$20 billion club: 2022 update

Funded status jumps to its highest level since 2007 on strong equity returns and rising rates, despite record low contributions

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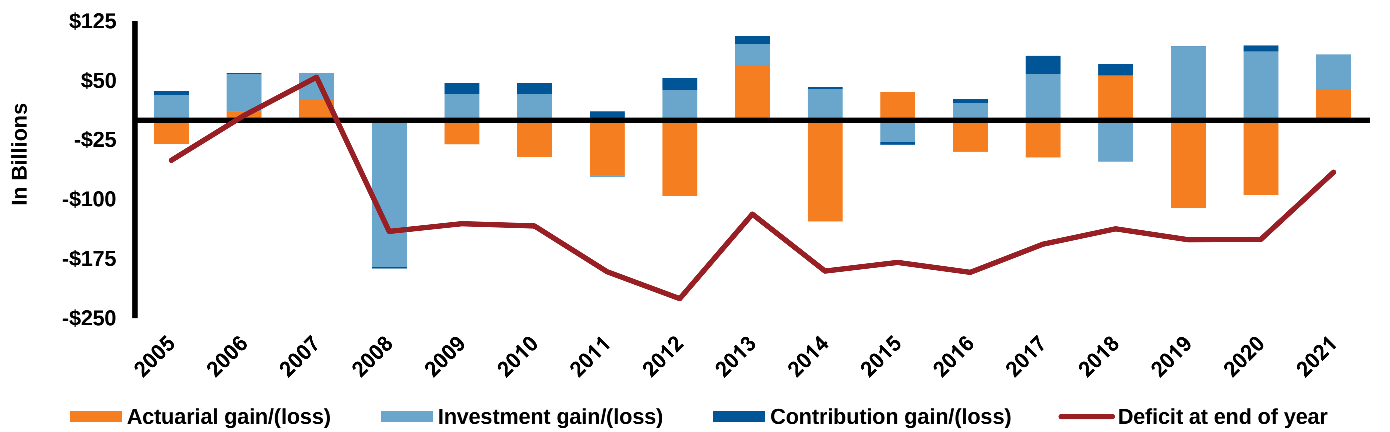
Two factors tend to contribute to funded status changes above all others: 1) discount rates and 2) investment returns. In 2021, defined benefit (DB) plan sponsors got the best of both worlds. Surprisingly, this has only happened *one other time* in the last 15 years, in 2013. In every other year, the impact of rates falling has been offset by strong investment returns, or vice versa. This windfall with a roughly 35 bps increase in discount rates and a 19% return in global equities **propelled funded status to its highest level since 2007**, the year before the Global Financial Crisis. For the 19 U.S.-listed companies with the largest corporate DB pension liabilities, this meant that the funded ratio improved from an average 86.2% to 93.8%. The funding deficit in dollar terms dropped dramatically from $150 billion to $65 billion.

A rising tide lifts all boats, and while some boats are larger than others, the same issues impact all of them. As such, we diligently follow this select group of companies. They are the “big boats” (they make up nearly 40% of all DB liabilities for listed US companies) and understanding trends among this group will help all DB sponsors in their fiduciary duties. Looking at the latest corporate disclosures, released within days of this publication, provides sponsors with the perspective and broad-stroke trends in the corporate pension industry.

Specifically, we are interested in how these companies have behaved in the current economic environment, and what strategies they have used to navigate their way toward achieving their goals.

Exhibit 1 illustrates the funded status experience for this group since 2005. The red line shows the dollar surplus or

Exhibit 1: Combined surplus/(deficit) of the $20 billion club, 2005-2021[1]



deficit, with the bars indicating the key drivers of change (i.e., attribution) in each year. As mentioned, sponsors enjoyed a tailwind of both actuarial gains (due to discount rates rising) and investment gains. The total funding deficit is now less than half what it was one year ago. In the year 2013 we saw the same pattern and similar jump in funded position.

Notably, this funded status improvement had almost nothing to do with employer contributions. In fact, 2021 contributions were at their lowest level in all 18 years we have tracked this data, and by a comfortable margin. The year 2022 looks no better (based on each company's disclosed expectations). Ongoing funding relief, improved funded status, and the prospect of higher corporate tax rates on the horizon are all playing into current decisions regarding contribution (or lack thereof).

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The average increase in funded ratio among these sponsors was 7.2%, and all 19 sponsors saw an improvement of at least 4%. The three companies with the largest funded ratio gains were **Dow Chemical** (up 10.6%), **UPS** (up 10.9%), and **Johnson & Johnson** (up 12.6%), all of which have adopted relatively aggressive asset allocations with 65% or more in equities and alternative assets (which performed well in 2021). But even for companies with less aggressive asset allocations, like Ford with over 80% in fixed income, the funded ratio improvement was still a solid 7.1%.

Overall pension liabilities fell below $1 trillion, a peak level only achieved once before (a year ago). Combined assets stayed at their same level of about $902 billion.

Exhibit 2 shows how liabilities and assets performed during 2021.

Exhibit 2: 2021 global pension assets and liabilities development

LIABILITIES	(IN $BILLIONS)
Liability (Projected Benefit Obligation) at Start of Year	1,052.2
Accrual of new benefits (Service Cost)	11.6
Benefits paid	(56.3)
Interest payable on liability (Interest Cost)	20.9
Impact of change in interest rates and in actuarial assumptions (Actuarial loss)	(39.5)
Miscellaneous other	(21.6)
Liability (Projected Benefit Obligation) at End of Year	967.3

ASSETS	(IN $BILLIONS)
Assets (Fair Value) at Start of Year	901.9
Employer contributions	8.0
Benefits paid	(55.2)
Investment return on plan assets	64.4
Miscellaneous other	(17.3)
Assets (Fair Value) at End of Year	901.8

SURPLUS / (DEFICIT)	(IN $BILLIONS)
Excess of assets above (below) liabilities at Start of Year	(150.3)
Excess of employer contributions over service cost	(3.6)
Actuarial gain (loss)	39.6
Investment returns less interest cost	43.5
Miscellaneous other	5.3
Excess of assets above (below) liabilities at End of Year	(65.5)

Source: Corporate 10-K Filings, Russell Investments calculations

Downward pressure on expected returns

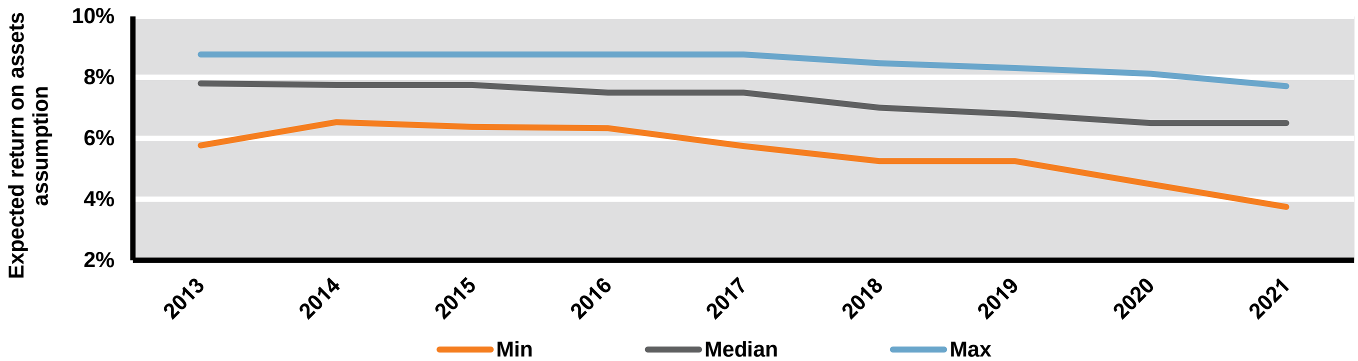
A key metric used in pension expense calculations (shown on the corporate income statement) is the expected return on assets (EROA). Just ten years ago, larger pension plans would often assume expected returns higher than 8%. Each year, this assumption has decreased. In 2021, the average expected return is around 6.3%.

This reduction is due to two factors. First, capital market expectations are declining over time. And second, many DB sponsors are implementing de-risking glidepaths that gradually reduce growth assets in favor of increased allocations to fixed income. Portfolios with higher fixed income allocations have lower return expectations.

This reduction in the EROA has been a barrier for some sponsors in implementing the glidepath. For most, however, the benefits of implementing a glidepath to protect gains in funded status outweigh the potential increase in pension expense.

Exhibit 3 shows this trend, in terms of the minimum, median and maximum EROA assumptions among this group of employers, showing a consistent drop over time as higher return assumptions are challenging to justify.

Exhibit 3: EROA assumptions since 2013



Source: 10-k filings

As expected, 2021 contributions hit a record low

In a dramatic turn, 2021 contributions fell by about 60% from 2020 levels. The reasons for this momentous shift include:

- Funding relief, further expanded by the American Rescue Plan Act (ARPA) and extended with the Infrastructure Investment and Jobs Act (IIJA) in 2021, have kept pension contribution requirements very low in the U.S.
- Uncertainty around the economic impacts of COVID have led companies to retain cash flexibility where possible
- Companies anticipate a higher tax deduction for contributions if corporate tax rates ultimately increase as previously proposed
- Plans are already better funded than in prior years

Exhibit 4 shows the pattern for contributions since 2005, including an estimated value for 2022 as disclosed in financial reporting.[2]

Other activity

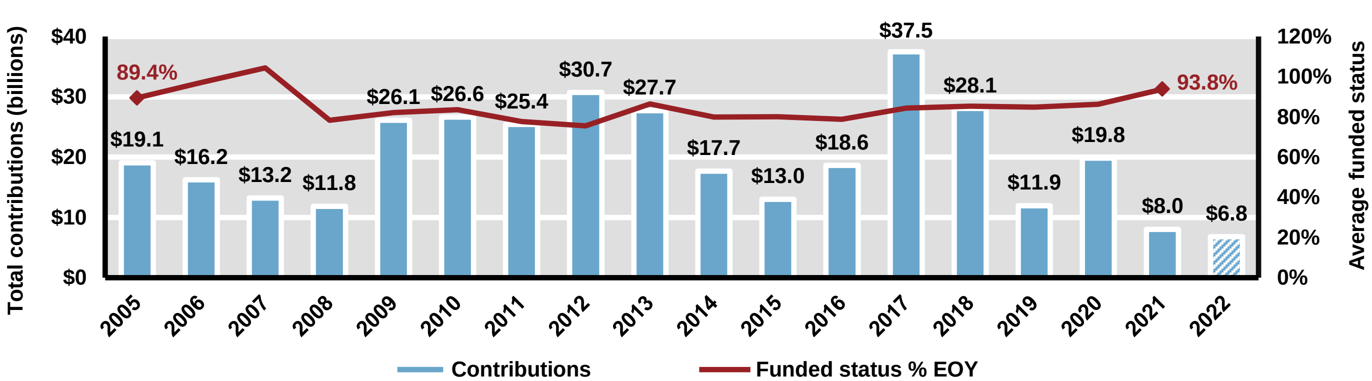
Lockheed Martin participated in a large risk transfer of nearly $5 billion. This was the largest annuity purchase transaction in the U.S. since 2018 (**FedEx**) and is the fourth year in a row Lockheed Martin have purchased an annuity contract to reduce the size of pension liabilities. Like prior years, this included a combination of buy-in and buy-out transactions.

Dow Chemical also purchase annuities from an insurance provider in 2021, for a total of $700 million settled. Dow also announced a plan freeze effective December 31, 2023.

In response to improving funded status, **Boeing** significantly increased its fixed income allocation from about 49% to over 60%.

3M changed how it measured pension expense by using a fair value approach to the market-related value of the fixed income assets. They did this to better reflect current market values and to better align with their liability-driven investment strategy.

Exhibit 4: Contributions 2005-2022



Source: 10-k filings

Membership of the $20 billion club

The $20 billion club consists of the following 19 corporations, generally included due to their global pension liabilities exceeding $20 billion:

1. 3M
2. AT&T
3. Boeing
4. Corteva
5. Dow Chemical
6. Exxon Mobil
7. FedEx
8. Ford Motor
9. General Electric
10. General Motors
11. Honeywell International
12. IBM
13. Johnson & Johnson
14. Lockheed Martin
15. Northrop Grumman
16. Pfizer
17. Raytheon Technologies
18. United Parcel Service
19. Verizon Communications

These are no longer the only U.S.-listed corporations with over $20 billion in liabilities. Merck, Exelon, Caterpillar, Citigroup, and others now exceed $20 billion in global pension liabilities. Observations and comparisons are more straightforward when the group is consistent, however, so for now we have chosen to maintain a fairly steady group from year-to-year.

No changes were made to membership this year. However, GE has announced the company will split into three divisions in early 2023. We do not know at this stage what this will mean for their $95 billion in pension obligations, but we will monitor closely in the coming years.

[1] Source: Russell Investments, Corporate 10-k filings

[2] This is the sum of all the individual companies expected 2021 contributions.

Related reading

Owens, J. (2021). “20 billion club: 2021 Update”, *Russell Investments.*

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Owens, J. (2019). “$20 billion club: Equity downturn in Q4 nearly overshadows higher discount rates and strong contributions in 2018”, *Russell Investments.*

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First used: March 2022 AI-29213-03-25