Principal Asset Management℠

Investment Solutions

The evolving role of CIOs in a fully funded environment

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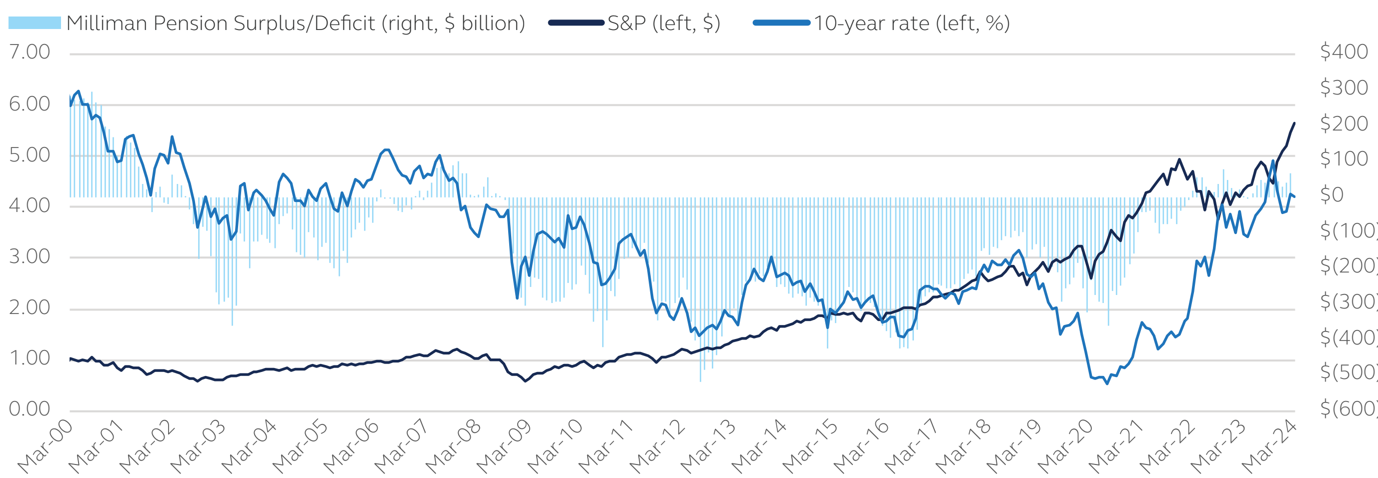
Key takeaways

- While most corporate defined benefit (DB) plans have achieved full funding, they're now confronted with a new challenge: devising a strategy to help protect their hard-earned gains and maintain their funding ratios.
- This new landscape may require chief investment officers (CIOs) to rethink asset allocations, restructure investment portfolios, shift in-house resources, tilt to a different performance measurement approach, and take a fresh look at the role of external managers.
- To maximize their chances of success, we believe that plans need to take a holistic approach by incorporating their pension liabilities within the context of developing an investment strategy.

After spending nearly 15 years fighting the headwinds of ultra-low interest rates and volatile equity markets, most corporate DB plans in the U.S. have now achieved fully funded status. Rather than declaring victory, CIOs have suddenly been confronted with a new challenge: devising a strategy to help protect their plans' hard-earned gains and maintain their funding ratios.

A "Goldilocks" moment for plan sponsors to de-risk their investment strategies



As of March 31, 2024. Source: Principal Asset Management, S&P, Milliman Pension Surplus/Deficit. S&P data depicts the cumulative growth of a dollar.

It's no small task, and the new environment calls for plans to consider a range of actions, including rethinking asset allocations, restructuring investment portfolios, shifting in-house resources, changing their performance measurement reporting approach, and taking a fresh look at the role of external managers. In some ways, the job of the CIO has never been more complex and demanding, and the stakes have rarely been higher. Fortunately, we believe that there are several things plans can do to help improve their chances of staying fully funded.

Building the right benchmark

One of the first steps that many CIOs may have to take is to put a larger percentage of their plan's assets into a liability-driven investing (LDI) strategy. Moving assets out of the growth portfolio and into the hedging portfolio is the easy part. Choosing how to structure and manage the hedging portfolio is considerably more nuanced and requires different analytical skills and staffing requirements than what plans had before achieving full funding.

To begin, plans must choose and create an investable benchmark that closely matches their liability profile along multiple dimensions, including interest-rate and credit spread sensitivities across the term structure. Unlike in the growth portfolio, there are no off-the-shelf benchmarks that will fit every plan liability, like the S&P 500, that plans can easily manage against. Instead, they need to translate their overall liability into investment terms (e.g. by calculating the duration, the credit spread, and the timing of the cashflows) and find the right mix of assets to replicate that liability.

Once they've done the work to construct an appropriate benchmark, plans need to decide what percentage of their overall assets to allocate to the hedging portfolio. The answer will differ depending on several factors including plan status (open, closed, frozen), overall funding ratio, sponsor's risk tolerance, and assets' liquidity status. In general, we have seen allocations to the hedging portfolio range from 70-90% for fully funded plans. Finally, it is imperative for plans to continuously monitor and measure their customized liability-replicating investable benchmarks to ensure that they are behaving as expected.

A five-step plan to help protect funded status

1. Analyze the liability cashflows
2. Construct a customized investable benchmark to match the cashflows
3. Determine the split between growth & hedging (LDI) portfolios based on sponsor's risk tolerance (future loss in funded status)
4. Find managers for each asset class
5. Determine whether to hire an LDI completion manager

Reevaluating the manager structure

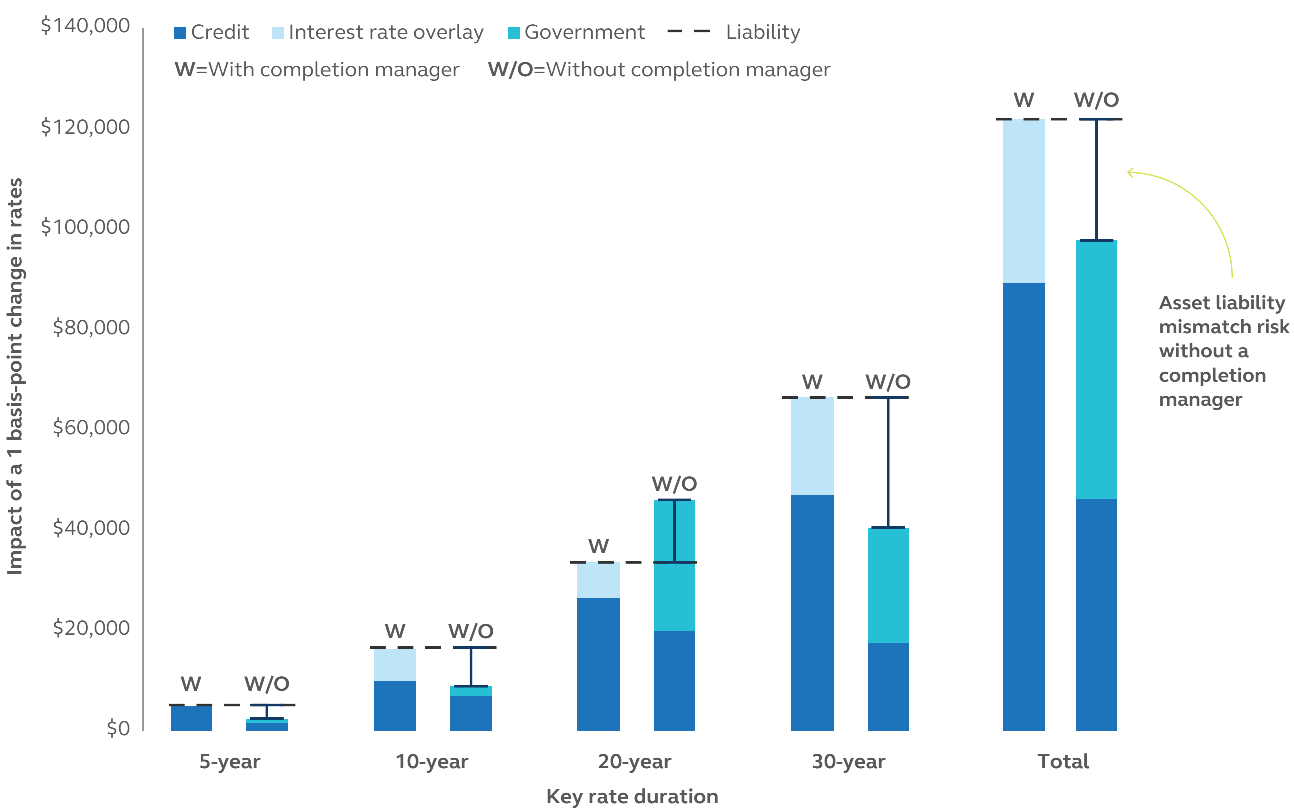
The shift of assets to the hedging portfolio may also mean that CIOs need to reassess their lineup of external managers. A manager with expertise in corporate bonds who can deliver low-tracking error returns is often at the top of the list. Beyond this core role, plans may also want to consider managers who have displayed a consistent ability to capture alpha in diversifying asset classes such as commercial mortgage loans and non-agency collateralized mortgage-backed securities. Private investment grade credit is also finding a home in many DB portfolios, thanks to its potential for delivering incremental yield (illiquidity premium) and diversification away from public-market credit.

As CIOs are selecting managers and asset classes, they also need to consider whether and how to employ derivatives and leverage in the portfolio. When plans were underfunded, many utilized leveraged positions in interest-rate derivatives in the hedging portfolio to help manage duration mismatch risk. Now that the hedging portfolio is likely to be anchored around corporate bonds, where exposure is not available synthetically, the growth portfolio may be the more capital-efficient place to use leverage, particularly for accessing large-cap public equities.

Even if plans are able to hire top-performing managers for all of the asset classes in their portfolios, they may still find that the managers' aggregate positions don't quite match the profile of their liability-proxy investable benchmark, because each manager operates in isolation. This leaves CIOs with yet another important decision to make: whether to hire an LDI completion manager.

An effective completion manager can fill in the gaps between a plan's liabilities and the managers' assets by taking a holistic view of the portfolio that includes a detailed analysis of factors such as duration and curve positioning. Of course, hiring a completion manager adds incremental management fees and an additional layer of governance complexity, so plans need to weigh the pros and the cons.

Filling the gaps with a completion manager



For illustrative purposes only. The columns represent the hypothetical impact of a 1 basis-point change in rates to strategies that use and don't use a completion manager, compared against liabilities. Strategies that do not use a completion manager can be exposed to curve mismatch risk, either being over- or under-hedged when compared to liabilities.

Rethinking resourcing

In addition to potentially changing their lineup of external managers, CIOs might also find that they need to reallocate some of their internal resources. In the long era in which underfunding was the norm, there was a strong impetus for plans to center their in-house expertise around growth-oriented assets. For fully funded plans, that equation has changed.

Now, we're increasingly seeing plans gravitate to hiring experts in fixed-income and liability-driven investing, and we've also noticed an increase in demand for employees with actuarial or financial engineering backgrounds. A common thread among these professionals is the ability to collaborate with external asset managers to analyze both sides of the balance sheet, in order to help deliver on the plan's overall objectives.

Reporting is another area where plans may find they need to reshuffle their resources. For fully funded plans, performance attribution is less about assessing how growth portfolios have performed versus their benchmarks and more about measuring funded status volatility and determining its causes. This is a big change in governance, one that requires CIOs to apply their acumen in a way that addresses the corporate objectives of the rest of the C-suite. Changing the pension committees' asset-only focus and educating them on the performance measurement relative to liabilities can be a challenge. Furthermore, the reporting content needs to shift to reflect this change in performance monitoring. Once the pension committee is on board, it's critical to develop and deliver a reporting package that utilizes all the components created by the LDI teams, the custodians, and the actuaries.

Setting up for success

It's a new world for many CIOs and their organizations, after years spent fighting against the tide of low interest rates and underfunded liabilities. Today's challenges are no less significant or complex than they were when plans were struggling to improve funded ratios. By taking the steps outlined above and increasing the focus on asset-liability management, we believe that CIOs can maximize their chances of success and help secure the financial future of their beneficiaries while simultaneously minimizing the risk of unexpected higher future contributions to the plan that may deteriorate shareholder value.

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