# Identifying the best risk mitigation strategy for a corporate DB plan

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A "one-size-fits-all" risk mitigation strategy for corporate defined benefit plans does not exist, particularly in the current environment.

However, it is possible to approximate the best strategy for a given plan by assessing the attributes of the major risk mitigation strategies — risk transfer, LDI, and asset protection — in the context of a plan's funded level, the economic environment, and the sponsor's financial position and risk tolerance.

## Risk transfer

The ultimate form of derisking a DB plan portfolio is risk transfer (e.g. purchasing an annuity or offering lump-sum distributions). With a risk transfer, a third party assumes responsibility for the pension liabilities. After the transfer, the plan sponsor is no longer required to report the liabilities on its balance sheet and incur administrative costs and expenses, such as Pension Benefit Guaranty Corp. premiums.

While prospects of jettisoning pension liabilities may appear appealing for many plan sponsors, the conditions that must be satisfied to implement this derisking strategy are likely to give most plan sponsors second thoughts. For example, paying lump sums will require that the transferred assets (i.e., payments to retirees or separated employees in lieu of future benefit payments) be equivalent to the present value of the liabilities. In the alternative case of annuities, insurance companies will require a premium to assume the annuitized pension liabilities. Thus, risk transfers through lump sums or annuities will require contributions for underfunded plans. Otherwise, any residual liabilities (those not included in the transaction) will be less funded than prior to the transaction.

For DB plans that are not fully funded, the question remains whether it is an optimal use of corporate cash or borrowing capacity to fully fund these pension liabilities. In addition, there are questions relating to current discount rates, accounting issues, and risk tolerance.

Providing lump-sum distributions or purchasing an annuity serves to settle liabilities at current discount rates and forgoes the possibility of reaping the potential windfall of an improvement in funded status from rising interest rates. Settling liabilities also may require special charges to a plan sponsor's reported earnings.

Risk tolerance is, of course, difficult to quantify. The recent announcements by both Ford Motor Co. and General Motors Co. to offer lump-sum distributions to certain salaried retirees and GM's plans to purchase an annuity covering virtually all salaried retirees are examples of how companies address extreme “balance-sheet” risks, in which market capitalizations are significantly less than the present value of the company's pension liabilities.

Although most plan sponsors are not likely to find it advantageous to transfer a significant portion of their DB liabilities to a third party in the near future, they can mitigate risk without materially compromising return objectives.

## Liability-driven investment

Liability-driven investment strategies should be a key building block of risk mitigation strategies for corporate DB plans, particularly as we transition from an asset-only mindset to a holistic view that takes into account funded status and corporate balance sheets.

In fact, LDI is becoming ingrained in the terminology (“liability-hedging” and “return-seeking assets”) that actuaries and plan sponsors use to describe policy mixes. The primary role of the liability-hedging assets, high-quality bonds in the asset mix and interest-rate overlays, is to dampen funded status volatility, whereas the principal role of the return-seeking assets, (e.g. equities, real estate, hedge funds) is to improve the plan's funded status and to reduce contributions.

Once we look at high-quality bonds as hedging assets, long-duration benchmarks are preferred over traditional, shorter-duration benchmarks, such as the Barclays Aggregate. In the United States where accountants and actuaries use Aa corporate interest rates to discount liabilities, adding long-duration corporate bonds to the high-quality bond allocation can enhance risk mitigation. In theory, using a liability overlay hedge will allow the overlay to offset the concurrent changes in the present value of the liabilities as interest rates change. Moreover, since the long-term expected return on an interest-rate overlay is zero or slightly positive, implementing an interest-rate overlay should not affect a plan's expected return on assets.

Implementing an interest-rate overlay hedge, however, can involve a host of practical issues, including the following:

1. minimizing tracking errors between hedging instruments (swaps, swaptions, etc.) and the discount rate,
2. selecting the best hedging instrument at a given point in time, and
3. deciding whether to implement the hedge tactically or passively.

Sorting out the optimal allocation and composition of liability-hedging assets depends largely on funded status and risk tolerance. For example, physical bonds (e.g., government bonds or corporate bonds) are typically a better hedge than an overlay because they reduce tracking errors. However, increasing allocations to bonds in place of return-seeking assets is likely to reduce expected return, making it more difficult for an underfunded plan to reach a fully funded position in the absence of corporate contributions.

## Asset protection

Risk mitigation has always been a pivotal consideration for plan sponsors in setting optional asset allocation policies. We are well schooled in efficient frontiers and the so-called free lunch from diversification. More recently, and particularly over the past decade, plan sponsors have increased allocations to so-called alternatives (e.g. hedge funds, private equity and real estate) to capture illiquidity premiums and enhance alpha opportunities.

At the present time, however, a key question persists: Is there anything else that plan sponsors can do to mitigate risk in their asset portfolios?

A tactical shift from return-seeking assets to fixed income could incur a significant opportunity cost. With equities fairly valued in the context of traditional metrics such as PE ratios and the consensus economic forecast calling for modest global growth, maintaining the "normal" allocations to return-seeking assets could help plans improve their funded positions.

On the other hand, if policymakers fail to keep the eurozone's crisis contained, return-seeking assets could be exposed to a Lehman-like event. Derivative strategies, such as put-spread collars and tail-risk hedges, warrant serious consideration by DB plans that would like to participate in the gains provided by return-seeking assets should the consensus outlook unfold while maintaining protection in case a downside scenario unfolds.

Our preference for protecting an asset portfolio in the current environment is a tail-risk hedging portfolio that can be implemented through cost-efficient strategies.

## Putting it all together

While risk mitigation is essential in the current environment, the optimal strategy for a given DB plan depends on plan-specific factors such as funded status and risk tolerance.

Risk transfers (annuities and lump-sum distributions) currently warrant consideration for well-funded plans or plans with extraordinary balance sheet risk.

LDI should be an integral part of the risk mitigation strategy for every corporate pension plan, particularly in the current environment in which pension funds and corporate finance objectives are becoming increasingly integrated. However, the best vehicles for implementing LDI will vary from plan to plan.

Methods for implementation include long-duration physical bonds, government or corporate bonds, and interest-rate liability overlays.

Lastly, asset protection strategies that do not materially impede upside potential continue to generate interest as plans seek to achieve returns to improve funded status and protect against downside risks. Well-designed, tail-risk hedges that can be implemented through cost-efficient strategies are well suited for allowing return-seeking assets to both participate in the upside and simultaneously protect against the downside.

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