

# A Clarion Call for LDI

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## Looking Back

- Significant improvement in funded status since 12/31/2020, almost 10% as of June 30
- Increase in rates resulted in declining liabilities during the first half of the year
- S&P 500 index finished the first half of 2021 with over 14% return
- Many sponsors locked in their funded status gain by shifting to fixed income, avoiding mistakes of the prior decade
- Passage of ARPA gave needed flexibility to plan sponsors with pension relief
- First-quarter annuitizations were the lowest we have seen in several years, but we nevertheless expect annuitizations to pick up

## Looking Ahead

- Rates derail – a harbinger of a volatile back half of 2021
- Inflation and what it means to corporate pension plans
- The Federal Reserve remains resolute on inflation

## Funded Status Bonanza

Corporate plan sponsors wrapped up the first half of 2021 giddy with their improved funded status position. Increases of over 10% in funded status on an accounting basis were prevalent, driven by a significant rise in discount rates, as well as strong asset returns.

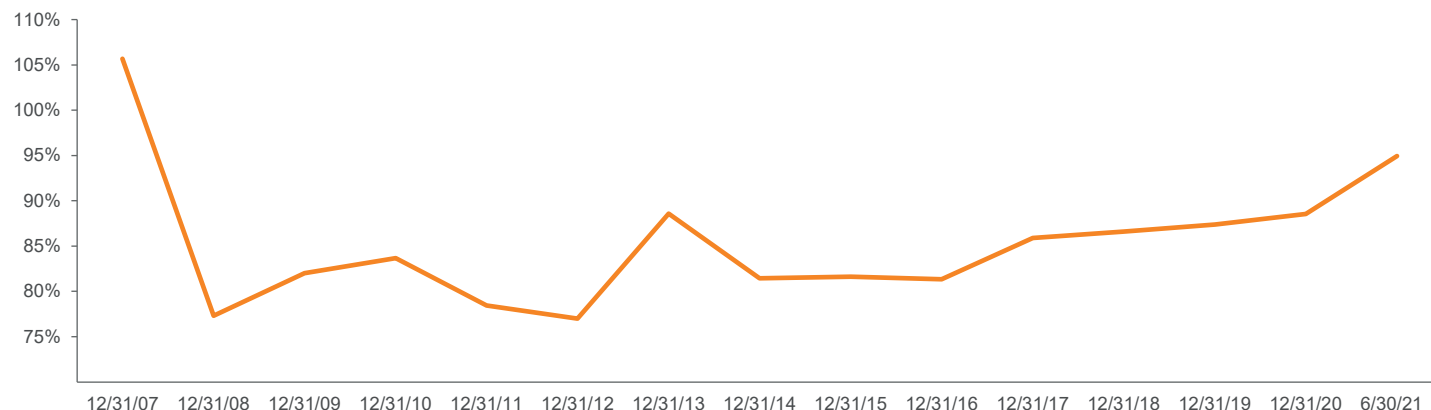
Rates ended June at 1.4% and 2.1% for 10-year and 30-year U.S. Treasuries, respectively. Despite ending June at their mid-February levels, rates were still 30 to 40 basis points (bp) higher relative to December 31, 2020. This impact was seen in the FTSE Pension Discount curve, a corporate pension industry standard, which increased just over 30 bp, reducing liabilities by 3% to 5%, depending on a pension plan's duration. Couple this with the strong equity returns where the S&P 500 delivered a 14% return over the first half of 2021. It's easy to see that an average plan starting the year at 80% funded (assets split evenly between growth-seeking and long duration fixed income) catapulted to over 90% funded by mid-year.

**Figure 1. Funded status of corporate plans has improved this year**

	12/31/2020	06/30/2021
Liabilities	100	96
Assets	80	87
Funded Status	80%	91%

Source: Voya Investment Management.

During this time, many sponsors acted based on breached glide path triggers that facilitated a rotation to long duration. In fact, there was downward pressure on the long end of the Treasury curve as sponsors rushed into long-dated Treasuries. The difference between the 10s and 30s declined from just over 70 bp at the beginning of the year to 60 bp by mid-year.

**Figure 2. Funded status of S&P 500 companies is trending toward pre-financial crisis levels****SP 500 Plans Funded Status (%)**

Source: Voya IM, S&P, Bloomberg, 10-k data. Represents funded status for the 151 S&P 500 companies in aggregate that sponsor U.S. defined benefit pension plans. As of 06/30/21.

### American Rescue Plan Act (ARPA)

On March 11, 2021 President Biden signed ARPA into law, allowing the use of higher interest rates in determining the liabilities for minimum funding requirements and amortization of plan deficits to 15 years instead of seven years. For many sponsors ARPA is providing welcomed flexibility, post-Covid, to shore up their core businesses.

However, sponsors are still on the hook to pay PBGC premiums on their pension deficit 4.6% of the unfunded position for 2021 and indexed to inflation for future years. Furthermore, the deficit used for PBGC premium purposes is not based on the liability using the higher interest rates prescribed by ARPA.

So, while relief may be welcome it may unintentionally indoctrinate a culture of *Regulatory Driven Investing*, in which sponsors react to relief rather than proactively improve their plans. For instance, sponsors are better off “paying now” to avoid PBGC premiums, rather than “paying later.” Incurring PBGC premiums does not benefit the pension plan, so to the extent sponsors are capable, they should accelerate contributions to avoid premiums. Lastly, relief may entice sponsors to take on more equity risk based on the belief that they can “earn” their way out of the deficit rather than implement a prudent LDI strategy with a potentially greater risk/reward, higher Sharpe profile.

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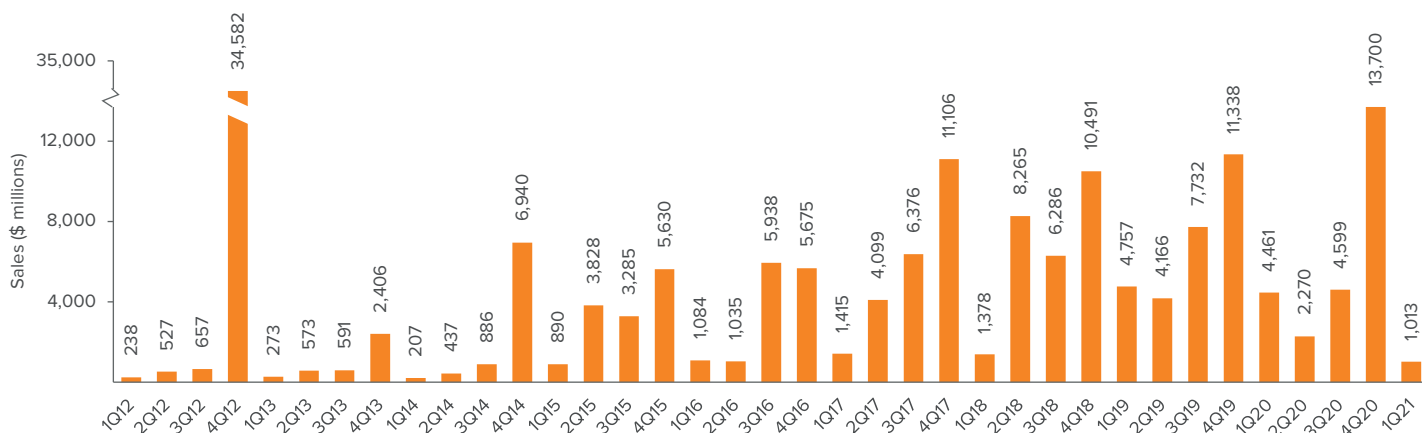
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### Annuitizations Stall ... but it's Temporary

Buyouts ramped up in 4Q20 following the mid-year Covid malaise. However, that momentum stalled in the first quarter of 2021 with the lowest buyouts in a first quarter since 2015 – a 77% drop compared to 1Q20. It's only natural that sponsors are cautious as they continue to recover and plan for a post-pandemic world. First quarters have historically exhibited lower transaction activity. We suspect the tides to turn in 2Q21.

In fact, we see several deals in 2Q21 and early 3Q21 that indicate a robust second quarter and foreshadow more deals to come:

- Arconic purchased \$1 billion in annuities for over 8,000 in-pay retirees
- Archer-Daniels-Midland purchased \$700 million
- JC Penny purchased \$2.8 billion in annuities for over 30,000 in-pay retirees
- Sonoco purchased \$900 million in annuities for over 8,000 in-pay retirees
- Lockheed Martin purchased \$4.9 billion in annuities for over 18,000 in-pay retirees

**Figure 3. Annuity payments have a volatile history, driven by headline events**

Source: LIMRA. As of 03/31/21.

## Pension Plans Picked a Plum But is the Best Yet to Come?

### Rates

If the first few weeks of July are a precursor of what's to come, then sponsors need to hang tight and heed the clarion call of LDI. The rate rally and volatility have almost reversed all the declines in liabilities from the first half of the year. Meanwhile, the S&P 500 and Dow Jones Industrial Average declined more than 2% on July 19 on fears of a spreading Delta variant. Such volatility proves time and again that it is always better to de-risk with a prudent LDI strategy. For just as quickly as funded positions improve, they can also decline unless meaningful, duration-matched de-risking takes place.

*It is always a good time to de-risk: recurring volatility proves time and again that it is always better to de-risk with a prudent LDI strategy.*

### Inflation

Adding to all the drama is inflation. Our view is that this is cyclical inflation. We might see some initial dislocation that could potentially be more cyclical in nature and extend longer than a few quarters, but we do not expect structural inflation. The release of pent-up demand will expose ongoing cyclical inflationary pressure, which is fueled by savings and labor frictions. Furthermore, wage trends beyond those Covid impacted sectors will ultimately define the magnitude and durability of these labor frictions. There are a lot of job openings revealing a mismatch in the labor market; however, without bargaining power from labor, there is no upward pressure for wages to move higher. If we start to see wage pressure inch higher, then there is potential concern for longer term structural inflation.

We would be remiss if we did not acknowledge the disinflationary influences coming from globalized supply chains that will result in a higher baseline. Yet, we believe these disinflationary pressures will begin to wane as pre-pandemic globalization reasserts itself in a post-Covid recovery.

### Pensions and Inflation

For corporate sponsors of closed and frozen plans without COLA increases, inflation is a devaluation of pension debt so the cost of these liabilities is lower for the sponsor. Unfortunately for the participants it is an erosion of their purchasing power. On the other hand, for plans that provide inflation-linked increases to retirees (more common in public pensions and in the UK) or open plans where wages may increase from inflation, it adds more headwind. However, some of this is mitigated by the fact that inflation raises discount rates, which lower liabilities. Take this one step further and note that a fully de-risked plan is indifferent to moves in both inflation and interest rates. So, while inflation reduces fixed income value, the same happens to liabilities and vice versa – they move in tandem.

### The Fed and Inflation

Fed Chairman Jerome Powell resolutely addressed the uptick of inflation in his testimony to Congress in mid-July – still qualifying that the Fed has not yet made a plan to adjust its purchases of Treasuries and agency mortgages, or to modify interest rates.

U.S. CPI prints in June surprised to the upside at 5.4%. Powell attributed much of the higher inflation print to a select group of industries, adding that it would be a mistake to act prematurely, as the Fed expects inflation to be transitory. Powell also predicted that job gains will be strong in the coming months, assuaging inflation fears.

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