that risk and get relief when it is needed most. We expect to continue to see rate volatility, and while the direction and magnitude of rate changes are uncertain, declining Treasury rates or corporate spreads are still possible. We also believe it is important to maintain glidepath de-risking strategies, especially after pullbacks in funded ratios. We observed many plans on glidepaths benefit from the eventual climb in funded ratios that occurred after the 2008 financial crisis, and having a forward-looking plan in place may be imperative now.

2. Stay "active" within fixed income – you get what you pay for!

In our view, it is important to keep allocations to fixed income actively managed, as passive implementation in this particular asset class is traditionally inefficient. Most pension plan long-duration portfolios primarily consist of corporate credit, due to pension liabilities being based on high quality corporate bond yields. The impact of bond defaults and downgrades could create a drag on pension-funded positions if not managed appropriately. When a corporate bond gets downgraded, the portfolio value *decreases*, which is magnified if the manager sells the bond at a loss after the downgrade. However, liabilities may *increase* if that bond drops out of the higher quality yield curve used to measure liabilities. In order to avoid excessive drops in funded status (from lower assets and higher liabilities), utilizing active management with a manager experienced in selling bonds before they are downgraded and navigating a volatile fixed income market is important.

3. Determine if your governance model allows for flexibility to make timely changes

The above best practice is focused on one asset class that is important for pensions; however, when we look broadly at financial markets, we see various sectors being impacted very differently by the current crises and we observe opportunities to take advantage of potential inefficiencies. It has become more important that clients have teams, either internal or external, that are focused on the investment markets, and have views that can be implemented in the portfolio before the opportunity passes. To provide one example, the Energy sector has been one of the most volatile sectors as it reacts to, and recovers from, frequent overabundance of oil supply relative to demand. Examining the entire portfolio and looking at each underlying manager's portfolio to understand the overall exposure to Energy allows the plan sponsor to get the desired exposure and avoid potential portfolio losses that we have seen in that sector.

4. Continue rebalancing; cash flows can help

We believe it is important to stay invested over the long term. That does not mean portfolios *should not* be adjusted over time, however. With prices moving significantly as a result of the equity market drawdown and bond market rally, many plans

have seen percentage declines of their equity allocation. We think now is the time to rebalance with careful consideration of upcoming cash inflows (e.g., contributions) and outflows (e.g., benefit payments or expenses) which should be relatively predictable for pension plans. Though some pensions are deferring contributions until year end due to Coronavirus Aid, Relief, and Economic Security Act provisions, others continue to make scheduled contributions. These contributions can be a good source of capital to take advantage of tactical (shorter-term) investment opportunities.

5. Use this as a time to revisit the role of diversifiers along with the overall strategy

Having a well-diversified portfolio can be important during volatile markets. If certain asset classes were considered in the past but have yet to be implemented, now may a good time to look for those opportunities. Allocations to assets that are more defensive or have lower correlation to the rest of the portfolio have helped during recent equity market drawdowns. Though frozen plans with a termination objective may want to avoid illiquid investments that traditionally produce high returns, there are many liquid diversifiers available that could produce excess returns above liabilities but still mitigate larger drawdowns.

On a broader level, plan sponsors may have experienced drawdowns in funded status that were more than expected during the current crisis. If this is the case, we recommend sponsors revisit the long-term strategy with forward-looking asset liability analysis; determine that the strategy in place can provided the necessary upside potential and downside protection required; and monitor, analyze, and report on the strategy frequently.

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