Employee Benefit Plan Review

The Pension Plan Paradigm Has Shifted…Should You?

Playing to Win the Defined-Benefit Game on the New "Course"

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Many years ago when I first took up golf, my father said; "You need to play the course and not let the course play you." The point of his advice was unless I understood the game and how to "play the course" there was no way I was going to "win" the game.

Over the past few years, and particularly since the Pension Protection Act (PPA) in 2006, "the course" has been redesigned, and in many ways, dramatically. But not until the precipitous market downturn of 2008 did we see the dramatic effects that the new rules of engagement could have on plan sponsors. With the dramatic market downturn, many plan sponsors find themselves in very unfamiliar territory and in a crunch to make key cash-flow, accounting, and plan-operation decisions in a compressed time frame. The questions are: How did we get to this spot, what can be done in the short term and is it too late for plan sponsors to do something for the future?

Lack of communication is perhaps the biggest reason for how we got to this spot. Conversely, more communication is the critical ingredient for success going forward.

Plans must have open lines of communication between the actuary, the consultant and the investment manager. The consultant must understand the paradigm shift brought on by the Pension Protection Act, and that the consultant, actuary and investment manager must be fully engaged in a true team approach.

The PPA necessitated a shift in the focus of defined-benefit pension plans from a strategic, long-range focus on asset management to one that has to be more tactical in nature, focusing on managing to the plan's liabilities and controlling volatility. The PPA also served to dramatically curb any upside of portfolio investment gain to a plan beyond the rate established by the phased-in bond rates. In essence, a plan may only apply one seventh of any investment gain in a given year, but at the same time, it must account for virtually any losses as they apply to the plan's compliance with funding level rules. That being said, why would any plan, particularly one that is frozen, have had anything but limited equity exposure? As the bond rates were being phased in, there was and is no real need for equities, particularly in a frozen plan because there is no need for and no true upside to the incremental risk". Plan sponsors that did not recognize these shifts and retained a significant exposure to equities were caught flat-footed as the market dropped in 2008.

As part of the Pension Protection Act, plans must also now mark to market every year with limited smoothing, and if they are not properly funded, the penalties can be numerous and far-reaching. Unfortunately, the reality is that frozen pension plans that had allocations (some significant) to equities and saw the value of plan assets significantly decline in 2008 more than likely should not have been there in the first place. The tremendous downside to the ill-advised equity exposure is now being felt by many plan sponsors as they struggle to reconcile what the resulting losses have now meant to their plan's funding status, their potential relationship to their employees, and ultimately, to the balance sheet and cash flow of the company.

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What's the best game plan for the sponsor of a pension plan that is now facing restrictions due to an underfunded status do in an economy where cash flow is tighter than ever and every dime counts? The first step is to make sure that you have an advisor that understands the new rules of engagement and can coordinate the efforts of the entire team including the actuary and the investment manager. It is critical that the goals of the plan sponsor are properly accounted for and volatility is controlled, and that the upside and the downside to all decisions are vetted and understood by the plan sponsor.

Part of this coordination includes ensuring that the plan remains compliant. In a time where "cash is king," plan sponsors need to understand what the minimum funding requirements are in order to be compliant. When is the next plan contribution due? What do different levels of contributions mean to the funding status of the plan? What do they mean from an accounting perspective? Have the Pension Benefit Guarantee Corporation premiums been paid? In the short run, given the financial constraints that companies are facing, the retention of cash in the organization may (at times significantly) outweigh the potential downsides of short-term plan benefit restrictions. Keep in mind that a plan may be "compliant" from a funding standpoint, while at the same time be subject to benefit restrictions. The difference between the two is an area where the actuary and advisor need to counsel the plan sponsor on their options and what they mean to the plan, their employees, and to the company.

As critical as the work of the actuary is the coordination of that work with an effective and customized investment strategy. Today, most plan sponsors are asking their actuary to report to them what various funding and return scenarios would cost over time. Experts describe an effective pension plan investment strategy as one that looks at not so much at yield, but at long-term income. Whether a plan is active, partially frozen, or completely frozen it is reasonable to adopt at some level a liability-driven or absolute-return strategy.

Reducing Risk with LDI

Liability-driven investing, or LDI, is an investment methodology that embraces the idea of matching predominantly fixed-income investments with the liabilities that you are trying to cover from both duration and return perspectives. It allows plan sponsors to "immunize" those parts of their plan portfolio--and it could be the entire portfolio depending on the plan status--that make sense and, ultimately, control the volatility of the liabilities from both a plan and accounting standpoint.

While LDI is not a new idea, it is one that plan sponsors have been slow to adopt or even look into. Some of this lag can be attributed to the aforementioned lack of understanding of the new rules of engagement. Additionally, when the economy was still experiencing bull-market returns, the prevailing attitude was "If it isn't broken, why fix it?" The bear market changed that reasoning, and LDI seems to be gaining more traction. But is it right for everyone and what should plan sponsors look for when gauging a money manager?

As we have seen in the news, a bad money manager can have a catastrophic impact to any portfolio. In the world of pension plans, where decisions can literally mean millions of dollars in a single year, it is critical that the money manager is "clean," transparent, and flexible, has experience in the product line, and that its philosophy and culture allow for the synergy that is so important between the consultant, actuary, and money manager.

Given the subprime mortgage debacle, the Madoff mess and poor bear-market performance by many money managers, plan sponsors must look "under the hood" at any investment vehicle that their pension plan may be utilizing. Sponsors must make sure there are no "toxic" securities such as collateralized mortgage backed securities, collateralized mortgage obligations, or structured investment vehicles. Without looking closely at the underlying framework of the strategy, sponsors may just be replacing the f equity risk with another type of risk. Transparency also demands knowing the cost of the overall strategy. Is the cost competitive? Remember, every basis point of return counts and can affect the bottom line. A lean expense structure can work significantly in the favor of the plan sponsor, and a knowledgeable consultant can help structure the best opportunity.

Flexibility is critical. The LDI piece of the strategy attempts to match the duration of the assets with the duration of the liabilities while at the same time providing return and controlling volatility. That can work for frozen plans, but is the strategy appropriate for plans that are partially frozen or still open to accruals? Does the money manager have products that address a type of "modified strategy" that allows you to immunize what makes sense as well as generate some return using other tools? Experienced money managers that have been involved with pension plans recognize the need for this type of flexibility and product.

Experience in the product line is also significant when choosing a money manager for a pension portfolio. A proven track record of results, as well as willingness to work as part of a team with the advisor and actuary, is critical. Does the money manager understand the pension plan dynamic? If the money manager is not in step with the actuary and consultant in understanding the structure of the plan, even the best strategies are destined to experience a critical disconnect. Once the actuary defines the liabilities and the plan structure, the money manager then needs to create the custom investment strategy. A sound pension-plan investment strategy accounts for every basis point of exposure and risk. In a proper structure, the money manager should not have to take bets. It should be able to see what the market is saying and take advantage of the signals. In the past, market "bets" were used by the money manager or the advisor as a tool to add incremental alpha to the portfolio. In the new paradigm, these "bets" can have more downside than upside and within a strategy such as LDI can lessen the overall effectiveness.

Should a plan sponsor consider a change to an LDI strategy? Is the time right to make the change if there's already been a significant decline in value in the portfolio? Is it painful to make the change? But it's a better question to ask, "Is our current portfolio going to expose us more?" The answer for most plan sponsors, particularly those with frozen pension plans is "yes".

The reality is that each January 1 starts a new year for a pension plan under the new rules of engagement. Even if you assert that you would like to "stay where you are" to gain some of the losses back, your ability to realize those gains should they occur is mitigated by the new rules. If you make the change now, you have a better chance to realize smart, risk-controlled gains that will in the long and short run help control both asset and balance sheet volatility. What about waiting for fixed income spreads to tighten? That's also a "bet" and not dissimilar to having equity exposure. Is making the change a painful process? Changing the money manager and even changing the actuary can be a smooth process with the right team that understands the critical success factors. The right consultant can be critical in helping to select and monitor the team and ensuring a smooth transition with no interruptions to service. Remember also, that changing the investment manager and the actuary does not necessarily mean changing the plan recordkeeper, especially if the recorkeeper is doing a good job.

With the regulatory and investment landscape changing on what seems to be an almost daily basis, it is more important than ever to ensure that you have the right team assembled so that you can understand, implement, and monitor your strategy. Don't wait to see if it makes sense for you to start "playing the course." Rather than waiting for another year to pass, find out what changes are possible now and what the implications of those changes could be. With the dramatic shift in the pension plan paradigm, it is critical that your advisor understand your plan and your design, and be able to work with the actuary and the investment manager to create your plan's roadmap for success.

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