Retirement News Highlights

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Coronavirus Creates Perfect Storm for DB Plan Funded Status Drop in February

By Rebecca Moore
PLANSPONSOR
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Pension funding ratios decreased throughout the month of February, with changes primarily attributed to declining Treasury yields and poor equity performance. Legal & General Investment Management America (LGIMA) estimates that the average plan's funding ratio decreased 5.3% to 74.4% throughout the month.

The firm notes that the coronavirus outbreak became the primary focus for equity markets in February. But it points out that the outbreak continued to dominate the rates narrative as well, as fears of a full blown pandemic further slowed domestic and global growth. LGIMA's calculations indicate the discount rate's Treasury component fell by 36 basis points while the credit component widened 19 basis points, resulting in a net decrease of 16 basis points. Overall, liabilities for the average plan increased approximately 2.7%, while plan assets with a traditional "60/40" asset allocation decreased by approximately 4.1%.

Sources stressed the importance of risk management investment strategies, but also diversification of equities. River and Mercantile Solutions says in its Monthly Retirement Update that plans with the greatest exposure to equities generally saw the largest funded status declines because of the equity market drops at the end of the month. Still, allocations which are largely liability matched saw see a drop in funded status for the month based on the magnitude of the equity market movements.

"So far in March, those declines have continued with the 10-Year Treasury falling below 1% for the first time and equity markets substantially off. While spreads have widened, pension discount rates are still down from the beginning of the month. Plan sponsors with significant liability matching strategies will weather this storm, however plans with any equity exposure will feel the effects. If the coronavirus is comfortably contained in the near future, markets will most likely rebound quickly; if the containment is prolonged, we will almost definitely see continued strain and volatility. This type of economic environment is exactly why plan sponsors need to have a comprehensive funded status risk management strategy that encompasses not only interest rates, but equity exposure as well," says Michael Clark, managing director at River and Mercantile.

Brian Donohue, partner at October Three Consulting, says, "Falling stock markets grab the headlines, but unprecedented low interest rates are at least as significant a story. For pension sponsors, the combination is a real gut check." Both model plans the firm tracks lost ground. Plan A lost more than 5%, ending the month almost 10% lower than at the end of 2019, while Plan B slipped 2% and is now down 3% for the year. Plan A is a traditional plan (duration 12 at 5.5%) with a 60/40 asset allocation, while Plan B is a largely retired plan (duration 9 at 5.5%) with a 20/80 allocation with a greater emphasis on corporate and long-duration bonds.

According to Northern Trust Asset Management (NTAM), the average funded ratio of corporate pension plans declined sharply in February from 85.5% to 81.3%. Global equity market returns were down approximately 8.1% during the month, it says. Average discount rate decreased from 2.48% to 2.3% during the month, leading to higher liabilities.

Jessica Hart, head of the OCIO Retirement Assets Practice at Northern Trust Asset Management, notes, "Diversifying assets have provided some downside protection from the broad equity decline. In particular, low volatility strategies, infrastructure and high yield bonds have performed better than a global equity portfolio."

The aggregate funded ratio for U.S. corporate defined benefit (DB) plans sponsored by S&P 500 companies decreased by 3.9 percentage points in February to end the month at 81.7%, according to Wilshire Consulting. The aggregate funded ratio is estimated to have decreased by 6.9 and 8.8 percentage points year-to-date and over the trailing 12 months, respectively, and now stands at its lowest levels since December 2016.

Ned McGuire, managing director and a member of the Investment Management & Research Group of Wilshire Consulting, says, “February marks the second consecutive monthly funded ratio decrease and the largest consecutive monthly decline in funding levels to begin a year since Wilshire began tracking in January 2013.”

The estimated aggregate funding level of defined benefit (DB) plans sponsored by S&P 1500 companies decreased by 5% in February to 79%, according to Mercer. As of February 29, the estimated aggregate deficit was $527 billion, an increase of $125 billion from the $402 billion measured at the end of January.

The S&P 500 index decreased 8.41% and the MSCI EAFE index decreased 9.23% in February. Typical discount rates for pension plans as measured by the Mercer Yield Curve decreased from 2.85% to 2.65%.

"Pension funded status has decreased by 9% since the beginning of the year as equity markets took a dive in late February and interest rates hit yet another all-time low,” says Matt McDaniel, a partner in Mercer’s Wealth business. “Concerns around the global economy loom with the coronavirus spreading around the world, illustrating just how quickly markets can react. Plan sponsors should continue to review their investment policies and consider adopting de-risking strategies as appropriate to ensure gains are locked-in when funded status improves in order to provide protection during economic downturns.”

COVID-19 boosts risk of recession – economist

By Margarida Correia
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The corona virus has substantially increased the risk of a recession, Harvard economist Megan Greene says.

The coronavirus has substantially increased the risk of a recession, said Harvard University economist Megan Greene at the Pensions & Investments' Defined Contribution East Conference in Orlando, Fla.

If the global supply shortage caused by the COVID-19 virus leads to companies going out of business, it could lead to a "demand shock," exacerbating the financial turmoil roiling the markets, she said.

Already there are indications that the "supply shock" is turning into a global demand shock, according to Ms. Greene. One is that inflation expectations have dropped sharply over the past month.

Ms. Greene noted that the Federal Reserve and central banks worldwide are limited in what they can do to address the crisis. "Rate cuts aren't that effective in the face of this kind of shock," she said. "No one has that much room to cut rates."

Fiscal policy, rather than monetary policy, can play a much bigger role, but the challenge is that "politicians have to agree on what measures to implement," she said.

Any fiscal stimulus will need to be carefully tailored to make sure it goes to businesses that need credit and individuals who are losing their jobs, Ms. Greene said.

The heightened risk of recession, however, doesn't mean retirement savers "need to liquidate and get out of the market," she said. Instead they need to "invest defensively" in things like utilities and health care.

Exclusive: CalSTRS Develops Quarantine Plans

By Randy Diamond
Chief Investment Officer
March 9, 2020

As coronavirus cases increase, the investment office of the California educator fund has developed plans in case investment staff are quarantined.

The California State Teachers' Retirement System (CalSTRS) has developed contingency plans in case the investment staff is forced to quarantine because of the coronavirus outbreak.

"If we had to isolate or quarantine all of ourselves, we would be able operate with a skeleton crew and still manage, not just the whole portfolio, but certainly the trading desks," said Chris Ailman, the system's chief investment officer.

Ailman made the comments to the CalPERS investment committee on March 4. The teachers' defined benefit plan is the second-largest US pension system with around $250 billion in assets.

More than 55% of CalSTRS assets are internally managed by its investment staff.

Ailman, shows a tape of the meeting, said when most people "think of disaster recovery, they think of losing the building," a reference in CalSTRS' case to its headquarters building in West Sacramento.

CalSTRS, he said, has an emergency backup location for the investment team to operate, but that the coronavirus is different.

"This is more a case of social distancing that we would all be separated from each other and need to be isolated in our homes," he said. "Then it really becomes a heavily technology-dependent solution, hopefully with the assumption that if this building had to be quarantined, the servers are still up and running, electrical supplies are up and running, and internet and cell providers are up and running."

Ailman said investment staffers could work from their homes for a short period, "fairly effectively," if needed.

But he noted, "Let's hope we don't get to that."

California has had at least 114 residents tested positive for COVID-19, one of the most hard-hit states along with New York and the state of Washington. One of the residents with positive tests is from Sacramento County, where a large portion of the CalSTRS investment staff lives.

Ailman also had some bad news for the investment committee as to the effect of the coronavirus on the system's investment returns for the 2019-2020 fiscal year. CalSTRS runs on a fiscal year that starts on July 1, and returns through February 28 were 8.2%, the CIO said. Ailman said that by March 3, the overall returns for the fiscal year had dropped to 4.5% because of the (equity) market reaction to the coronavirus.

"So it took about 4% off our total return," Ailman said.

The CIO did not reveal how much the pension plan had lost in its stock portfolio. It had $126 billion invested as of January 3, CalSTRS statistics show.

Ailman said those details would be provided to the investment committee in closed session.

He did say the pension plan had made money during the coronavirus crisis in its more than $31 billion fixed income portfolio and its approximate $23 billion risk mitigation strategies. He said the specifics would also be discussed in closed session.

CalSTRS has built the risk mitigation strategy over the past several years to counter a prolonged equity downturn. It combines US Treasuries with other complex hedge fund type strategies such as trend-following and alternative risk premia.

Ailman said what will happen investment-wise in the next few months until the end of the June 30 fiscal year is unclear. CalSTRS shoots for a 7% assumed rate of return each fiscal year.

The pension plan is under 70% funded.

“It’s just really tough to forecast at this point how it will play out from an investment staff standpoint,” Ailman said.

He said the pension plan’s risk allocation committee is meeting regularly to see if portfolio adjustments are needed. He said CalSTRS liquidity bucket has been increased but did not offer specifics.

The pension plan had $3.75 billion in liquidity assets as of January 31, CalSTRS financial records show.

Ailman said investment research firms that CalSTRS staff had talked to are assuming “that we might have at least a quarter of no growth or maybe two quarters of no growth in the U.S.A., which is in essence a recession for us.”

Still, the CalSTRS CIO says it’s impossible to determine the future, because we don’t know how big the coronavirus will grow. He said one thing is clear: market swings are likely.

“The market’s going to be probably pretty volatile as it reacts to the news as it comes out,” he said.

Ailman said the ultimate unknown is what happens post-virus, say in the summer of 2020, as to whether the market will resume its bull activity cycle that had been interrupted by the coronavirus.

“The question will be, does the economy restart right where it left off?” he said.

Michael Golden
Director of External Affairs
Maryland State Retirement and Pension System
120 East Baltimore Street | Baltimore, MD | 21202-6700
Tel: 410-625-5603 | 1-800-492-5909 | TDD/TTY: Maryland Relay
sra.maryland.gov