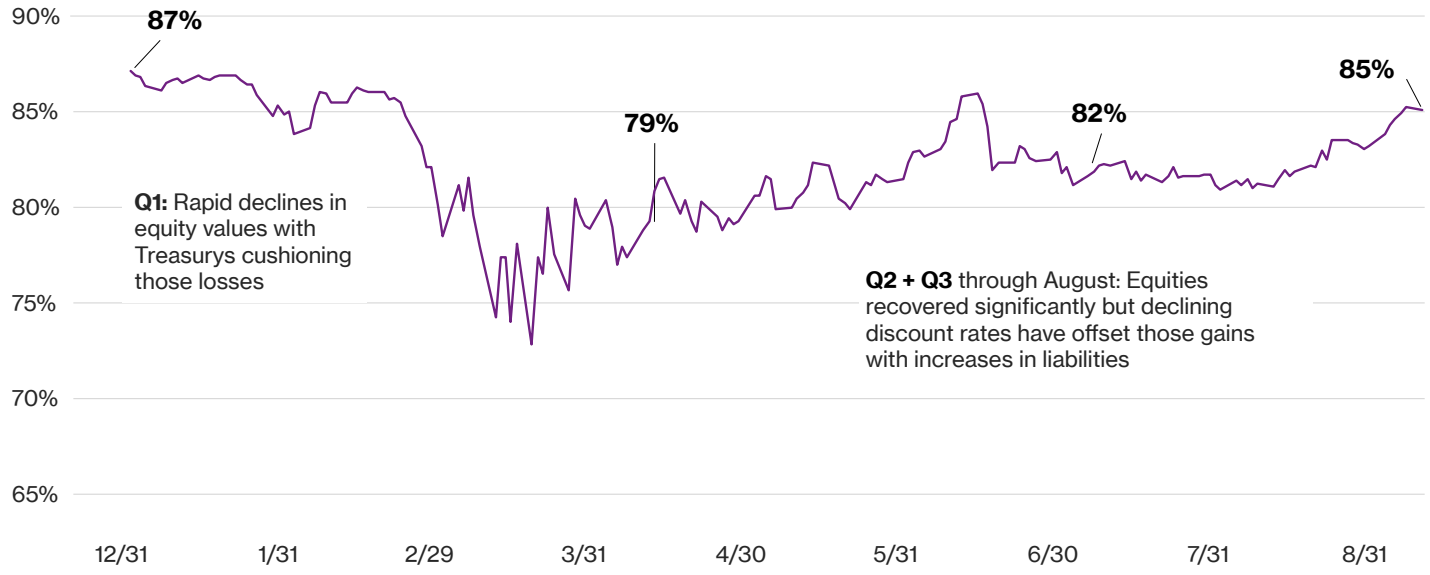
Hold onto your mask!

Four actions pension plan sponsors can take to help manage investment risks

More than five months have passed since the shock to the markets at the end of March. Five months of social distancing. Five months of mask-wearing. And for many plan sponsors, five months of pension volatility amid countless human resource and financial stresses.

A quick glance at the markets suggests optimism may be warranted. After all, despite being down nearly 20% at the end of March, the S&P 500 is now up over 10% year-to-date (as of August 31, 2020). Yet, we estimate that the funded status impact of a typical U.S. plan is a 2% decline over that same period – with the majority of plans experiencing a decline in funded status this year.

Figure 1: **Illustrative Funded Status – Typical U.S. DB Pension Plan**[1]



[1]Willis Towers Watson actuarial calculations as of August 31, 2020 based on a sample frozen final average pay plan with duration of 13 years and no contributions. Portfolio performance based on index returns with allocation of 29% S&P 500, 7% Russell 2500, and 12% MSCI EAFE, 22% BB Aggregate, 15% BB Long Government and 15% BB Long Credit. This is being shown for illustrative purposes only.

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We have found that a key driver of deviations in funded status outcomes was the composition of plan sponsors' hedging portfolios. We believe those that have fared the best in 2020 have done so because they insulated their portfolios against both equity and rate shocks. We compared three illustrative 60/40 portfolios with different hedging profiles: (1) aggregate bonds, (2) long credit bonds, and (3) long government bonds. The portfolio with the long government bonds allocation had the best outcomes year-to-date benefiting from both a tail risk and liability hedge.

Illustrative portfolios: YTD returns through 8/31/2020[2]	
60% global equity, 40% aggregate bonds	**5.6%**
60% global equity, 40% long credit bonds	**6.3%**
60% global equity, 40% long government bonds	**11.1%**

Is it too late to act?

We don't think so.

Many do not believe that yields have room to fall further. After all, the federal funds rate, which influences short-term rates, is near zero, and the Federal Reserve has signaled its intention to keep it that way at least into 2022. Ten-year Treasury yields have been hovering between 50 and 70 basis points since March.

However, short-term and medium-term rates do not have a large impact on pension plan outcomes. It is the long-end of the curve that matters most to pension plans – and long maturity rates tend to be driven primarily by market forces.

With the yield on ICE BofAML AA-AAA 15+, a proxy for discount rates, at 2.6% and the 30-year Treasury yield at 1.5% (as of August 31, 2020), rates still have plenty of room to drop.[3] There's no shortage of credit risk either. The first half of 2020 saw more defaults than all of 2019, and the second quarter of 2020 saw the most U.S. corporate downgrades of any quarter in the past 25 years.[4]

Discount rate and credit risk are derived from the outlook of the underlying economy, which currently has many sustained sources of uncertainty. The size of the COVID-19 outbreak and the size of fiscal and monetary responses remain uncertain. New cracks have formed in global supply chains, geopolitics risks are heightened, and social safety nets have been challenged. Countries have been compelled to take insular views in their responses, intensifying the anti-globalization secular trend.

What actions can plan sponsors take now?

So far, some pension plans have been resilient to the economic impacts of the pandemic, while others have not. Many may face higher pension plan costs moving forward among other corporate headwinds, such as revenue declines. Even when the pandemic and its effects subside, systemic risks, whether economic, societal or environmental, will continue to arise. Taking the time to evaluate risk and build portfolios that are more resilient can better protect your plan and generate better outcomes over time. Here are some actions you can take now:

1. **Focus on strategy:** Affirm if goals and risk appetite have changed and reassess the level and types of risks taken by the plan. Evaluate plan risk at the total portfolio level and consider return seeking and liability hedging assets in tandem. Can your plan weather another shock to the system?

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[2]FactSet

[3]Bloomberg, FactSet. Treasury yield is 30-year spot rate.

[4]S&P Global, "Credit Trends: U.S. Corporate Downgrades Rise To A New High In Second-Quarter 2020"

2. **Hedge better:** Many traditional hedging approaches do not use capital efficiently. You can do more with less. A Treasury-focused hedge can provide a tail risk hedge when risk assets fall and a liability hedge when interest rates decline while also enabling participation when risk assets recover.

3. **Diversify:** Look for risk premia outside of corporate financials. Real estate and infrastructure are attractive, especially strategies with exposure to less traditional sectors. A credit portfolio can be expanded outside of corporate lending to include consumer, emerging market, or private debt. Pockets of the investment universe are benefitting from the current environment; find them.

4. **Stay nimble:** Making changes to your strategy and thoughtfully positioning your portfolio takes time, particularly in our current, ever-changing environment. If you need help prioritizing your resources on big picture issues, you might look outside your organization for support in managing the investment and operational details. We are here to help.

Capital efficient hedging – downside protection when funded status is hit the hardest

Since 2007, 25+ year Treasury STRIPS (*i.e., Separate Trading of Registered Interest and Principal of Securities*) have meaningfully outperformed long credit bonds both in quarters where liabilities grew by 5% and in quarters where equities fell by 5%; by more than 15% and 18% respectively. STRIPS hedge funded status from two major sources of risk: interest rate and equity risk.[5]

[5]Willis Towers Watson, eVestment, FactSet. Liability returns based on a hypothetical pension index and are being shown only for illustrative purposes. Global Equity based on the MSCI ACWI, Long Government based on the Bloomberg Barclays Long Government Index, STRIPS 25+ based on the Bloomberg Barclays US Treasury STRIPS 25+ Years Index and Long Credit based on the Bloomberg Barclays Long Credit Index. The average return is a simple average of returns since the inception of Willis Towers Watson RATE:Link (used to calculate liability returns), which is January 1, 2007. Past performance is no guarantee of future results.

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