Retirement News Highlights

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Table of Contents

Public Pensions Suffer Worst Investment Quarter Since 2020

Funds still outperformed all-plan assets, 60/40 strategies
Pensions allocate more to risk investments, raising volatility

By Hadriana Lowenkron
Bloomberg
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Public pensions this year endured their worst quarter of investment performance since the onset of the Covid-19 pandemic in 2020.

Public pension assets posted a median return of -8.86% for the second quarter and -7.91% for the year ended June 30, according to a report published Tuesday by Wilshire Trust Universe Comparison Service. The pension funds still beat returns for all plan assets tracked by Wilshire, which posted a median return of -9.63% for the second quarter and -10.59% for the year.

Pension funds three years ago posted returns of 6.46%, and five years ago reported returns of 6.82%.

“If you look back 50 years, you’ll be hard pressed to find another quarter where global equities were down by double-digits and investment-grade bonds were down 5%,” said Wilshire President Jason Schwarz in a statement accompanying the report.

Both large and small public pensions outperformed the traditional 60/40 portfolio loss of -11.36% and the multi-asset Wilshire Risk Parity-12% Target Volatility Index loss of -12.37% for the quarter. The same is true for the year, with public pensions beating the 60/40 portfolio loss of -13.42% and the WRP-12% index loss of -11.41%.

Public pensions have increased their allocation of assets to risky investments such as publicly traded stocks, private equity and hedge funds to more than 66%, according to a May 2022 report by Pew Charitable Trusts, increasing the chances for volatility in their portfolios.

Earlier this month, Wilshire Associates, a consultant to pension funds, said that second-quarter losses caused state retirement systems’ percentage of assets to promised benefits to decrease to 70.1% from 81.4%. State pensions have a median assumed rate of return of 7%, according to the National Association of State Retirement Administrators.

Back to top

Defined Benefit Plans May Have New Life

Don't call it a comeback: Plan sponsors could thaw frozen defined benefit plans to return them as a retirement benefit for workers.

By Noah Zuss
PLANSPONSOR
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Defined benefit plans, the dinosaurs of the retirement world, may once again roam the private-sector benefits landscape, according to retirement industry veterans with pension actuarial expertise.

For plan sponsors with a frozen defined benefit plan, it could be a good time to consider unfreezing, says Zorast Wadia, principal and consulting actuary, Milliman.

Regulatory relief from Congress in the American Rescue Plan Act, economic and labor market conditions, hybrid pension plan designs and the emergence of modern investment approaches such as liability-driven investing—which focuses on using fixed-income instruments with durations matched to plan liabilities—have coalesced into a favorable environment for plan sponsors to consider defrosting a frozen pension plan, Wadia argued in an article for Milliman.

Innovative plan designs, including cash-balance and variable annuity plans, can enable employers to essentially eliminate the two biggest balance sheet risks posed by traditional pensions—those from interest rates and investment returns.

ARPA Effects

The conditions for considering defrosting a frozen DB plan may never again be as optimal as they are now, which should drive employers to consider a reopened pension, Wadia says.

"Now, plan sponsors have got this tremendous boost—they almost got a restart," he explains. "It's like we have this new blood or lifeline injected in these pension plans with the American Rescue Plan Act that was passed in March of 2021, essentially, that allowed plans to be now fully funded."

ARPA allowed "plan valuations' liabilities to be based on interest rates that reflect what I'll call 'smoothing,' or they have certain mechanisms built in there so the interest rate can't go lower than 5%. What that does is it stabilizes the liabilities, and that funding relief was provided through the end of the decade, through 2030," Wadia says.

Per IRS rules, ARPA provides that for DB plans, the floor for the 25-year average of interest rates cannot be less than 5%.

"Nothing is free, but use this contribution of cash funding relief wisely," he says, "and as long as you create a plan design structure where your assets and liabilities are essentially going to be matched and be fully funded, then in a sense, they are free—because you've managed them properly."

Michael Marks, senior vice president and consulting actuary at Segal, agrees that ARPA's effects are significant for pensions.

"Recent changes to the funding rules in the United States [in] the ARPA legislation … reduced cash costs for pension plans, and also provided for a longer deferral period for paying off unfunded liabilities, which gives plan sponsors more flexibility in terms of managing their costs," he says. "And in general, we're seeing that plan sponsors have more experience in terms of managing pension plans [for] managing the costs and risks. To the extent that's something that can help benefit them in terms of their business needs and their other strategies, it's worth re-looking at and bringing back pension plans."

Marks adds that a reopened pension could reinvigorate the "social contract [that] has been significantly tested in the past few years because of the pandemic," and therefore accrue benefits to the employer with regard to worker loyalty and a heightened ability to attract and retain talent.

Avoiding Past Pension Mistakes

Plan sponsors will want to proceed cautiously to not repeat past mistakes and consider how a thawed-out pension can withstand down markets, effects to funding and beneficiary obligations challenges that are sure to emerge, Wadia says.

He suggests that plan sponsors can draw upon better plan designs to ensure plan assets are aligned with and track plan liabilities. Plan sponsors were influenced to freeze pensions from financial crises, but employers were only focusing on one side of the balance sheet, Wadia says.

Plan sponsors also stumbled in the past by making pension benefits richer at times of surplus.

"When times are good, I'm going to increase my benefits, but when times are bad, I'm going to freeze my plan [and] I'm not going to contribute anymore," he says. "You can't have that kind of mentality, you have to be a little steadier. But with the newer designs, you don't have to worry about the two biggest risks: interest rate and investment return. You don't want to unfreeze your plan and continue with what I'll call a traditional form—final average pay, or what some people even call a 'dinosaur' defined benefit plan," he explains. "You want a newer solution, a hybrid solution where you're always going to maintain a full funding approach that can be done through a hybrid plan, a cash balance plan or more popularly a variable annuity plan."

It may still be early days for employers to consider a reopened pension, Marks says.

One overriding consideration is timing. If a plan sponsor were to reenter the pension market, Marks says, they would need to determine the right time to do so.

"Thinking about when to reenter the pension plan environment is important, and it comes back to … why we're not necessarily seeing a lot of people acting on this now. But they're considering it. They want to see if all of the risk mitigation strategies that have been implemented prove to be successful in this current challenging environment. Then it's something that they would probably be open to considering as conditions [and investment market returns] improve a little bit," Marks says.

He says that plan sponsors have "robust tools available for managing plan costs and risks, both on the benefits or the liability side, as well as on the asset side," such as variable annuity plans, that may make a reopened pension more than a passing consideration.

Considering the Benefits

One factor driving plan sponsors to consider a pension thaw, Marks says, is competition for employees.

“Are [employers] looking to be more competitive [for] recruiting, or retention? [For] developing a strategy that’s best for their organization and for its people, a pension plan can be a very powerful tool to help meet those needs and those strategies,” Marks says.

Wadia also suggests that for plan sponsors, moving a DB plan out of deep freeze may make financial sense, distinguish an employer in the battle to attract and retain talent and improve employees’ financial outlook. Additionally, the tax and cost implications of the pension, with regard to the total employer cost, could make it cheaper than maintaining a match or contributions to workers’ individual defined contribution accounts.

Employers should “start by looking at what you’re currently paying annually in your defined contribution budget,” Wadia says.

“Basically, a 5% DB plan [contribution] versus a 5% defined contribution plan [contribution], you’re always going to have more tax efficiency with a defined benefit plan, even such that you might even want to lower the [rate of] accrual on the DB plan, and that’s an additional source of savings,” he says.

Plan sponsors can begin by consulting an actuary and ask, “‘What’s a 5% [of payroll] contribution going to get me in terms of a defined benefit plan? Is that going to allow me to have a 1% of pay per year of service design?’ That’s how to use your DC budget, and for your [pension] retirement formula,” Wadia adds.

Also important to consider: Many plan sponsors have frozen pensions that remain on their balance sheets that don’t have a positive function, Wadia says.

“You have this [frozen] pension plan, but presumably you’re also investing in your employee’s retirement benefits through a defined contribution program—but you have to have a DC plan in combination with a DB plan in order to make it work. And so what I’m suggesting is, if you’re a CFO, it just makes financial sense to consider utilizing the defined benefit plan—[because] you already have it.”

Ultimately, plan sponsors’ embrace of pensions could prove to head off a pension retirement crisis, Wadia concludes.

“We currently have a retirement crisis,” he says. “It’s just not elevated to the level where enough people are feeling it yet [or] speaking about it yet.”

Back to top