Willis Towers Watson

10 investment actions for defined benefit plans in 2020

Sponsors navigating their defined benefit (DB) journey over the past decade may soon reach an inflection point where more action is thrust upon them, ready or not. Others may still find themselves far from their goals, requiring a need to reevaluate the level and types of risk-taking by the plan in an attempt to get back on track.

In either case, we believe markets are evolving, the demand for financial and operational resources is increasing, and the DB landscape is changing. The stakes are high: A hiccup could set back a decade of progress or exacerbate existing challenges. How might you batten down the hatches? Stick around.

Actions on the horizon

1 Prepare your budget (and maybe your checkbook).

Sponsors may be shocked by their required contributions over the coming years. The funding relief that sponsors have enjoyed is nearing an end, which could lead to higher required contributions. Know what you may owe, budget and identify potential sources for cash to help avoid surprises. Be prepared to manage investment risk if, after your contributions, the plan becomes better funded. And if you are behind your goals, evaluate how investment decisions may help to reduce required contributions over the long term.

2 Manage interest rate sensitivities.

With multiple rate cuts by the Federal Reserve during 2019, interest rates are back to near all-time lows. For many sponsors, this has broader implications than higher liabilities. For example, plans with ongoing lump sum features may see a liquidity drain due to an acceleration in lump sums as potential retirees see higher lump sum values. Cash balance plans may experience increased rate sensitivity in liabilities if a minimum crediting rate is in effect. Sponsors who are sensitive to short-term contribution requirements should consider the effects of expiring funding relief when evaluating hedging strategies. Each situation requires coordinated short- and long-term planning around investments, funding and liabilities.

3 Plan for the end game.

More frozen plan sponsors are nearing the end of their de-risking journey, and a vague idea for an exit strategy is no longer good enough. It's time to decide whether your objective is termination, hibernation or somewhere in between. In each case, you will likely need to look to enhance cash-flow matching and credit spread exposure. For termination-ready sponsors, you should prepare for upcoming liquidity needs, monitor transaction costs of potential trades and consider asset-in-kind transfer opportunities to streamline the final transfer to an insurance company.

4 Invest responsibly.

Stakeholders are increasingly considering how sustainable practices and culture can be embedded into decision making. If these are goals of yours, we advocate that decisions remain financially driven (i.e., expected to deliver better risk/return outcomes), are based on long-term views and adhere to applicable laws. You might further assess how investment managers support your sustainability goals by examining their governance practices (e.g., executive pay) and stewardship practices (e.g., proxy voting). You might examine culture by evaluating minority involvement in decision making, gender pay gaps and parental leave policies.

5 Get outside help if you need it.

You will likely have to make a number of big investment decisions in the coming years, comprised of many more little decisions. Be realistic about the time, resources, money and expertise you can devote to investment actions and evaluate whether owning the big picture but outsourcing the details is right for you. We are seeing increasing numbers of companies move to a delegated framework with a goal with improved financial outcomes, time and experience, and value for money[1].

Portfolio enhancement opportunities

We expect lower returns over the coming years and higher volatility than what investors are accustomed to. We believe equity and investment-grade bond valuations are inflated, that there are high risks of recessions (especially in Europe and Japan), and that central banks are running low on policy tools to offset shocks.

We believe investors who limit their investment opportunity sets to equities and bonds are especially susceptible to market cyclicality, and, as the saying goes, "You shouldn't put all your eggs in one basket." So, in this section, we will discuss five opportunities to help expand your suite of return drivers.

6 Add non-corporate credit.

Even though aggregate bonds, long credit bonds, high-yield bonds and bank loans may seem fairly different, they're all tied to U.S. corporate borrowers and can be more correlated with equity returns than one might hope. To better diversify your credit investments, we suggest considering other types of borrowers, such as consumers (e.g., securitized debt like credit cards, mortgages and student loans) and sovereigns (e.g., non-U.S. government and corporate debt). You should further look to diversify across capital structure and collateral backing. Credit market dynamics can evolve quickly, so nimbleness is key.

7 Invest in real assets.

Investments such as real estate and infrastructure – or even such things as alternative energy, water or farmland – can potentially provide attractive, differentiated and inflation-linked returns plus strong cash flows backed by physical assets. We feel real assets are perhaps the easiest space to take incremental steps into diversification: You can start with listed real assets; expand into core real estate; and then foray into more niche, illiquid or thematic opportunities. We expect each step to deliver incrementally more diversification benefits (e.g., potential improvements in returns, lowering of overall risk) to portfolios.

8 Exploit systematic premia.

Sometimes diversity isn't only about accessing a new asset class but rather changing how you interact with the current ones. If you expand beyond the traditional long-only mindset, you may find opportunities to earn premiums for strategies such as merger arbitrage, volatility and momentum, even while using equities and bonds. Within a diverse set of liquid alternatives, you may find that a few excel exactly when you need them the most – when equities are faltering.

9 Increase your illiquidity budget.

Unless settlement is just over your horizon, you may be overestimating the liquidity you need in your portfolio. While private markets are one potential way to earn outsized returns, there are other ways you might earn illiquidity premia without the 10- to 12-year lock-ups. Even if you're ultimately limited to investments with five-year, annual or even quarterly liquidity, you may still be compensated for the less frequent trading.

10 Concentrate active management

Across the investment universe many active managers have failed to earn their keep net of fees, and investors are rightly frustrated[2]. Our view is that a large part of that underperformance is because managers are over-diversifying and you're stuck paying a high fee for something that doesn't look all that different from something you could have just invested in passively. So when it comes to active investments, work with your managers to include only their very best ideas and avoid the "filler" holdings.

[1] Pension & Investments (P&I) Survey 2018
[2] S&P Dow Jones Indices SPIVA® U.S. Scorecard, 2018

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