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Investment Publications Highlights

US Corporate DB Pension Plans—Today's Challenges

Martin L. Leibowitz and Antti Ilmanen, *The Journal of Retirement*, vol.3, no. 4 (Spring 2016): 34–46

The funded status of corporate defined benefit (DB) pension plans has decreased sharply in recent years, partly as a result of heightened levels of market turmoil and accounting and regulatory changes. The authors examine how DB pension plans have evolved, suggesting that efforts to improve funding ratios require careful cost-benefit analysis.

Historically, pension sponsors preferred to invest in equities over bonds to increase returns and minimize contributions from the sponsor to the portfolio. However, high equity allocations during recent market downturns have hurt DB pension plans' funding ratios. While the average pension plan had 105% of its liabilities matched by assets in 2007, plan levels plummeted to near 80% after 2008.

The trauma of the global financial crisis was particularly painful to DB pension plans because accounting and regulatory changes had tied liability discount rates to market-based corporate bond yields. Previously, many pension plans discounted liabilities using the portfolio's expected return, which lowered the present value of its liabilities. But rule changes in the mid-2000s prohibited this approach and helped make fluctuations in funding status more visible on corporate balance sheets.

DB pension plans have also been challenged by longer life expectancies, which have increased pension obligations, leading many administrators to consider how they can de-risk portfolios. While some administrators, in an effort to reduce the impact on plan sponsors, have decided to either terminate plans fully or close them to new employees, others have looked to de-risk portfolios through a glide-path approach. In this approach, DB pension plans gradually reallocate assets from higher-risk equities to liability-hedging long-duration bonds as the funding ratio improves.

However, the glide-path approach exposes pension plans to downside risks that should not be overlooked. Retaining a high level of exposure to equities to help overcome a low funding ratio could also work to make the problem larger if the market dips. The authors suggest DB pension plans carefully evaluate exposures to both interest rate risk and equity risk in evaluating options to de-risk portfolios.

How Public Pension Plans Can (and Why They Shouldn't) Ignore Financial Economics

Lawrence N. Bader, *Financial Analysts Journal*, vol. 71, no. 5 (September/October 2015): 14–16

Too often, public pension plans ignore current market conditions because they claim their perpetual existence and taxing power exempt them from adhering to financial economics. This approach has resulted in inadequate funding, leading to questions about the security of public pension benefits.

Financial economics suggest that the current value of a secure, fixed future payment is calculated by discounting future payments at a default-free rate. Ignoring this advice, many public pension plans value their liabilities using discount rates well above current government bond yields, in an effort to lower the true cost of future payments. According to an industry survey, administrators at half of the 126 pension plans surveyed used discounts rates of 7%–8% in late 2014, versus the then 30-year Treasury bond yield of 2.75%.

Public pension plans regularly cite the taxing power of their sponsors and the fact that they will exist in perpetuity as justifications for aggressive discount rates. Plans also use these reasons to defend risky asset selection. Unfortunately, the idea that risk decreases over longer time periods has been debunked in academic literature. But if this is the case, why have public pension plans largely survived and private plans broadly shuttered?

The authors suggest that public pension plans have benefited from what they refer to as "intergenerational risk sharing," which has allowed them to remain solvent to date. The failure to meet investment targets today is offset by public pension plans' ability to acquire future generations of plan members who share in the risks created by previous generations. This fact compounds the risks to public pension plans and violates a fundamental principle of public finance—that each generation should pay for the services it consumes. If public pensions want to ensure the sustainability of their plans they should revisit key lessons of financial economics on how to properly value future liabilities. ■