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Dynamic Asset Allocation for DB Plans:

Compelling Concept, but Questions and Caveats Remain

Ed Sullivan, Investment Strategist

Dynamic asset allocation – systematically reallocating from equities and other return generating assets to bonds that hedge pension liabilities – is of particular interest for many underfunded, defined- benefit pension plans. The overarching strategic objective for many plan sponsors of underfunded plans with frozen or nearly frozen liabilities is to get to a fully funded position and lock in the returns. The lessons of the "perfect storms" of 2000-02 and 2008 when we experienced simultaneous declines in interest rates and equity prices that pushed pension funds from comfortable surpluses to underfunded positions are ingrained in the consciousness of plan sponsors.

At full funding, the risks are asymmetric for pension plans with frozen, or nearly frozen, liabilities. There is little, if any, benefit to be derived from market outcomes that raise funded levels much above 100%, whereas downside outcomes that push a plan to an underfunded position can trigger the need for costly contributions. Asymmetric risks and perceived market opportunities suggest that dynamic asset allocation or glide-path strategies may have considerable appeal for many underfunded plans. They can be a valuable complement to the asset-liability management studies ("ALM"s) widely employed by pension plan sponsors to set

an optimal policy mix. Moreover, in the current environment they are of particular interest from both strategic and tactical perspectives.

Glide Path Can Be A Valuable Complement to Traditional ALM

A well-designed glide path can be viewed as a three-stage ALM which includes formulating an optimal current portfolio, a targeted de-risked asset mix to be implemented when full funding is reached, and a plan for incrementally moving to the target end-state portfolio. Although an improvement funded status is the preferred trigger for moving along the de-risking glide-path, other triggers such as time can be used. As funding levels improve and approach the full-funding target, risk aversion is likely to increase and the need for incremental returns to close the funding gap should diminish.

Strategic Case for Glide-Path - A Simplified Example

For most plan sponsors of underfunded plans that intend to de-risk, a glide-path is well aligned with their strategic objective. The portfolio that locks in a fully- funded position for a plan that is closed to new entrants and in which current participants cannot accrue benefits is a fixed-income portfolio that hedges the liability discount rate. The end-state, fully-funded portfolio in our simplified example does not need an incremental return above the discount rate. In contrast, for plan sponsors with underfunded plans and capital market expectations in line with historical norms – e.g., positive, equity-risk premium and equilibrium bond yields significantly above current levels – the optimal portfolio is likely to include exposure to return generating assets and liabilities that are not fully hedged.

For a plan that is 80% funded – roughly the current average for S&P 500 companies with DB plans – an asset mix with considerable exposure to return-generating assets and less than fully-hedged liabilities leaves open the possibility that market outcomes will do much of the heavy lifting in closing the funding gap.

Tactical Case for Glide-Path Strategy

Many plan sponsors with underfunded plans are reluctant to make large discretionary contributions to de-risk in the current environment. In essence, de-risking at the current juncture foregoes the opportunity to benefit from rising bond yields or future favorable asset returns. Although significant risks and headwinds

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overhang the global economy, the consensus outlook calls for continuing expansion at a subdued pace. Gradually de-risking is an attractive option for plan sponsors with economic growth expectations roughly in-line with the consensus and who look for the central banks' "financial repression" that is holding interest rates at historically low levels to subside over time. As funded ratios improve and the needs for a return much above the discount rate diminishes, it makes sense to reallocate toward the end-state, fixed-income portfolio.

Questions that need to be addressed

Although dynamic asset allocation is a sound principle and arguably well suited to the current environment, important questions remain for plan sponsors who have implemented or are considering implementing the strategy.

- Should the process be automatic or should the reallocation targets be thresholds at which plan sponsors reassess their investment policy?
- Should the policy be symmetric – reallocating between return- seeking and hedging assets in response to both positive and negative changes in funded status? Or, should it be a one-way de-risking policy that aims to increase the allocation to hedging assets as funded ratios improve?
- Should plans that do not fit the prototypical mature, underfunded, de-risking plan described in our simple example consider dynamic asset allocation?

Automatic Rebalancing or Signal to Reassess?

Proponents of automatic rebalancing argue that pre-approval results in more, timely execution and removes the emotional aspect of the decision making process – i.e., investment committees will not be asked to sell stocks as markets are rallying or to buy bonds when interest rates are rising. The principal argument for committing to reassess investment policies when certain funded-status thresholds are reached is that better decisions will be made if all of the relevant factors are taken into account prior to a reallocation. For example, in

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addition to funded status, many investment committees take into account their corporation's financial health and market views before initiating a shift in a plan's asset mix.

Committees may also want to give special consideration to reallocations that may involve less-liquid, difficult to trade, and relatively scarce assets. Alternative asset classes – i.e., private equity, real estate, and hedge funds – which currently account for fifteen percent of the asset mix of the pension plans of the S&P 500 companies, might be difficult or impossible to include in automatic rebalancing plans. Correspondingly, high-quality corporate bonds which are likely to have an important role in a hedging portfolio are relatively scarce, and some plan sponsors may not want to include them in an automatic reallocation scheme.

Symmetric or One-Way Reallocation Rule?

As we outlined in our simplified example, there is a compelling case for moving to a less aggressive/more hedged portfolio as funded status improves. A sponsor who assigns a high priority to de-risking may favor a one-way process focused exclusively on increasing the allocation to hedging assets. The case for a symmetric program in which a deterioration in funded status could trigger a shift from hedging to return-generating assets revolves around the risk tolerance and market views of a plan sponsor. Plan sponsors who assign a high probability to mean revision of markets after a crisis or who are severely cash constrained might favor a symmetric program with increased latitude to benefit from possible favorable market outcomes in the aftermath of a crisis.

Is a Glide-Path Strategy Suitable for all Plans?

Glide-path rebalancing programs, in our opinion, are worthy of consideration by all plans. However, the further the profile of a plan's liabilities deviates from that of the mature plan depicted in our simplified example, the more difficult it is to define the end-state portfolio. The return on the fully-hedged, end-state portfolio in our simplified example is in line with the liability discount rate and no further contributions are required. In contrast, an active plan with large service costs would risk being required to make significant contributions, if it were to rebalance to an all-bond portfolio at current interest rates. Funding future service costs adds significant

complications for active plans that are trying to define their end-state portfolio, as they must take into account both the need to fund future service costs as well as de-risking objectives.

Pulling It All Together

Many sponsors of underfunded plans are temporarily holding their de-risking plans in abeyance due to cash constraints and/or market views. We believe that there is a compelling case for these sponsors to formulate glide-path strategies. Risk aversion, required rates of return, and the optimal investment policy will change as a plan's funded ratio approaches the end-state, de-risking portfolio. The glide-path, in essence, specifies the optimal mix at a given funding ratio and sets in advance funding levels at which rebalancing will occur automatically or at which policy should be reassessed. The rebalancing glide-path can be symmetric or one-way for plans that place a high priority on de-risking. Defining the end-state portfolio of a glide-path is more challenging for an active plan than for a mature plan with fixed liabilities but it is a worthwhile exercise for all plans interested in de-risking.