STATE STREET GLOBAL ADVISORS

POST-CONFERENCE BRIEF

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Dynamic derisking: How an OCIO can help plan sponsors manage funding volatility

Two trends are converging to make life for defined benefit plan sponsors much easier: improved funded status leading to more interest in — and flexibility to deploy — derisking strategies and the evolution and growth of the OCIO, or outsourced chief investment officer, market.

Taking a page from the defined contribution world, where target-date funds automatically shift equity and fixed income allocations along a specified glidepath, many DB plan sponsors use the concept of a glidepath as a derisking tool, and using an OCIO to craft and manage that glidepath makes sense. An OCIO manager can manage both liability based fixed income exposure as well as return-seeking assets, notably, equity risk.

"It's hard to get a pension plan to change its target asset allocation abruptly," said Thomas Kennelly, managing director and head of investment strategy at State Street Global Advisors, speaking on the sidelines of Pensions & Investments' recent conference on the evolution of OCIO. "The persistent strength in the equity markets combined with low bond yields has posed challenges for plan sponsors seeking to derisk. Many plans still seek growth of returns to recover from deficit, so the use of a glidepath allows for a more incremental derisking process.

Kennelly said pension funds have largely embraced the glidepath idea, which is simply a systematic or dynamic way to think about asset allocation as funded status changes. This has typically involved a shift from growth assets, notably equity, to fixed income.

"We're constantly working with plan sponsors and their investment committees to think about ways to improve the [portfolios'] downside protection if and when they get better funded," he said. "We effectively design a glidepath, monitor funded status and stick to the plan. So it becomes a cognizant decision to say, 'All right, now that we're at 85% funded versus 75%, we are set to change our asset allocation from 70/30 to 60/40'. But if time has passed, the potential sub asset allocation within the 60/40 target mix should be reviewed and adjusted, to account for current return and risk expectations."

The path to pension plan stability — whether to move toward termination or bolster funded status — is a goal shared by many, but Kennelly noted that the low interest rate environment, which plan sponsors have been dealing with for years, often complicates the situation and has plans seeking alternative methods of derisking.

"Let's say a plan moved from 90 to 95-98% funded over the last several years. They're now saying, 'Do we move out of equities into fixed income to de-risk?' You would think yes, but they're also starting to say, 'Well, we still think interest rates might not be attractive,' or 'We still like equities,' or both," Kennelly said. "And so we've been looking at ways to derisk their equity book without going into fixed income."

DERISKING WITH DERIVATIVES

Strategies that plan sponsors can use to derisk without adding fixed income include smart beta or factor investing, specifically via low volatility or managed volatility strategies, and using equity collars as well as multi-asset credit strategies, to generate higher income to compliment the use of a futures overlay within the LDI allocation, according to Kennelly. The idea of derisking within a current asset allocation using these strategies is what he called the next evolution of capital efficient derisking.

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"The low vol or managed volatility strategy is often in physical investment strategies but there are also some solutions we've worked on with plan sponsors who are willing to use derivatives and do an equity collar," he said. "In that case, you're truncating the wings of your potential outcomes. You might be giving up a little upside, but you're protecting some of the downside. It's a way to lower that volatility and that return-seeking portfolio without liquidating equities or moving it to fixed income."

Kennelly offered an example of how a glidepath approach could work. Consider a plan that has a 65/35 asset allocation, with a portion of the fixed income allocation in intermediate core bonds. The plan has long-duration liabilities, but with the low yield environment, it doesn't want to add to its fixed income allocation. Here, the plan can incorporate interest-rate triggers to make allocation shifts. Rising interest rates, for example, could signal a better time to start to shift the core fixed income portfolio longer.

"For some plans, they don't really want to derisk into fixed income because they still need that return and that growth to offset service costs and expenses," he said. "They tend to seek more risk-efficient growth assets and capital-efficient fixed income. The plan can extend the duration of its fixed income assets, either through use of long-dated Treasury STRIPS or synthetically via Treasury futures, to maintain or modestly increase its asset-liability hedge ratio but free up capital for lower-risk growth assets."

OPEN, CLOSED OR FROZEN

Two other components that can have an influence on how an asset allocation is structured are the status of the pension plan — whether it's open, frozen or closed — and the plan population. Pension risk transfers often take place when a plan sponsor is well funded and has a significant retiree population to which it is paying benefits. In many cases a pension risk transfer, lump sum payout or annuitization will cover the retiree portion of a plan sponsor's workforce, leaving the assets and liabilities for the remaining portion to manage.

"We look at across the board, how the liabilities are structured and how the demographics look," Kennelly said. "If and when a plan is starting to get toward that end state and they feel that there could be a pension risk transfer, lump sum activity or ultimately, annuitization termination, we have seen some clients look to carve that component out, in which case you'd have a more discreet [liability-driven investment] strategy and then the remaining portfolio, if there are still some active participants, that's when you might have more of a 70/30 risk-seeking portfolio because the liabilities are a little bit less certain and you have to have a higher hurdle rate for your assets to work."

If a plan is over funded or well funded, it won't need as much risk from its asset allocation strategy and will have flexibility to hedge the remaining liabilities using an LDI strategy. "You start to mimic the liability so there's less funding volatility," Kennelly said.

All these strategies can be managed via the glidepath structure, and having an OCIO oversee the program can be helpful since it can get complicated and costly.

"We're OCIOs but we have a pretty good grasp of liquidity and managing liquidity through trading, the ability to be a little bit more nimble as investment managers," Kennelly said. "I think that's a big difference in the market today where clients are looking more for that hands-on liquidity management because that could become costly if you're not trading on an efficient basis or you're out of the market or you're forced to liquidate at the wrong time." •

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