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Know Your DB Plan's 'Persona' to Help Make the Right Strategy Choices

As the promise of a defined benefit pension has become more difficult and fraught with challenges — from issues such as market volatility, longer retiree lifespans, interest rate fluctuations and other outside economic forces — DB plans today can look more like a liability.

And with that shift, management of DB plans has moved from the human resources department to chief financial officers, plan sponsors and trustees. Many CFOs are looking at their pension plans — whether active, closed or frozen — as unpredictable liabilities. They are asking themselves how best to mitigate this financial risk and what is the best strategy to simplify what has become unnecessarily complex.

"You're not going to be able to predict interest rates or equity market returns continuously, and so your strategy has to be agile," said Michael O'Connor, head of MassMutual's defined benefit business. "It has to be flexible, and you have to work your strategy with a predictable cadence, during which you're reviewing all aspects of your plan and modifying it based on prevailing financial and economic triggers — and those triggers are always going to be there."

"What a CFO today has to do is consider establishing a strategy for the plan and then actively work the strategy. The days of setting a course and letting it go, which probably is how a lot of pension plans were handled for generations, are now gone," he said. "And it doesn't have to be as complex a strategy as some may be telling you."

The first step is to understand the plan's "persona."

THREE APPROACHES

"There really are just three core personas for a plan," O'Connor said. "There's an approach for active plans, an approach for closed plans and an approach for frozen plans. From there, you begin to create your strategy based on that persona. It requires you to get your head around the fact that this can be simpler, and it incentivizes you to integrate your service model [so that] one provider is providing investment, actuarial and administrative services."

Once the persona is identified, the plan's funded status becomes the key basis for developing a simplified strategy, which should include an integrated service model that can see the plan through any market environment.

"Understanding your funded status should lead to an overarching investment policy that you hold in good times and bad times," O'Connor said. "As soon as you start to talk about the investments one-off or on their own, you often get yourself out of alignment with your strategy. That happens when you have an unstructured or a nonintegrated service model, in my view. Because then you're having conversations with three disparate entities and none of it is connected."

It's up to the CFO to ensure that all components are integrated and that conversations around the plan's strategy are connected.

"Everyone should have the same interests that you have, which helps simplify" management of the plan, he said. "If you are getting advice from three separate entities around your administration strategy, around your actuarial strategy and around your investment strategy, which many plans are, then it's going to be really hard to take a disciplined approach to working your strategy."

FOCUS ON THE OUTCOME

He added that understanding the difference between the outcomes one wants and the strategies one needs is key to taking the pension, and its liability issues, along the right path. Focusing on the outcome, which is linked to the plan's persona, can lead to easier decision-making and improved management.

Consider a frozen plan, for example.

"If it's frozen, which usually means the end is in sight in terms of termination, everything you do today must be accretive to arriving at a termination point," O'Connor explained. "You should be getting your arms around the overall expenses associated with the plan. Plans that are nonintegrated have expenses coming from investment advisers, actuaries and record keepers, and it gets very unwieldy."

Complexity can emerge in an active plan just as easily.

"If it's an active plan, then the persona and reason for funding is often more altruistic in nature, with a purpose of helping employees and retirees secure their futures," O'Connor said. "This persona may have you on a separate strategic path, where it's all around the participant experience, all around a record keeper that can provide the right level of digital capabilities and an actuary that's going to help keep you on the right path. Where it becomes unnecessarily complex is when you bring multiple parties into the equation and you're trying to, in essence, manage three different sets of priorities as opposed to one plan strategy."

Once CFOs have set their strategy and simplified their service model by aligning it to a persona for their plans, the challenge becomes what's next in terms of execution, or what O'Connor called "working" the strategy.

"It's risk management at the core," he explained. "For established insurance companies like MassMutual, it's the same asset-liability modeling they have been doing for the past 150 years.... But strategies like liability-driven investing require active management; and so once you set your strategy, you have to work it. You can say you're doing LDI, but you're really not doing it unless you're actively doing it. For some plans, that's weekly portfolio rebalancing, it could be monthly, and the minimum is quarterly."

It also means regular meetings with plan vendors and rebalancing from equity to fixed income, depending on the persona of the plan. "Because what in essence you're doing is continually derisking," he added.

Last year's market fluctuations provided a good example of what plan sponsors needed to monitor and react to when rebalancing portfolios.

"If you were looking at your pension plan and following it on a quarterly basis, which you should be, you would have seen incredible run-up through the third quarter in terms of an equity market's performance. And then, for most plans, certainly those that are closed and frozen, which is almost two-thirds of the plans, you should have seen a shift in the fourth quarter toward more of a fixed-income approach.... You're taking some of that equity risk out of the plan, you're locking in those earnings, and now you're going to move more toward derisking."

'VALUE OF STABILITY'

Regardless of the persona of a particular pension plan, CFOs and pension plan sponsors have to take the first steps to simplify their plan through an integrated service model, and that will set the stage for more effective funding decisions, something O'Connor recognized is not easy.

"It takes a lot of courage to make a pension funding decision," he said. "There are lot of other capital projects that that money could be put toward. But I think a CFO understands the value of stability on the balance sheet and income statement. The board of directors understands the value of stability on the balance sheet. And companies are now looking at making investments in those plans to get them into a better spot." •

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