U.S. corporate defined benefit (DB) plans' funding ratios have been nudging higher since the Great Financial Crisis (GFC) and many are now within the reach of full funding. However, dispersions across industries continue to persist, and some plans are taking on either too much risk or not enough to meet their targets. BlackRock’s Client Insight Unit analyzed data of the 200 largest DB plans to understand what’s creating dispersions and how plans can align their investment strategy with their end-state objectives.

Summary
Since the GFC corporate defined benefit plans’ average funded status has steadily improved with average funding ratios over 95% as of July 30, 2021.

However, funding levels differ between sectors. On average, funded status of pensions in the financial and the consumer discretionary sector were over 100% funded, while plans in the information technology, energy and real estate sectors are around 80% funded.

We estimate approximately 30% of plans may better align their investment strategy with the end-state risk profile. Solutions across Liability-driven investing (LDI) strategies and growth buckets can help bridge this gap.

Within LDI buckets we see advantages in a more expansive approach across fixed income sectors to offset headwinds from downgrades and defaults, which impact assets and liabilities differently. From our research this headwind on traditional LDI strategies may be approximately 40 basis points annually.

Plans that are underfunded could benefit from custom overlay approaches, not only to help close duration gaps, but also for capital efficiencies purposes.

Authors
Calvin Yu, CFA
Head of the Client Insight Unit at BlackRock

Angela Zhang
Vice President in the Client Insight Unit at BlackRock

Avik Mittal
Vice President in the Institutional Product Strategy Group at BlackRock
The 2006 Pension Protection Act (PPA) aimed to strengthen workers’ pension benefit protections and improve funding levels, but in the wake of GFC the funding ratios plummeted. Now for the first time since 2007, DB plans’ average funding status is estimated to be over 95%. To stay on track, we believe pension investors need to focus on preserving funded status improvements, while mitigating risks and positioning for the future. The next market event is always around the corner, and the recovery might not be as swift as what we saw in 2020.

Dips and dispersions
While most plans weathered the market volatility of 2020 and retained higher funding ratios, we saw meaningful dispersions existed across sectors. We found evidence that the materiality of a pension to a company’s financials could influence the amount of risk plans may take, contributing to funding dispersions.

At the beginning of the pandemic, global equity markets fell precipitously, rates across the U.S. Treasury yield curve fell below 1% and credit spreads widened, resulting in the steepest drawdowns since the GFC. However, with unprecedented monetary and fiscal stimulus, many plans recovered, and have even seen significant improvements in funded status. The BlackRock Investment Institute estimates the cumulative activity shortfall in the U.S. and Europe following the pandemic will end up being a fraction — roughly a quarter — of what we saw during the GFC. The discretionary fiscal response now is a multiple of the response following 2008 — roughly four times — a policy reaction that may not repeat itself in the face of another crisis.
Evaluating the enterprise

We analyzed the funded status and plan materiality of the client as well as their industry peers. Based on year-end 2020 data, funded status of pensions in the financial and consumer discretionary sector was over 100% funded on average, while plans in the information technology, energy and real estate sectors are around 80% funded on average. One potential cause of this dispersion is the different level of pension benefits across sectors. The more well-funded sectors of the peer study, such as financial services, were also where nearly all pensions were closed to new participants. Whereas, the less well-funded plans tended to be ones in sectors with a growing liability (often open plans that are still accruing benefits) and where the sponsor has been less willing or able to contribute over the last several years.

While funded status is a good barometer of overall pension plan health, other underlying plan metrics also have a meaningful influence on DB plans. Our peer study compared a DB plan’s risk profile in the context of the plan sponsor’s corporate enterprise and identified additional factors that could affect the asset allocation decisions and ability for the plan to achieve higher funding.

For example, our analysis showed a relationship between the materiality of the pension to the company’s balance sheet (i.e., how much market capitalization was represented by pension obligations) and the amount of risk a plan deployed. On average pension obligations represent roughly 40% of a plan sponsor’s market cap, with the median closer to 16%. When pension plans comprised a smaller portion of the balance sheet, sponsors appear to have more flexibility to both contribute and to take investment risk, pushing average funding ratios higher. Plans that represent more of the company’s balance sheet may have lower tolerance for risk and in turn could be more focused on downside risk and LDI strategies to avoid making any unplanned contributions. We have seen plans in some industries (e.g., autos and communications) undertake partial risk transfers to reduce the size of the plan on the balance sheet, potentially giving them more future flexibility to take investment risk to close funding gaps.

Fund status and plan materiality

Source: S&P Capital IQ, corporate annual reporting and BlackRock as of December 31, 2020. For illustrative purposes only. Assets and PBO (projected benefit obligation) include qualified and non-qualified U.S. plans. Ranks are in ascending order and compared against the top 200 defined benefit plans in AUM from the S&P1500 sponsored companies. Peers are selected based on client input.
We also saw a wide range of impacts that a company’s income statements could have on their pension’s investment strategy. We found that some industries with stronger cash flows, such as regulated utilities, tend to take more risk in the investment portfolios, since they may have more control over their prices and costs that allow them to make higher contributions during market drawdown scenarios. Another possible rationale is some plans may hold more risk in their portfolio because of the impact pension expense has on the income statement.

Honing in on the hurdle
To understand how plans can efficiently earn the returns needed to meet its objectives, we compared the hurdle rate of return to the Expected Return on Assets (EROA) assumption. We determined the hurdle rate of return required to achieve the target funding level at the horizon (assumed to be 110% in 10 years), by considering the funded status, interest cost, service cost, PBGC expenses, benefit payments, estimated contributions, etc.

Our analysis showed that around 30% of the plans look to be misaligned between their investment strategy and end-state objectives. Approximately 17% of plans may be taking on more risk, while approximately 13% of plans may be taking too little risk than is required to meet their objectives.

Hurdle rate of return required to achieve target funding

"Hurdle rate" is defined as the required rate of return for the plan to reach 110% funded ratio in 10 years. It is estimated using the PBO, asset, interest cost, service cost, planned contributions, projected liability payout and other data from the annual reporting as of December 31, 2020.

Driving towards full funding

We believe the learnings of our comparison can help plans determine the best path forward to either improve funding levels or maintain in the face of future volatility.

There are three primary levers DB plan managers can pull to steer the pension plan to full funding: investment performance, contributions and time horizon. The American Rescue Plan Act (ARPA) provided some funding relief that alleviated immediate contribution needs. As a result, this may put more focus on investment returns if plan sponsors chose to not contribute beyond the minimum required amounts, especially after future market drawdowns. Therefore, implementing a strategic asset allocation (SAA) with an appropriate level of expected return and risk is paramount for pension plans to successfully meet funding targets.

Given the level of dispersion across funding, we believe pensions will not benefit from a one size fits all solutions but can apply learnings from our peer study to help them reach their goals. This will depend on each plan’s specific situation, as well as the portfolio’s goals and constraints. We have outlined some of these key trends that different plans across the study have implemented to improve their portfolio positioning going forward.

De-risk and diversify

With improved funding levels, many pensions are hitting glide path triggers and allocating more to LDI strategies. As traditional LDI strategies take on a greater allocation, it is common to invest more in investment grade bonds to better match liabilities. However, with corporate spreads at historic tights, some plans are looking to diversify the exposure beyond long corporates in strategies such as multi-sector and securitized debt. We saw plans that had more flexibility to allocate across fixed income sectors offset the headwind from downgrades and defaults, which impact assets and liabilities differently. From our research this headwind on traditional LDI strategies may be approximately 40 basis points annually.

Additionally, many plans may have the opportunity to better manage their funded ratio risk through custom overlay approaches. Whether on a mandate-level, truing up shorter duration mandates toward liability duration or at a plan level through completion strategies, these strategies can allow for both reduction of oversized or unintended risks, as well as the flexibility to meet return objectives.

Efficient growth of funded status

Plans that were underfunded may need to look beyond traditional strategies to improve funding levels. Custom overlay approaches not only help close duration gaps but can be very capital efficient and allow a larger allocation to the growth portfolio (i.e., hedging more interest rate risk with less dollars in fixed income).

Additionally, many are rethinking income-oriented strategies within the growth portfolio. In a lower-for-longer environment and dynamic markets, traditional fixed income strategies may not offer the same level of income or diversification expected in the past. Increasing flexibility into unconstrained fixed income and incorporating the ability to spread exposures across the liquidity spectrum, into areas like private credit, may help investors to meet higher return expectations, diversify existing risks in the growth portfolio and align the portfolio with liability risks.

Lastly, plans with longer time horizons, such as open plans, may have greater ability to take on more private assets and earn illiquidity premia. We modeled the impact of reallocating from public equity to private markets (e.g., private credit, real estate, infrastructure and private equity) and found expected returns increased. Risk increased commensurately, but the returns per unit of risk improved on average.

None of these strategies offer the perfect solution. But we are optimistic on the opportunities of the post-pandemic recovery and possibilities of previously overlooked portions of the market. Pension plans will need to consider each carefully in the context of their current allocations, return targets, assets, liabilities, stakeholders and other characteristics. As we mentioned in our 2021 corporate pension themes, acting on any of these ideas, however, may require an ability to be nimble and respond when opportunity knocks. Plans should position themselves to move quickly to capitalize on potential opportunities.
Capital at risk. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed.

The material is for information purposes only. It is not intended for and should not be distributed to, or relied upon by, members of the public.

It is not intended to be a forecast, research or investment advice, and is not a recommendation, or an offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed are subject to change. References to specific securities, asset classes and financial markets are for illustrative purposes only and are not intended to be and should not be interpreted as recommendations. Reliance upon information in this material is at the sole risk and discretion of the reader. The material was prepared without regard to specific objectives, financial situation or needs of any investor.

Past performance is not a reliable indicator of current or future results.

In the U.S., this material is for Institutional use only – not for public distribution.

In Canada, this material is intended for permitted clients only, is for educational purposes only, does not constitute investment advice and should not be construed as a solicitation or offering of units of any fund or other security in any jurisdiction.

The information provided here is neither tax nor legal advice and should not be relied on as such. Investment involves risk including possible loss of principal.

FOR INSTITUTIONAL, FINANCIAL PROFESSIONAL, PERMITTED CLIENT AND WHOLESALE INVESTOR USE ONLY. THIS MATERIAL IS NOT TO BE REPRODUCED OR DISTRIBUTED TO PERSONS OTHER THAN THE RECIPIENT.