Largest corporate DB plan sponsors tune up their strategies

The year 2014 was eventful for the 19 members of the $20 billion club. Despite strong asset returns (over 10%, on average), these sponsors fell victim to falling discount rates and updated mortality tables,[1] which led to an average funded status drop of more than 6%.[2] This is in stark contrast to the 11% average improvement from 2013, when rates rose for the first time in several years and the equity markets were bullish.[3]

On the heels of a successful 2013 (in which few strategic changes were made publicly), and perhaps in anticipation of a tough year developing, most members of the $20 billion club took time to tune up their funding and investment strategies to adjust to current conditions. Rates had risen, Congress had passed new funding relief, and average funded status was the best it had been in years. This led to dramatic changes to expected contributions, asset allocation shifts and ongoing risk transfer.

Club members' stories are intriguing, because this group has such a significant foothold in the DB world. Of course, group size – 40% of the DB liability of U.S. listed corporations – is a factor. But also due to their scale and available resources, these corporate DB plans define trends. For instance, Bank of America created the first well-known cash balance plan in the 1980s. Now cash balance plans make up 25% of all DB plans.[4] Ford Motor Co. made history when it announced a retiree lump sum cash-out program, which has since been mimicked by half a dozen other companies.[5] The first widely publicized DB annuity purchase was that initiated in 2012 by General Motors, which a year earlier had famously announced it would "take the pension risk off the table."[6] Several more annuity purchases surpassing $1 billion in price have followed, and risk management has gained significant momentum.[7]

Understanding the actions of this group gives other DB plan sponsors and their advisors a glimpse into the thoughts of those who collectively manage over $750 billion in pension assets. This in turn helps give perspective to sponsors considering adjustments to their own strategies.

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An evolution of plan objectives

Sponsors ought to develop funding and investment strategies with specific objectives in mind. They should ask themselves what they are trying to achieve with the plan. These goals can change over time. Take Ford, for example: for many years, Ford's focus was on achieving strong long-term asset returns, via an asset allocation strategy of 70% equities and 30% fixed income.

In July 2007, however, around the time PPA[8] came into effect, Ford shifted its focus "to reduce the volatility of the value of [its] U.S. pension assets relative to U.S. pension liabilities." It moved to a 55% equities and 45% fixed income target, and has since changed its ultimate target to 20% equities and 80% fixed income.[9]

Ford is not alone in changing its objective. With just a few exceptions, the largest plan sponsors in the country have adopted an explicit asset/liability focus – meaning, they focus on more than achieving strong and stable investment returns. Instead, they also turn their attention to such matters as managing contributions and funded status. The first major wave toward pension risk management began in 2012, as six of these companies made noticeable shifts toward fixed income and some adopted de-risking glide paths.[10] By the end of 2014, 16 of the 19 members of the club disclosed asset/liability priorities, with many making these metrics their *top* priority.[11]

Defining the key drivers behind funded status change

Many sponsors base strategy on the goal of either maintaining or stabilizing funded status (sometimes referred to as managing assets relative to liabilities). They typically set out to achieve this objective through contribution and asset allocation changes. Some may ask if those that committed to these ideas fared better than others that did not. The test could be in a challenging year like 2014. In a year when some experienced funded status declines of 10% or more, could funded status have been preserved?

Before answering that question, it is important to mention the three main ways by which funded status improves:

- First, companies can pay contributions. This is one of the only factors that is completely within the sponsor's control, and it is driven by funding policy. When a sponsor pays contributions, funded status always improves.
- Second, plans can earn investment returns. But the risk inherent in investing can also put funded status at risk. Sponsors seek to mitigate risk with sound investment policies, but of course they cannot control the markets.
- And third, plan liabilities can change due to adjustments to assumptions or plan structure. Sponsors can control some of these factors – for example, by closing a plan to new participants, or freezing a plan – but they have little influence over other variables, such as changes to discount rates or mortality assumptions.

While the average funded status decline during 2014 was about 6%, Ford managed to *improve* its plan's funded status, by about 1%. Not coincidentally, we believe, Ford has been the most aggressive in adopting liability-driven investing (LDI). As plan liabilities increased, due to falling rates, asset returns of 16% (the best in the group) compensated. Verizon, the sponsor that fared second best, experienced only a 1% drop in its plan's funded status, an outcome the corporation realized by making plan contributions worth 7% of PBO (the highest contribution relative to PBO in the group). Such favorable outcomes were not passively achieved; conscious strategic decisions pointed the organizations in the right direction.

The company that experienced the steepest funded status decline was General Electric. Its strategy recently has been to contribute very little, and to focus on asset returns (at least publicly). Unfortunately, 2014 was not a rewarding year for that particular risk position and strategy, and to top it off, GE's 17% liability loss was one of the highest in the group.[13]

Exhibit 1 shows the change in funded status for each member of the club for FYE 2014 and includes the contributing factors mentioned above. For the five companies that have allocated the highest portions of their portfolios to fixed income (which typically indicates an LDI strategy), asset returns are shaded in light gray. Note that Exhibit 1 does not delineate all possible factors influencing funded status. For example, Lockheed Martin (LMT) implemented a plan change that reduced liabilities and tempered its funded status decline. However, the figure does paint an interesting picture of the wide range in 2014 funded status outcomes.

Exhibit 1: Change in funded status from FYE 2013 to FYE 2014[12]

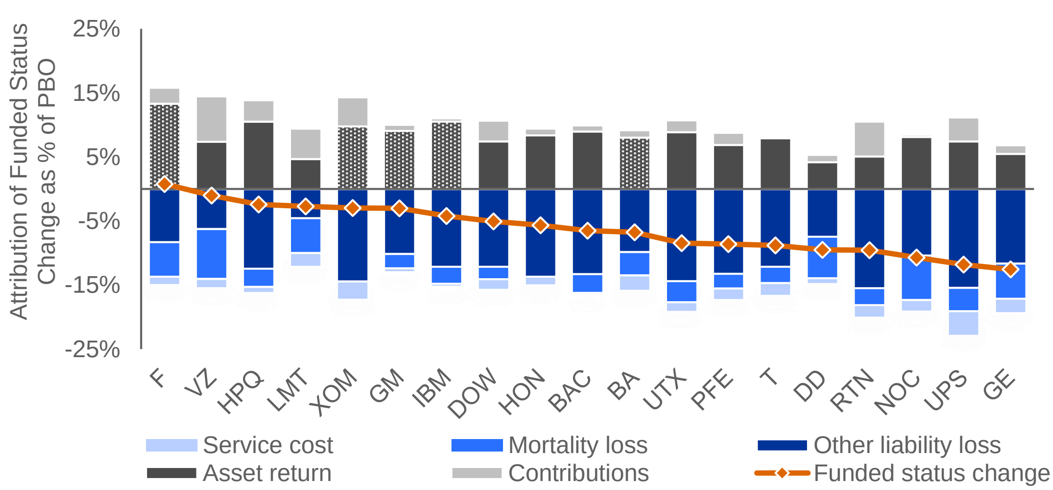
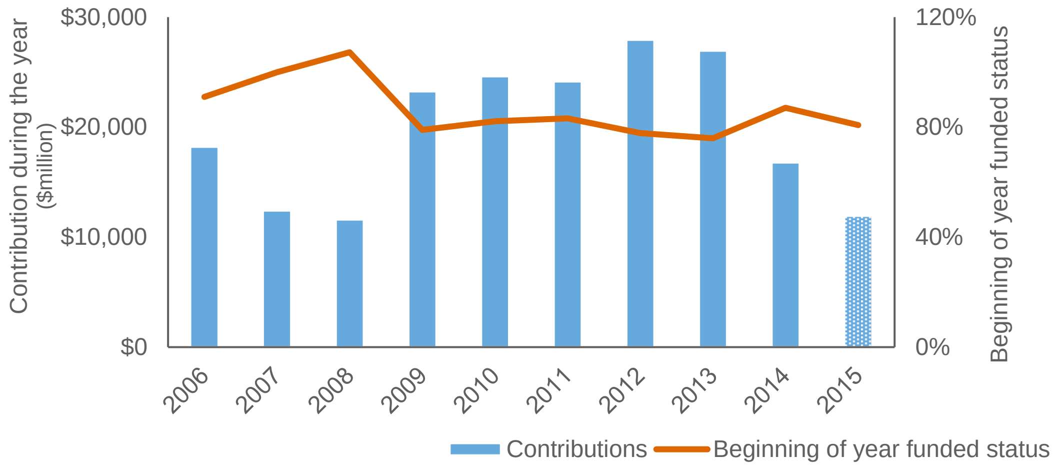


Exhibit 2: Corporate contributions and DB plans' funded status history for $20 billion club



Funding relief puts contributions on the back burner

Let's take a closer look at funding strategy. The year 2012 was the high point for employer contributions, totaling nearly $28 billion. That was also the year lawmakers passed MAP-21 funding relief.[14] The following year, contributions were just slightly lower (though we should note that 2013 included a $9.4 billion inflow from AT&T). Despite the dramatically improved funded status in 2013, Congress passed HATFA[15] funding relief in 2014 (for reasons other than easing the pension burden[16]), which seems to be having a meaningful effect on contributions going forward. Contribution levels for 2014 were already at the lowest levels since 2008, and expected 2015 contributions (which could of course be higher than anticipated) are even lower, very near 2008 levels.

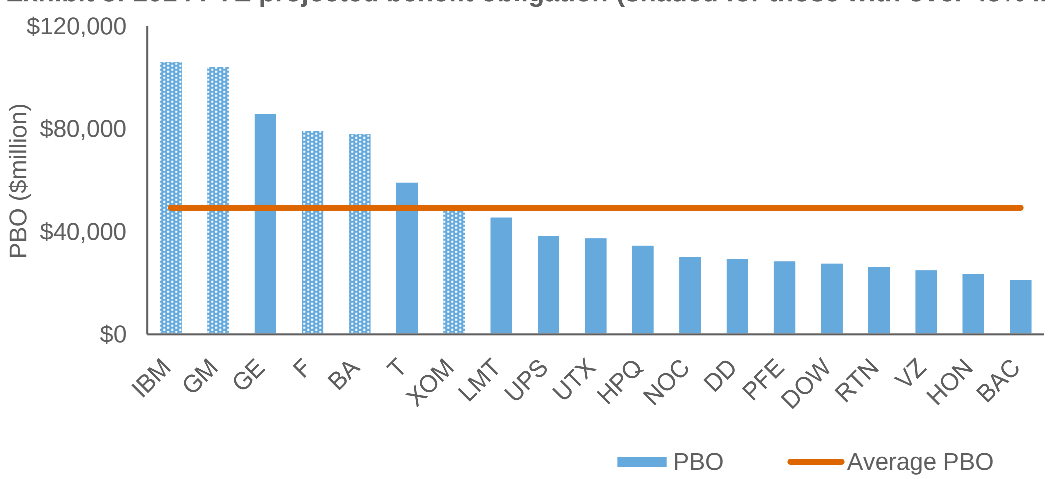
As shown in Exhibit 2, corporate contributions to DB plans typically correlate with the plans' funded status. When funded status decreases or remains low, contributions increase or stay high. This explains the sudden increase in contributions paid in 2009 and the sudden decline in 2014.

However, 2015 alters this trend. Even though funded status has declined again, contributions are not expected to increase. In fact, they are expected to decline by 30%. The reason is simple – due to recently passed funding relief under HATFA (and the fact that mortality is not updated for funding purposes), many corporations' required contributions have been reduced to nothing. In fact, 15 of these 19 corporations have disclosed that they are not required to contribute any significant amount to their U.S. plans in 2015. This is despite 18 of these 19 companies having underfunded global pension liabilities.

Compare this to 2011, when average funded status was almost identical to 2014, and 11 of these 19 firms contributed over $1 billion. In 2015, only four expect to contribute more than that. United Technologies, Lockheed Martin and General Motors have also announced they expect to see no U.S. contribution requirement for years to come, despite the fact that the highest global funded status among the group is about 87%.[17]

While many of these firms are taking advantage of the flexibility that HATFA offers, other factors may influence them to boost contributions in the years to come. The IRS

Exhibit 3: 2014 FYE projected benefit obligation (shaded for those with over 45% in fixed income)



will likely update mortality tables used in funding calculations, and the effects of HATFA will begin to wear away. Also, we believe that the ongoing rise in PBGC variable rate premiums will motivate sponsors to improve funded status by making more discretionary contributions.[18]

Major asset allocation shifts, almost all in one direction

One of the simplest ways to determine whether a DB plan sponsor has adopted LDI is to look at the plan's fixed income allocation. An increase in the overall allocation to fixed income is typically a signal that a sponsor is trying to increase its liability hedge. Basic asset allocations are disclosed in the company's 10-K filing, and they are useful, but we should note that they do not tell the full story. For example, while we know the overall allocation to fixed income, we do not know the corresponding duration of the fixed income. A higher allocation to fixed income does not necessarily improve the hedge any more than would an increase in the duration of the existing fixed income portfolio. We also do not know if derivatives are used to improve the liability hedge. Therefore, while a look at basic asset allocations is instructive, we should bear in mind its limitations.

In FYE 2010, not a single member of the $20 billion club had allocated more than 45% of its portfolio to fixed income.[19] The average allocation was just 34%. However, by FYE 2014, the average fixed income allocation had increased to nearly 40%, and five members of the club had passed or far exceeded the 45% threshold. The very largest plans have been more apt to adopt large allocations to fixed income. As shown in Exhibit 3, five of the largest seven DB plans have allocated at least 45% of their portfolio to fixed income.

For some, the historic improvement in funded status experienced in 2013 was the push they needed to dial back risk, as they sought to "lock in" the gains they had realized. We expected that the improved funded status would trigger moves toward more fixed income, particularly since several among this group have adopted de-risking glide paths.[20] Ford, Verizon and United Technologies have made this an explicit component of their investment strategies.[21]

About half of this group disclosed at least a 4% increase in fixed income. While some of this increase may be due to delayed rebalancing to target asset allocations (as fixed income performed well in 2014), in several cases, the target allocations changed too. For example, AT&T now targets 4% more to fixed income. Exxon now targets 10% more, as does IBM. These are not subtle shifts that occurred by chance, but conscious changes sponsors made to their strategies, to help them achieve their objectives. Exhibit 4 summarizes the changes in fixed income as a percentage of the total portfolio.

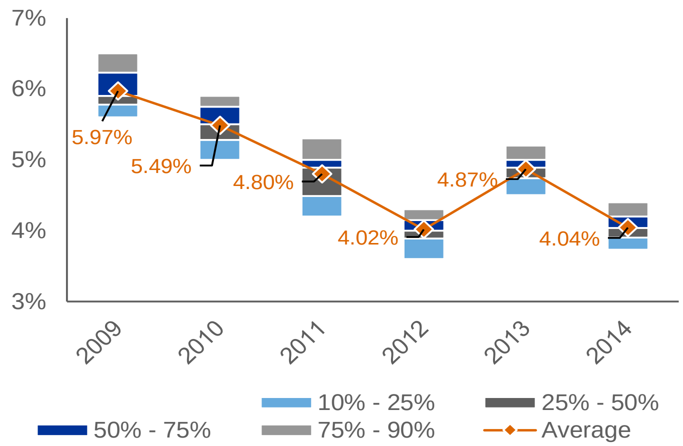
Exhibit 4: Fixed income allocation change[22]

DECREASE > 4%	NO MAJOR CHANGE	INCREASE > 4%	INCREASE > 8%
Lockheed Martin	Boeing	AT&T	Exxon
	Dow Chemical	Bank of America	Ford
	General Electric	E.I. DuPont de Nemours	IBM (targets)
	Hewlett-Packard	General Motors	
	Honeywell	Pfizer	
	Northrop Grumman	Raytheon	
	United Parcel Service		
	United Technologies		
	Verizon Communications		

Other observations

The key reason for funded status declines in 2014 was the change in discount rate. Executives frequently mentioned this in Q4 2014 earning calls.[23] The average discount rate among the $20 billion club dropped 83 bps in 2014, from 4.87% to 4.04%. Significant discount rate changes year-to-year have become the norm, with rates changing by an average of 73 bps each year since 2009, as shown in Exhibit 5. Interest rate risk, or the risk that funded status will be hurt as rates change, has become very real.

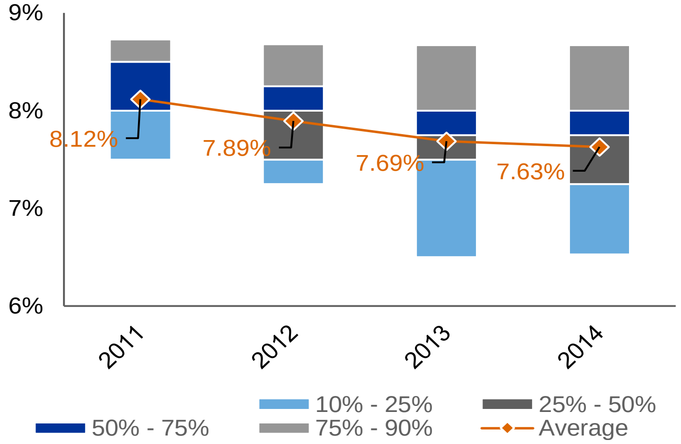
Exhibit 5: Discount rate changes (2009 – 2014)[24]



Risk transfer transactions also continued, but with fewer headlines among this group than in previous years. There were no major annuity purchases, but several corporations, including United Technologies, Boeing and Lockheed Martin, offered lump sum pension payouts to certain participants.

The expected long-term return on assets (ELTRA) has also continued to fall, with the average ELTRA falling by about 50 bps in the last four years (see Exhibit 6, below). Only one corporation, General Motors (which started with the lowest ELTRA), increased its ELTRA in 2014. The overall decline in this assumption probably stems, however, from a combination of two factors: first, a general shift toward fixed income, and second, lower expected returns across most asset classes during this period.

Exhibit 6: ELTRA changes (2011 – 2014)[25]



Concluding thoughts

After the encouraging improvement in funded status in 2013, members of the $20 billion club took a closer look at their funding and investment strategies. The year 2014 turned out to be a challenging one, due to the impact of changes to mortality tables and falling discount rates, the latter effect not being new to sponsors. Nick Fanandakis, CFO at DuPont, summarized it like this: “It doesn’t take much in the way of discount rate change to have a significant impact.”[26] In a few words, Mr. Fanandakis expressed what many sponsors have recognized for several years: Interest rate risk is real, and often meaningful, for DB plan sponsors.

The key difference this time, in comparison to past hurdles, is that more large companies were prepared to weather the storm, having recognized interest rate risk and hedged against it. They aligned their funding and investment strategies to meet those challenges headfirst. While some are still early in the process, their new strategies are already paying off. As Ford’s CFO, Bob Shanks, recently stated in relation to Ford having maintained its DB funded status in 2014, “These results are clear evidence that our de-risking strategy is working.”[27]

As we continue to track the progress of these massive DB sponsors, we will learn how their strategies help them achieve their desired outcomes. And by doing so, we will better understand the issues that affect the plans for which we are responsible.

Appendix

TICKER	COMPANY NAME
BA	Boeing
BAC	Bank of America
DD	E.I. DuPont de Nemours
DOW	Dow Chemical
F	Ford Motor
GE	General Electric
GM	General Motors
HON	Honeywell International
HPQ	Hewlett-Packard
IBM	International Business Machines

TICKER	COMPANY NAME
LMT	Lockheed Martin
NOC	Northrop Grumman
PFE	Pfizer
RTN	Raytheon
T	AT&T
UPS	United Parcel Service
UTX	United Technologies
VZ	Verizon Communications
XOM	Exxon Mobil

[1] Owens, “How will the new RP-2014 mortality tables affect by DB plan strategy,” Russell Research, 2015.

[2] Collie, “The pension world’s $20 billion club stung by improving longevity,” Russell Research, 2015.

[3] Based on FYE 2014 10-K filings.

[4] Based on 5500 filings from the DOL.

[5] Other retiree cash-out programs have been initiated by General Motors, NCR, Alcatel-Lucent and Johnson Controls Inc.

[6] GM Vice Chairman Steve Girsky in the September 2011 Credit Suisse Automotive & Transportation Conference. Quoted from Deepa Seetharaman in “GM aims to move ‘pension risk’ off table,” Reuters, September 7, 2011.

[7] Other annuity purchases exceeding $1 billion have included Verizon, Bristol-Myers Squibb, Motorola Solutions, and Kimberly Clark

[8] The Pension Protection Act of 2006.

[9] See Ford 10-K for fiscal years 2007 and 2014.

[10] See Owens, “Large U.S. corporations begin to favor LDI strategies,” Russell Research, 2012.

[11] Based on FYE 2014 10-K filings.

[12] Assumed 5% increase in PBO due to mortality effect for Ford and Lockheed Martin. Both indicated that mortality was updated but did not specify the amount.

[13] Liability loss percentage is calculated as the ratio of liability loss to the average of beginning of year and end of year PBO.

[14] “MAP-21” stands for the Moving Ahead for Progress in the 21st Century Act of 2012.

[15] “HATFA” stands for the Highway and Transportation Funding Act of 2014.

[16] See Collie, “Pension smoothing has become a modern-day Indiana Pi Bill,” at fiduciary-matters.russell.com, August 1, 2014.

[17] It is important to note that liability calculations for funding and accounting requirements differ in a few ways. First, the discount rate basis is different, with accounting based on current interest rates. Second, accounting calculations can include future pay increases. And third, for funding purposes, asset values can be smoothed over a two-year period. Other differences in methods and assumptions can also exist. Namely, updated mortality is in place for most plans for accounting purposes, but not for funding purposes.

[18] See Gannon, “Do PBGC premiums incent plan sponsors to borrow to fund their pension plans?”, Russell Research, December 2013.

[19] See Owens, “Large Companies begin to favor LDI strategies” Russell Research, 2012.

[20] Based on investment strategy disclosed in their 2014 10-K filings. See Collie, “Now that pension plans are better funded, big asset allocation moves could follow,” at fiduciary-matters.russell.com, January 13, 2014.

[21] See Collie and Gannon, “De-risking glide paths, five years on,” *Treasury and Risk*, June 18, 2014.

[22] Based on asset allocations disclosed in the 2013–2014 10-K filings.

[23] Discount rate changes were called out in earnings calls with UPS, DuPont, Dow, United Technologies, Northrop Grumman, Verizon, Ford, IBM and Raytheon.

[24] Based on disclosed assumptions in FYE 2009–2014 10-K filings

[25] Based on disclosed assumptions in FYE 2011–2014 10-K filings

[26] From Q4 2014 Earning Call transcript for E.I. DuPont De Nemours & Co. on January 27, 2015; seekingalpha.com (March 10, 2015).

[27] From Q4 2014 Earnings Call transcript for Ford Motor Company on January 29, 2015; seekingalpha.com (March 10, 2015).

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