BlackRock

Adapting to a new world

Key themes for U.S. corporate pension plans after Q1 2020 volatility

2019 ended up being a strong year for corporate pension plans, with funded ratios up around 4%.[1] That now seems like a distant memory. According to BlackRock's U.S. pension funding update, the funded ratio for the average plan was down 7.8% in the first quarter of 2020, but that figure varies widely depending on strategic asset allocation, plan status and contribution policies. Plans that hedged more interest rate risk did better, and a few well-funded plans with most of their assets in liability-matched fixed income strategies saw funded status improve.[2]

7.8%
decline in average funded ratios in Q1 2020

In this note, we update our 2020 investment themes for corporate plans given the sharp declines in equity markets and risk assets around the world, in order to help plan sponsors navigate potentially choppy waters and to reposition themselves for success in reaching funded ratio goals. Our view is that *many of the themes still apply*, albeit with an increased focus on preserving funding levels and taking advantage of investment opportunities to help funding levels recover.

We also do a deep dive on some of the most pressing topics clients have been asking about, and propose solutions including:

- **Dealing with decreasing contributions**
- **Rethinking the balance of credit and Treasuries**
- **Instituting best practices in rebalancing and managing liquidity**

1 https://www.blackrock.com/institutions/en-us/literature/publication/pensionfundingupdate.pdf. **2** As of March 31, 2020. The observation that plans that hedged more interest rate risk did better is based on U.S. defined benefit clients for which BlackRock manages whole portfolio solutions on a discretionary basis. For our clients the average funded ratio decline in Q1 was -2.7% with a range of +2.8% to -9.5%.

An update of 2020 investment themes

Many themes still apply

Proposed plan sponsor and fiduciary initiatives

Plan sponsor-driven initiatives at the start of 2020	Updated potential actions after Q1
Redesign, close or freeze the plan	We had expected the gradual trend toward closing and freezing plans, as well as the regular drumbeat of lump sum offers, to continue in 2020. There are a small handful of companies that may still consider cutting benefits as a way to keep the workforce employed or the company afloat, but in general these steps now appear less likely in the balance of the year.[3] Further, the benefits of pension cost reductions tend to be felt over the medium to long term and may not help shorter-term cash flow or liquidity needs from a sponsor perspective.
Make voluntary contributions	A BlackRock analysis of public disclosures from U.S. corporate plans showed that contributions were around 70% lower in 2019 than in 2018, because in 2018 many plan sponsors brought forward multiple years of voluntary contributions to deduct them at higher corporate tax rates. In early 2020, we had encouraged sponsors to continue voluntary contributions to help close funding gaps, given the backdrop of a healthy global economy at the time. In the past two months, companies in many industries have canceled their plans to make voluntary contributions this year, given the sharp drop off in economic activity and the need to conserve cash. This is likely to have implications for the return required to improve funded ratios. We expect that many sponsors will seek to review their strategic asset allocation and glide-path construction heading into the summer, given these new circumstances. As a part of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) passed by the U.S. Congress on March 27, DB sponsors can also delay compulsory contributions to the plan until January 1, 2021. This reinforces our point above, that lower contributions warrant a review of investment policy. See detailed summary of the new legislation in the *Dealing with decreasing contributions* section on page 4.
Borrow to fund at low yields	This method of closing funding gaps re-emerged in 2019 given low bond yields and the fact that it generally offers an attractive 10+% internal rate of return (IRR), improves funded ratios, reduces PBGC costs, and presents opportunities to build out the liability-hedging program. Since the Federal Reserve's announcement that it plans to substantially increase its balance sheet, including by purchasing corporate bonds, investment grade credit spreads have rallied substantially. Corporate bond issuance also increased to record levels in March, but the use of these proceeds varies widely between issuers. Overall, we believe fewer companies will use borrowed proceeds to fund plans, since leverage and interest-coverage ratios remain elevated and many companies are solely focused on short-term cash and solvency needs. For some less cash-strained companies, we expect borrow-to-fund will remain an attractive way to close funding gaps and reduce costs.
Transfer risk to an insurer (PRT)	The PRT market had another solid year in 2019, exceeding the activity from 2018 (per LIMRA). There are a small handful of companies that may still proceed with partial PRT to reduce headcount and cap PBGC variable rate premiums. However, with funded ratios now materially lower for many plans, it is likely more of a cash burden to transfer risk to an insurance company. We still reinforce the need to incorporate PRT considerations into long-term strategic planning, yet PRT activity is likely to be lower for the balance of 2020.

3 Note that if a company is shut down or more than around 15% of the workforce is reduced, this may trigger a "partial termination" of the retirement plan, and/or liability under 4062(e) of ERISA due to a "substantial cessation of operations" in the form of the potential for forced contributions by the PBGC. See: https://www.morganlewis.com/blogs/mlbenefits/2020/03/covid-19-related-layoffs-may-create-more-liabilities-for-retirement-plans

Investment fiduciary-driven initiatives at the start of 2020	Updated potential actions after Q1
Allocate to the "right" kind of growth assets	Most plans invest in growth assets to close funding gaps, but they also have a role to play in preserving funded ratio levels and reducing risk. We continue to believe that not all diversifying growth assets are created equal when considered in liability-relative terms. For example, we highlighted that commodities are commonly considered a sound diversifying asset class in asset-only terms, but are one of the least effective asset classes in preserving funded ratios in the worst environments for DB plans. In Q1, broad commodity exposures, as measured by the S&P GSCI index, declined 42%, although there was a material difference between sectors, particularly energy and precious metals. For DB investors strategically, we continue to favor diversifying growth assets that perform better in the worst periods for funded status. Other, more interest rate sensitive growth asset classes, did much better in Q1, with the Bloomberg U.S. Aggregate High Yield Index and JP Morgan GBI EM Global Diversified Index (local) down 13% and 15%, respectively.
Make fixed income portfolios more efficient	Strategically, we continue to believe DB plans should maximize the interest rate risk they are hedging through capital efficient instruments. These are often priced based on Treasury curves, and so perform a dual purpose of closing duration gaps relative to liabilities and acting as a diversifier relative to equity and spread risk. Long Treasuries proved their worth in Q1, with the Bloomberg U.S. Long Treasury Index producing a 21% return, outperforming the S&P 500 Index by 41% and outperforming liabilities, as proxied by the Bloomberg Long Corporate Index, by approximately 25%. We still believe in the strategic role of Treasuries and capital-efficient instruments in LDI portfolios, but the very low level of nominal yields and the explosion in government debt make us watchful of their defensive attributes. Wider credit spreads have also made investment grade bonds more attractive. We explore this point in the *Rethinking the balance of credit and Treasuries* section below.
Rebalancing and managing liquidity	Dynamic management – where the portfolio is tilted to potentially increase return or mitigate volatility over short- or medium-term horizons – can be particularly useful in an environment where market movements cause asset allocations to drift outside rebalancing bands. Managing liquidity and transaction costs are also particularly important to ensure benefit payments can be made, and capital preserved. In the current environment, BlackRock generally advocates rebalancing through smaller trades spread over a number of days, rather than in a single large trade. We expand upon this in the *Instituting best practices in rebalancing and managing liquidity* section below.

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Deep dive on the most pressing topics

Some of the themes we cover above have been persistently on clients' minds this quarter and thus warrant a deeper dive.

Dealing with decreasing contributions

As described above, in addition to our expectations that *voluntary* contributions will materially fall in 2020, the recently passed CARES Act allows DB sponsors to delay *compulsory* contributions to the plan until January 1, 2021. Specific provisions include:

- The ability to delay any contribution due to a pension plan during calendar year 2020, until January 1, 2021. Note, however, that contribution requirements continue to accrue interest. So, if a $100M contribution was due September 15, 2020 and the interest rate is 5%, the contribution due on January 1, 2021 would be $101.5M.
- The ability to use an adjusted funding target attainment percentage (AFTAP) – the measure used to determine if benefit restrictions under PPA apply to a plan – from the last plan year prior to January 1, 2020 as the AFTAP for plan years including 2020. This appears particularly helpful for severely underfunded plans that may face benefit restrictions if not for this relief.

To the extent the provisions are relatively modest in providing at most an 8.5-month delay in contributions, additional relief may be likely if the crisis extends into the fall. For example, on April 10 the PBGC announced that it had extended deadlines for premium payments to July 15, 2020, and the IRS announced that it had extended the deadline for filing Form 5500s to the same date.

Regardless of the path of future potential funding and PBGC premium relief, lower contributions in 2020 are likely to have implications for the long-term return required to improve funded ratios. We encourage sponsors to review their strategic asset allocation and glide-path construction heading into the summer, given these new circumstances.

Rethinking the balance of credit and Treasuries

The funded ratio experience of many plans in the first quarter of 2020 mirrors that felt in the first few months of the global financial crisis. During that period credit spreads widened and discount rates rose, resulting in lower liability values, which helped cushion the impact of declining equity values. It was only in November 2008, when credit spreads started to narrow at the same time that equities were still falling – the 'perfect storm' for pension plans – that plans felt the real pain from a funded-ratio perspective.

Given how low Treasury yields are and the explosion of government debt, now may be the time to evaluate the strategic credit versus rates mix in liability-hedging allocations. As shown in the *Long Corporate and Credit Index Spreads* chart in Exhibit 1, spreads in high-quality credit became more attractive than they have been at any time since the 2008-2009 period, although they did retrace about 60 basis points once the Fed announced it would be purchasing corporate bonds.

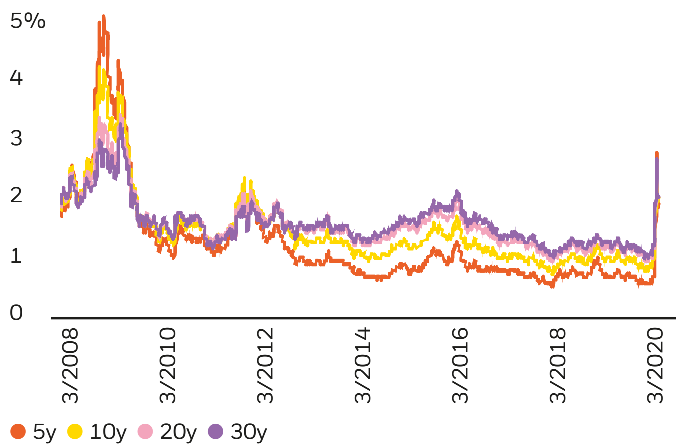
Exhibit 1: The Fed steps into corporate bonds

Corporate spread changes in Q1 2020

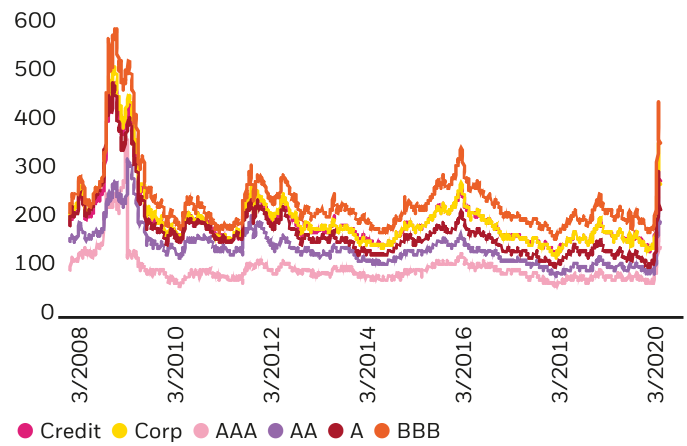
Past performance is not indicative of future results.

Exhibit 1: The Fed steps into corporate bonds

AA Credit Spreads[4]



Long Corporate and Credit Index Spreads[5]



Past performance is not indicative of future results.

As of April 14, 2020, long corporate spreads are around 90 basis points above where they were at the end of the 2019. As always, active avoidance of downgrades and defaults remains an important element of success relative to liabilities.

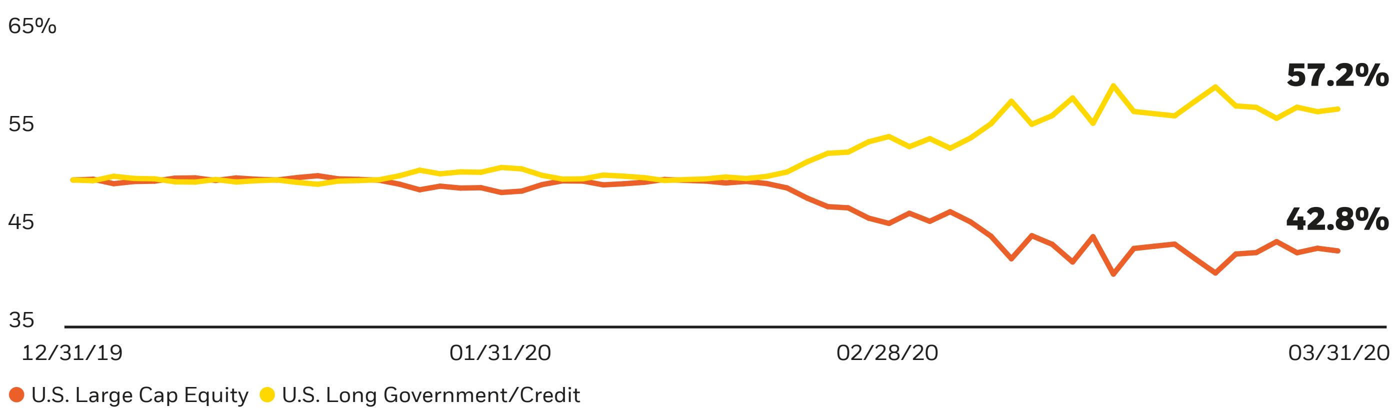
Instituting best practices in rebalancing and managing liquidity

This was the most common topic raised by clients and prospects in Q1. Exhibit 2 shows how dramatically asset allocations may have drifted from strategic targets based on market movements through the quarter – up to 10% away from policy weights.

In periods of extreme volatility, BlackRock generally advocates rebalancing through small incremental trades spread over a number of days, rather than in a single large trade, balancing the desire to reduce transaction costs with the desire to take advantage of potentially dislocated asset prices. This was particularly the case in March, when bid-ask spreads and transaction costs increased substantially, even in the most liquid asset classes. Thirty-year Treasury bond bid-ask spreads rose from 0.2-0.5 basis points in early March to 6-7 basis points on March 20.[6] Investment grade credit bid-ask spreads rose from 2-3 basis points and peaked at 37 basis points over a similar time frame.[7] This was around the same period that investment grade credit spreads widened to over 400 basis points above Treasuries, as shown in the *Long Corporate and Credit Index Spreads* chart in Exhibit 1. The subsequent decline in spreads in the last week of March demonstrated that the opportunity to take advantage of market dislocations can be fleeting. We encourage clients to understand the return required to offset trading and rebalancing costs in these more volatile times.

Exhibit 2: Dramatic deviation

Portfolio weights of a 2-asset pension portfolio assuming no rebalancing



Source: BlackRock, Bloomberg. Portfolio modeled at 50% US LC Equity represented by the Russell 1000 Index, 50% U.S. Long Govt/Credit Index as of 12/31/19 with weights allowed to drift with market movements assuming no rebalancing. Past performance is not indicative of future results.

4 BofA Merrill Lynch yield curves. **5** Barclays 10+ year bond maturity indices. Also BlackRock U.S. pension funding update. **6** Source: Bank of America Merrill Lynch, as of 3/31/20. **7** Source: Morgan Stanley, as of 3/27/20.

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