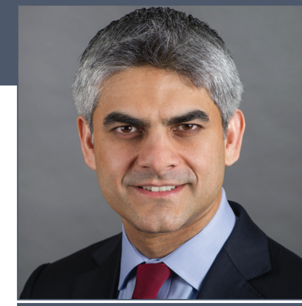

OWAIS RANA
Head of Pensions LDI Solutions
CONNING

ADVANCEMENTS in Pension Derisking

A Goldilocks moment has plan sponsors taking risk off the table

More defined benefit plan sponsors are taking advantage of their pensions' improved funded status — thanks to the bull market in stocks and rising interest rates — by moving assets out of equities and into fixed-income securities. Their goal: Reduce balance-sheet volatility and better match assets with liabilities.

"Based on conversations I've had over the last year or so, clients are determined to derisk," said Owais Rana, head of pensions LDI solutions at Conning. "They want to take investment risk off the table by making their portfolios more liability driven."

According to Conning's monthly Pension Funded Status Tracker, the average corporate defined benefit plan was 85% funded at the end of March, down slightly from 86% in February, but up from 82% in March 2017.

Selling equities and buying fixed income sounds straightforward, but it is not always a simple decision. "Companies understand the merits of pension risk management, but a CFO may not want to reduce the company's earnings by lowering the expected return on plan assets," Rana explained. "When you reduce your equity allocation in favor of bonds, the expected return assumption — which is really phantom income, as it is uncertain — is also reduced."

He added that pension risk management should supersede this artificial earnings contribution phenomena, since pension plans are not part of companies' main business. However, even in these cases, a balance can be struck between the desire to reduce funded-status volatility and the impact on expected return assumptions.

"Sponsors need to think more broadly about the available instruments," Rana said. "You may be able to achieve that objective by using derivatives to maintain exposure to growth assets, such as equity markets, and release capital from the equity allocation to buy long-duration corporate bonds that hedge the plan's liabilities. It's a more efficient use of capital."

But with equities still running relatively strong this year, despite a few bumps, and a pickup in volatility, many plan sponsors are hesitant to take too much risk off the table. However, risk of an equity market correction also seems elevated, and a correction could thwart plans to take advantage of improvements in funded status.

What's an institutional investor to do? Rana suggests that clients consider the impact on the plan's funded status in a worst-case scenario.

"I say to clients: You've seen a surge in the stock market and an increase in the long end of bond yields. How much more are you betting on that trend?" Rana said. "There may be a little more room on the upside, but there is a lot more to lose on the downside if the tide turns. So think about locking in some of the gains.

"We also tell clients that if they strongly believe that long-term interest rates will continue to rise, then we could use interest rate triggers as a derisking tool," he added. "As interest rates go up and hit trigger points, we sell out of equities and buy bonds. And any new contributions made to the plan after that also go toward buying bonds." ■

CONNING®