$20 billion club

Equity downturn in Q4 nearly overshadows higher discount rates and strong contributions in 2018

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The 20 companies that sponsor the largest corporate defined benefit plans listed in the U.S. felt the wind at their backs for three quarters of 2018. A blend of higher discount rates and strong equity performance led to funded ratio improvements rivaling the 5% increase in 2017. But it was not to be. In Q4 global equities lost 13% in value, a headwind that negated much of the growth in funded ratios, which on average rose slightly from 84.4% to 85.3% during the 2018. The funding deficit in dollar terms fared better as both assets and liabilities fell during the year, and the $157 billion starting deficit dropped to $137 billion, the lowest level since 2013.

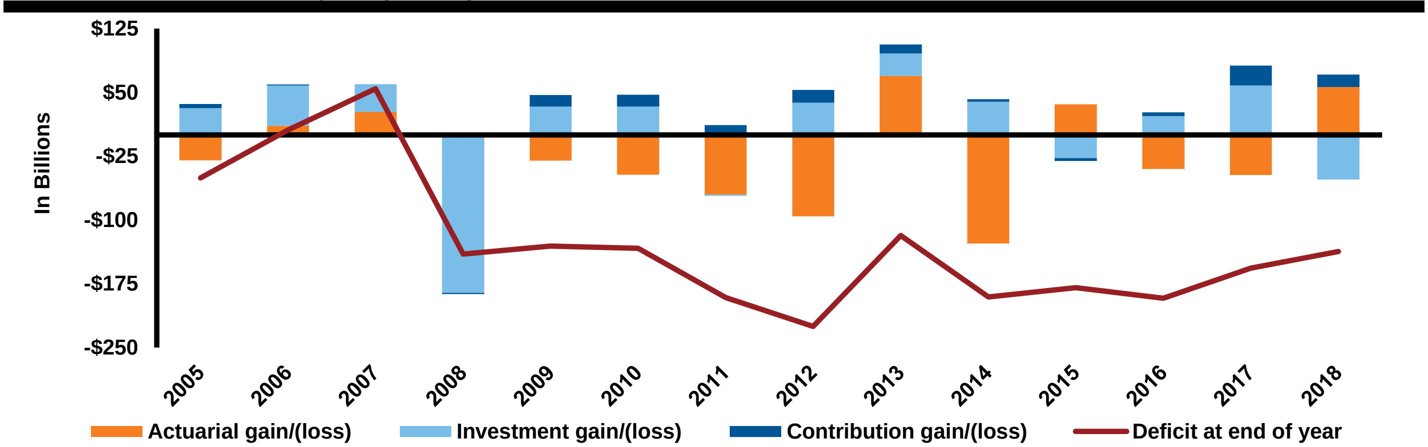
The sponsors that make up the $20 billion club have a couple things in common. First, each is a publicly-listed corporation that sponsors global defined benefit (DB) liabilities exceeding $20 billion. And second, each is a trendsetter, large enough to pave their own path. The major developments in the corporate DB space have often begun with this group, and observing them helps us understand the industry at large.

Exhibit 1 below illustrates funded status experience for this group since 2005. The red line shows the dollar surplus or deficit, with the bars indicating the key change drivers in each year. In 2018 the actuarial gains and investment returns offset one another, with the contribution gain helping to push the average deficit down.[2]

Note that in very few years do we see both investment and actuarial gains. When discount rates rise (e.g., 2015 and 2018) the investment experience has often been poor, and the opposite is also true. The one notable exception was 2013, when rates rose and investment experience was positive.

Most funded ratios stayed within 2% of their starting position in 2018, but we saw a few notable exceptions. FedEx's fiscal year is non-calendar, so the Q4 losses have not yet been reflected in their annual reporting. Their funded ratio increased by 7%. Lockheed Martin made a $5 billion contribution which helped improve their funded ratio by about 6%. General Electric also made a significant contribution that led to their funded ratio increasing by over 4%.

Exhibit 1: Combined surplus/(deficit) of the $20 billion club, 2005-2018[1]



Investment losses mostly offset the actuarial gains, which were driven by a 60-70 bps increase in discount rates

Exhibit 2: 2018 global pension assets and liabilities development

LIABILITIES	(IN $BILLIONS)
Liability (Projected Benefit Obligation) at Start of Year	975.1
Accrual of new benefits (Service Cost)	13.5
Benefits paid	-54.1
Interest payable on liability (Interest Cost)	30.6
Impact of change in interest rates and in actuarial assumptions (Actuarial loss)	-56.3
Miscellaneous other	-12.2
Liability (Projected Benefit Obligation) at End of Year	896.6

ASSETS	(IN $BILLIONS)
Assets (Fair Value) at Start of Year	818.5
Employer contributions	28.1
Benefits paid	-52.8
Investment return on plan assets	-21.8
Miscellaneous other	-12.5
Assets (Fair Value) at End of Year	759.5

SURPLUS / (DEFICIT)	(IN $BILLIONS)
Excess (Shortfall) of assets below liabilities at Start of Year	-156.6
Excess of employer contributions over service cost	14.6
Actuarial gain (loss)	56.3
Investment return less interest cost	-52.4
Miscellaneous other	1.0
Excess (Shortfall) of assets below liabilities at End of Year	-137.1

Source: Corporate 10-K Filings, Russell Investments

Contributions in 2018 were strong, but not as high as 2017

We observed significant contributions during 2018, about $6.5 billion higher than expected at the beginning of the year. In fact, the $28.1 billion total in 2018 was the third highest year for contributions in recent history, surpassed only by 2017 with $37.5 billion and 2012 with $30.7 billion.

The largest individual contribution last year was General Electric's $6.8 billion, making their combined 2017/2018 contribution almost $10 billion, a great improvement for the sponsor with the lowest funded ratio in this entire group just two years ago (funded ratio improved from 67% to 75.6% during that period).

Lockheed Martin contributed $5 billion, or about 10% of their beginning of year liability. The prior three years they had only made minimal contributions (just $74 billion total between 2015-2017). They now expect to avoid contribution requirements in their US plans until at least 2021.

Other companies with noteworthy 2018 contributions included FedEx ($2.6 billion), Raytheon ($2.1 billion), GM and Dow Chemical (both about $1.7 billion).

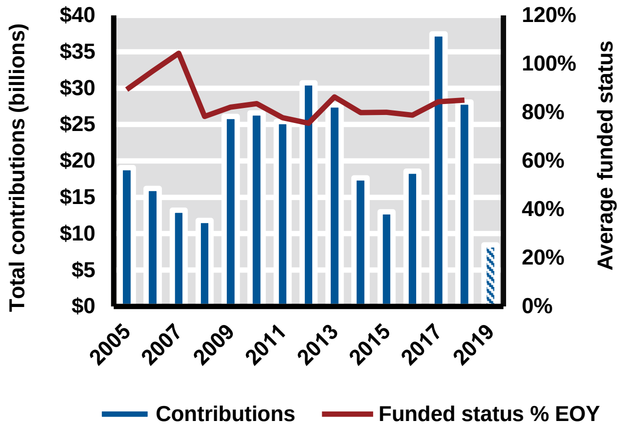
Contributions expected to plummet in 2019

The discretionary contributions in 2017 and 2018 were mostly opportunistic and strategic. Many sponsors hoped to take advantage of the relatively high tax deduction before new corporate tax rates took effect.[3] Among this group, 75% made contributions exceeding $1 billion in either 2017 or 2018.

This short-term window of opportunity has now closed,[4] and sponsors have less appetite for funding their plans in the near future. This is particularly true since for most of these sponsors, funding requirements in their US DB plans are at or near zero. For these reasons, contributions are expected to drop in 2019, perhaps to the lowest level in the last 15 years. In fact, expected contributions from annual filings show just $8.5 billion in 2019, compared to the 2017 high of $37.5 billion, a drop of over 75% in just two years.

Exhibit 3 shows the pattern for contributions since 2005, including an estimated value for 2019.[5]

Exhibit 3: Contributions 2005-2019



M&A activity in 2018 affects DB plans

Merger and acquisition activity set records in 2018, with deal volume exceeding $4 trillion globally.[6] This trend included the members of the $20 billion club. For example, Dow Chemical and E.I. du Pont de Nemours have merged (though they still report separately) and plan to split into three entities early in 2019. It is unclear at this point how the DB plans will be split up.

Northrop Grumman acquired the aerospace and defense technology firm Orbital ATK, along with its nearly $3 billion in global pension liabilities. This increased plan liabilities by about 10%

United Technologies also acquired an aerospace company with the purchase of Rockwell Collins. This acquisition led to a liability increase of about 10% due to their roughly $4 billion in liabilities.

In addition, AT&T acquired Time Warner in 2018, which led to the addition of about $2.5 billion in asset, or about a 5% increase in liabilities.

Risk transfer: the trend continues

The trend in annuity purchases charged ahead in 2018, thanks in part to FedEx, which agreed to offload a large portion of their retirees to insurer MetLife. This transaction, which was the largest such deal since GM and Verizon in 2012, exceeded $6 billion and stands as the third largest annuity purchase in recent memory.[7]

Lockheed Martin transferred a significant portion of their plan to insurers (Prudential and Athene) for about $2.5 billion. This annuity purchase affected about 40,000 retirees. What makes this transaction unusual is that it included a buy-in annuity purchase in anticipation of a plan termination. With buy-in annuity purchases, the sponsor still pays the benefits to participants, but they are reimbursed by the insurer. While buy-in transactions have been uncommon in the US until now, this move by Lockheed Martin may signal a new move in that direction.

Membership of the $20 billion club

The following 20 corporations currently make up the $20 billion club, generally included due to their global pension liabilities exceeding $20 billion:

1. 3M
2. AT&T
3. Boeing
4. Dow Chemical
5. E.I. du Pont de Nemours
6. Exxon Mobil
7. Federal Express
8. Ford
9. General Electric
10. General Motors
11. Honeywell
12. IBM
13. Johnson & Johnson
14. Lockheed Martin
15. Northrop Grumman
16. Pfizer
17. Raytheon
18. United Parcel Service
19. United Technologies
20. Verizon Communications

Observations are more straightforward when the group is constant, but at times we must make minor adjustments. We made no adjustment to the group this year, but with the fate still unknown for of the Dow/DuPont liabilities, we will need to make some change next year after the split is final.

[1] Source: Russell Investments, Corporate 10-k filings
[2] The actuarial gain/loss represents changes in the deficit due to changes in actuarial assumptions (e.g., discount rate, mortality, etc.). Investment gain/loss is the asset return, minus the yield on liabilities (interest cost). The contribution gain/loss is the employer contribution minus the cost of new benefit accruals (service cost). Other changes in funded status, due to settlements, currency exchanges, etc. are typically insignificant on this scale.
[3] See "Tax Reform has been signed–what could this mean for DB plan sponsors?", Russell Investment Blog, January 3, 2018
[4] For the majority of plan sponsors. Some with non-calendar year plans still can contribute under older tax rates.
[5] This is the sum of all the individual companies' expected 2019 contributions.
[6] Brownstein et al, "Mergers and Acquisitions – 2019", Harvard Law School Forum on Corporate Governance and Financial Regulation
[7] See "FedEx delivers the largest DB annuity purchase since 2012", Russell Investments Blog, May 9, 2018

Related reading

Owens, J. (2018). “Tax Reform has been signed – what could this mean for DB plan sponsors?”, *Russell Investments Blog*, January 3

Owens, J. (2018). “Record-breaking contributions and returns for $20 billion club”, *Russell Investments Blog*, February 28

Owens, J. (2018). “20 billion club posts record contributions in 2017 as funded status jumps”, *Russell Investments*

Owens, J. (2018). “FedEx delivers the largest DB annuity purchase since 2012”, *Russell Investments Blog*, May 9

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First used: March 2019 AI-27276-03-22