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WHY ARE CORPORATE PENSION PLANS REDUCING RISK NOW?

By Evan Inglis

Why are corporate pension plans reducing risk now, when conditions for de-risking seem so poor—interest rates are lower than low, and equities seem to offer reasonable if not favorable opportunity? In a nutshell, the question of how to invest pension assets is becoming a corporate finance issue rather than an investment issue. The corporate finance view looks at the pension plan from the perspective of a shareholder in the plan sponsor's business. Plans are bigger relative to the size of their plan sponsors than they used to be, and they cannot be ignored in thinking about the financial prospects of the plan sponsor's business.

While pension accounting and funding rules still incorporate a lot of smoothing and averaging, they have moved close enough to pure market measurements that short-term volatility in the funded status is an issue. Despite the conventional wisdom that pension plans are long-term investors, most corporate pension plans can no longer take this view. Although the transition is slow for many, corporate pension assets are being allocated with a shorter term view in mind.

There are a number of reasons why the corporate finance view of pension investing leads to very different approaches than have been used in the past. These include:

- Business results are cyclical and equity investment makes pension costs cyclical as well. Another way to say this is corporations double up on beta (their own corporate beta, plus the beta in their pension investments) to the extent that they invest pension assets in equities.
- Unpredictable pension results causes lots of problems for a corporate plan sponsor. Some of the problems relate to the plan itself (such as additional notices and benefit restrictions). Other problems include difficulty in planning capital expenditures, hits to balance sheet equity and investor concerns about uncertainty in earnings and cash flow.
- Uncertain pension information results in a higher required return for a corporation's equity. Because future earnings become less predictable, a higher return is demanded on equity investment. Equity investment in a pension plan adds no value for a corporation.
- Financial stakeholders in a corporation have access to all the equity exposure they want. Their individual efficient frontiers (presumably) guide their investment decisions and additional equity exposure through corporate pension plans is less efficient and effective than an investor simply allocating more assets to equity directly in his/her portfolio.
- Because bonds are taxed at a higher rate than equities, equities provide less compensation for the risk taken when they are held in a non-taxable pension trust.
- When financial analysts look at a pension plan sponsor's financial information, they typically reverse out the smoothing in pension expense information. They may also expand the balance sheet by consolidating the pension assets and liabilities similar to the way a subsidiary would be treated. With this view, key financial metrics such as the debt to equity ratio look very different and the risk posed by the pension assets and liability is apparent.

Even from an investment perspective—looking at the pension plan on its own without the context of the sponsor's business—the wisdom of making large equity investment in corporate pension plans is questionable:

- The equity risk premium is smaller, given that the lowest risk investment is long duration bonds, so the compensation for taking on equity risk is smaller than for other investors.
- Many pension plans have short time frames for equity risk to pay off. Frozen plans will be forced to be fully funded within seven years by PPA rules.

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- Most corporate pension plans intend to reduce their equity exposure over the next several years, which may put downward pressure on equity prices and upward pressure on long bond prices. First movers may have an advantage.

It's hard to get excited about investing in bonds with yields as low as they are in the middle of 2012, but for corporate pension plans, the problems with mismatching assets and liabilities have become all too apparent during the 2000s. It's ironic that the de-risking of pension plans has accelerated as interest rates have dropped.

Why has it taken so long for these compelling considerations to become drivers of pension plan investment strategies (indeed, even today many plans have still not made this adjustment)?

If we wound the clock back 30 years, and looked at pension plans of the time, we would find much smaller, younger plans. Smaller plans did not have the same impact on the corporate financial situation and the corporate finance perspective could be ignored to a large extent. Plans grew dramatically during the 1980s and 1990s, but during that time, consistently high equity returns masked the potential financial problems that plans might pose and plan sponsors, actuaries and investment professionals, did not need to learn good risk management. However, as we move through time and enter the 2000s when equity markets took a turn for the worse, we also find rules that changed to recognize the financial situation of pension plans more immediately and directly. Plan liabilities had grown large as populations aged and interest rates dropped, so the pension plan had a bigger impact on the corporation.

In 2012, tough lessons have been learned and plan sponsors are changing their approach, some slowly, some dramatically. Not all of them are conscious of the shift from an investment perspective to a corporate finance perspective, but the actions (closing, freezing, lump sum settlements, group annuity purchases) tell the story. It may be useful to describe explicitly the corporate finance considerations—looking at the pension plan with a shareholder's eyes—for DB plan sponsors who are struggling to deal with pension risk.

END NOTES

[1] MAP-21 legislation may effectively extend this period when the lower bound of the interest rate corridor applies

Evan Inglis, FSA, CFA, is principal and chief actuary at Vanguard, Investment Strategy Group. He can be contacted at r_evan_inglis@vanguard.com.