Strategic advice: Focus on funded status to improve results

Diversified approach helped improve funded status while reducing funded status volatility

Client case study

The organization

A large utility company focused on natural gas services across the American Southwest. The client hired Russell Investments as the Outsourced Chief Investment Officer (OCIO) provider on their traditional defined benefit pension, with just over $1B in plan assets.

In 2016, when Russell Investments first partnered with the client, the plan was approximately 64% funded. The plan is closed, but legacy employees continue to accrue defined benefit plan pensions.

The challenge

The client wanted an investment portfolio that reduced their accounting funded status volatility, smoothing the impact of changing interest rates on the company's financial position and funding requirements, while reducing funding requirements over time. Furthermore, due to the low interest rate environment, they wanted to avoid a large initial shift in the approach to their fixed income allocation – which internal and external stakeholders often challenged.

The solution

Russell Investments altered the asset allocation to reduce the amount of interest rate risk that the client was taking, adding a de-risking schedule to increase it gradually as funded status improved and the rates rose. A de-risking schedule reduces the amount of investment risk as their funded status improves. In most cases, this means moving assets from equity to liability-hedging fixed income. In this case, the client wanted to continue taking equity market risk to cover the cost of benefit accruals. In response, Russell Investments developed a de-risking schedule that retained their equity allocation, but continued to increase the duration of their bond portfolio and hedge ratio as funded status improved.

In addition, the equity allocation was updated to increase exposure to international equities. Interest rates and the funded status are monitored over time and the plan has undertaken six separate actions to increase their hedge since September 2016. **These changes have added over $70M to plan assets relative to their prior approach through March 2022.** The strategy also held up remarkably well during the coronavirus market panic in early 2020, due to the treasury component of their hedging allocation, which historically provides downside risk protection during periods of equity market stress. This allowed the client to rebalance into equity markets and achieve the long-term return we would expect from this diversified approach.

Diversified approach

- De-risking schedule retaining equity allocation
- Increased exposure to international equities
- Monitor interest rate and funded status to increase their hedge
- Be aware of what changes in yields imply for the risk/return and the cost of hedging liabilities

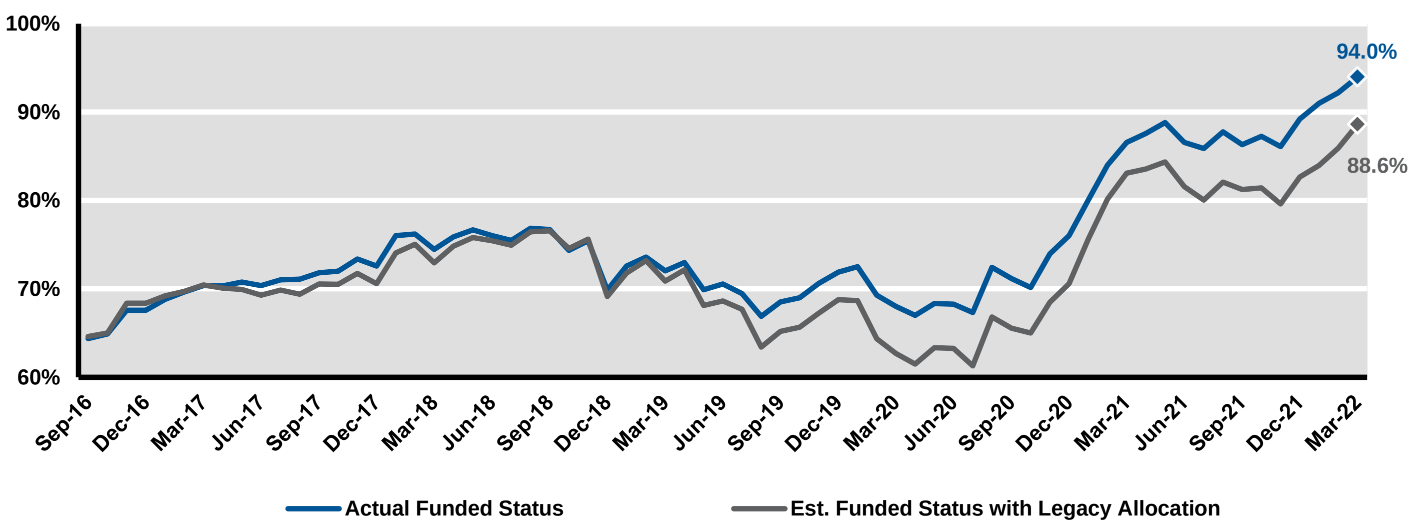
The results

Since partnering with Russell Investments, the strategic advice has added over $70M and improved funded status by over 5% versus the legacy strategic asset allocation (as shown in Exhibit 1). The benefits were even more significant during the downturn in early 2020, as funded status was over 5% higher amid the downturn. As of March 31, 2022, the funded status is 94%, a result of both the strategic asset allocation and contributions, due to the policy of funding above the minimum required levels. In addition, funded status has been more stable as interest rates declined from 2018 through mid-2020, driving plan liabilities higher.

The benefits of this approach have been maintained even as rates have risen in early 2022. In fact, rising rates have created an opportunity: Higher treasury yields imply higher future long term returns on all assets and the “cost” of hedging liabilities has declined with long treasury bond prices. Sponsors can now consider whether to reduce funded status risk while maintaining their expected return from the end of 2021 or staying with their current approach and targeting higher returns over time. A well-managed pension plan focuses on managing funded status risk, reducing risk as the funded status improves and the need for higher future returns declines.

Exhibit 1: Funded status comparison - Value add of strategic advice

Through the end of 1Q 2022, funded status has improved 5.36% versus the legacy portfolio since Russell Investments began working the client.



Data is from 9/1/2016 to 3/31/2022. Assets and liabilities used to calculate funded status are unaudited and subject to change. Comparison of estimated legacy allocation to the actual results are shown for reference and intended to show the long-term benefits of our strategic asset allocation advice.

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If you’re an institutional investor, then your situation, your constraints and your challenges are just as unique to you.
If you’re ready to demand a customized, holistic solution set, we’d like to talk.

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