Hindsight Is 2020: A Wild Ride For LDI

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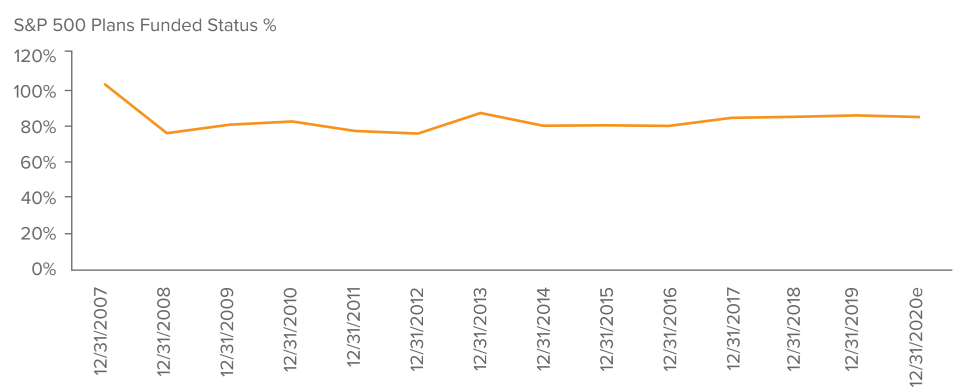
Looking Back

- The average funded status of S&P 500 pension plans has remained stubbornly stuck at 87% for the last two years – and rangebound between 85% and 87% each fiscal year end since 2017.
- Similar to 2019, strong equity returns in 2020 helped offset the increase in liabilities from a 70 – 80 basis points (bps) drop in investment grade AA rates during the year.
- However, unlike 2019, it was a wild ride in the markets and pensions that were not hedged experienced meaningful funded status volatility. At the end of Q120, the funded status of pension plans, on average, was down 7 to 10 percentage points but retraced to pre-COVID crisis levels shortly after the Fed's swift actions and commitment to support the financial markets.
- The Fed's Zero Interest Rate Policy (aka ZIRP) is here to stay for the foreseeable future, further allaying any hope of a sustainable rise in rates.
- Contributions scheduled for 2020 were postponed in many cases, adding to the sticky funded status position of many plans.
- Eventually some sponsors found a way to the exits as annuitizations were relegated to the back half of 2020.

Looking Ahead

- Sponsors face the start of 2021 in an unprecedented environment of stimulus, quantitative easing, historically low rates and equity valuations at all-time highs.
- MAP-21 funding relief corridors will phase out in 2021, creating the potential for an increase in contributions absent any further extension of relief from Congress.
- As more plans look to de-risk in the year ahead, we expect sponsors to explore nontraditional fixed income asset classes such as investment grade private placements, commercial mortgage loans and securitized assets.
- The roller coaster of 2020 reinforced the efficacy of LDI programs and interest-rate hedging as optimal risk management solutions. While funded status ultimately ended 2020 unchanged, plans without an LDI program in place experienced significant funded status volatility over the course of the year. Plans with LDI in place experienced less volatility. It's better to be good than lucky.

Funded Status "L" Shape Non-Recovery Slogs Along



As of December 31, 2020. Source: Voya IM, S&P, Bloomberg. Represents funded status for the 158 S&P 500 companies that sponsor U.S. defined benefit pension plans.

Equities Do It Again: Pensions Avoid Deficit Rout, But What A Wild Ride

While the average funded status of S&P 500 pension plans has remained stubbornly stuck at 87% for the last two years, sponsors can thank the strong stock market performance for averting a pension deficit rout.

The last time that stocks and bonds rose in tandem was 1997. Now this seldom seen phenomenon has occurred in two consecutive years. And for plan sponsors without an LDI program in place, it's a good thing it did, as the punch that falling rates had on funded status during 2019 and 2020 was countered by the ascension of equities.

Indeed, equities had another strong year, with the S&P 500 up 18% in 2020 despite a free fall in late February and March. Meanwhile, the FTSE Pension Discount curve, a corporate pension industry standard, dropped almost 80 bps during the year. This indicates that many plans with a December 31 fiscal year end will see their discount rates down another 70 – 80 bps (rates were already down 100 bps during 2019). Pension plan discount rates are now uncomfortably anchored in the middle of a "2 handle".

For 2020, the year over year comparison in funded status masks the tumultuous markets and stormy weather plan sponsors had to navigate. Plans that were appropriately hedged and de-risked performed the same but with much less worry as they exhibited more stability and less surplus volatility.

The doubt and second guessing of investment strategies were on full display by plan sponsors who were baring white knuckles at the helm during the dark days of February and March of 2020 as their funded status dropped 7 to 10 percentage points in March alone when discount rates moved 100bps in a matter of days. Conversely, sponsors of plans that were better hedged as part of an LDI program or plans that were fully de-risked took solace by the low volatility of their plans and validated their LDI effort before their investment committees.

Rates Are Low But Don't Be Fooled - They Can Go Even Lower

It's important to remember that interest rate hedging is not about timing the level of where rates are, but rather managing risk going forward regardless of the level of interest rates. As sponsors reassess the rate moves of 2020 we believe they will gain a greater appreciation for the inherent convexity in their interest rate exposure (i.e., rates declining even further at these low levels will cause greater increase in liabilities than at any other point in history). Against this backdrop, we expect more de-risking from sponsors.

"Interest rate risk is more important than ever and duration matching in the asset portfolio is key especially to parry the nefarious effects of negative convexity"

The downside of not hedging interest rates is far more hazardous than the upside is favorable – better said, it is unrewarded risk. Not only is there pain from convexity, there are knock-on effects from PBGC premiums and/or contingent call on capital that may further deepen the downside.

At Voya we continue to maintain and increase interest rate hedge ratio positions by matching the key rates of participant cash flows. This approach has resulted in a remarkably stable funded status for the following reasons:

- Interest rate hedges are meant to offset interest rate risk and reduce funded status volatility.
- When rates go up or down the funded status is more stable for plans that are better hedged. Plans are not hedging the level of rates but rather the rate volatility.
- An aggressive move higher in rates is needed to meaningfully reduce liabilities, and that is not expected to happen anytime soon.

Contributions: Pay Now or Pay Later

The start of 2020 was full of promise as sponsors mapped out their discretionary contribution strategies only to be reversed as the pandemic took hold. With the emergence of the "K" economy in the middle of 2020, the divergence among winning and losing industries became apparent further impacting the ability of certain industry plan sponsors to make their promised contributions. We expect the effects of this to continue to impact many plan sponsors into 2021.

Many sponsors during 2020 were eager to get relief from required contributions. While the CARES Act allowed sponsors to delay their required contributions to 2021, it remains to be seen if more relief will be on the way. We expect any such relief will be a manipulation on the "corridor" applied to the 25 year average of interest rates. The corridor is set to begin to widen in 2021 allowing for the discount rate used to determine required contributions to gradually fall. Narrowing the "corridor" was proposed in the HEROES Act but that failed to pass the Senate.

For plans that are underfunded, contributions, together with a de-risking strategy, are an integral part of getting to full funding in a risk efficient way. Sponsors who can afford to contribute and de-risk (rather than wait for the IRS to require contributions) benefit from reduced or eliminated PBGC premiums and receive a tax deduction; better to pay now than pay later. Lastly, with borrowing costs at an all time low, we expect many sponsors to borrow in the capital markets and use the proceeds to contribute to the plan and take advantage of the aforementioned benefits.

Some Sponsors Found Their Way To The Exits But Had To Wait Out The Storm

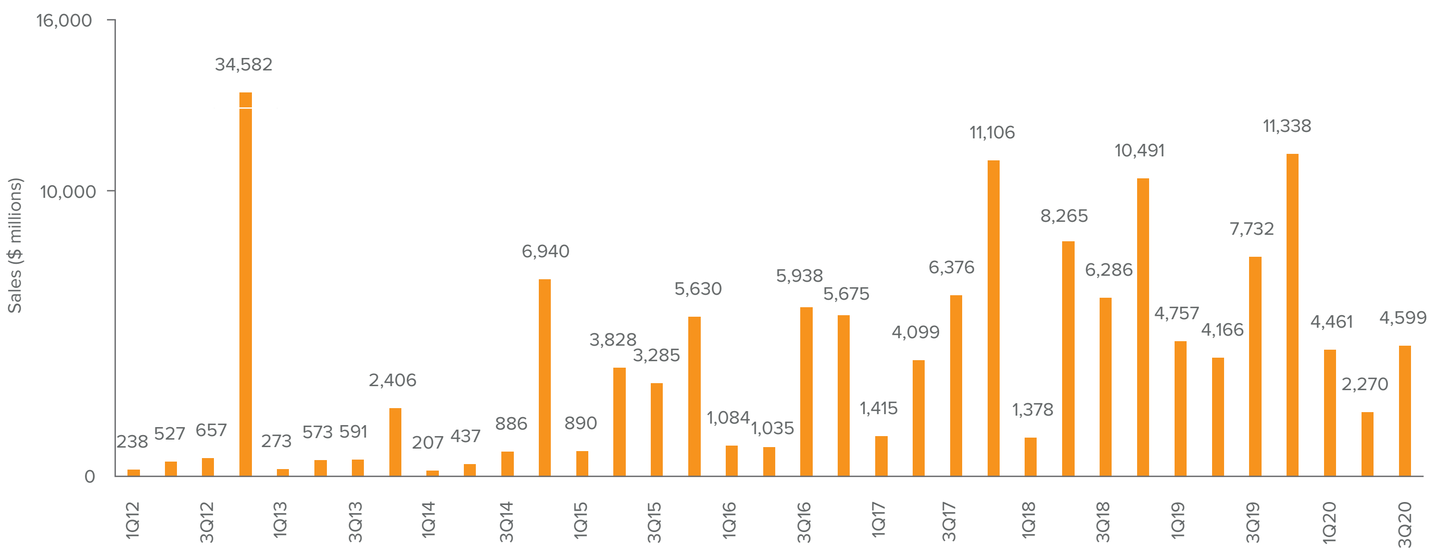
Pension buyout activity was strong during 2019 through the third quarter (you read that right – 2019), with $17bn in annuities transferred to insurance companies – that's 40% more than the first three quarters of 2018.

Not so for 2020. While there is a lag in available data, the first three quarters of 2020 show that buyout activity totaled $11bn, a 35% decline from 2019. For obvious reasons, Q2 2020 became a challenging time to commit to a buy-out. Nevertheless, $2.3Bn in pension liabilities were transferred off of corporate balance sheets during this time.

We suspect Q4, which historically has more transactions than other quarters (see **Pension Buy Activity by Quarter**), to be higher than each of the last three quarters of 2020. Why? For sponsors who had planned such a transaction and still had the wherewithal to execute post COVID, the events of 2020 may have been the final straw and solidified their desire to transfer risk. They simply had to ride out the storm and reposition transactions to take place in Q4. Already we know that GE transferred $1.7bn in Q4 to Athene who will take over payments for 70,000 retirees receiving less than $360 per month.

A recent MetLife survey (*2020 Pension Risk Transfer Poll*) suggests that while the first half of 2020 declined compared to 2019, we can expect to see more transactions in the second half of 2020. The survey shows that 27% of respondents made no change to their buy-out plan and 55% indicated that COVID-19 increased or accelerated the likelihood of a transaction.

Pension Buy Activity by Quarter



Through September 30, 2020. Source: LIMRA

Is The Future A Hot Mess?

Investment strategy setting for pensions at the start of 2021 is a daunting endeavor to say the least. And yet, plan sponsors face an environment that is eerily similar to the outlook at the start of 2020. Equity valuations at all-time highs – dare we say untenable – and interest rates are at historical lows… again! However, this time we are in an ultra-low rate environment, by design, with unprecedented quantitative easing, fiscal stimulus and possibly even more stimulus with a democratic president and majority congress. Add to this a nation divided and a capital stormed – the pendulum teeters instead of swings.

The best strategy is one reinforced with safety. Plans will continue to look to de-risk in the year ahead and even explore discretionary contributions, whether through borrow-to-fund strategies, taking advantage of low rates, or outright contributions out of treasury coffers. Relief from congress be damned. We expect to see long duration investment grade credit to continue to be a foundation for these de-risking programs integrated with nontraditional investment grade fixed income asset classes such as investment grade private placements, commercial mortgage loans and securitized assets.

Interest rate risk hedging and LDI programs continue to provide the ballast pension plans need for optimal risk-management solutions. It's true that, from endpoint to endpoint, funded status was ultimately unchanged over 2020. But for plans without LDI the lack of change came with abundant volatility, while those with LDI arrived at a similar position with far less deviation. It's better to be good than lucky.

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