

David Bianco  
Chief Investment Officer &  
Strategist, Americas



### In a nutshell

- S&P 500 aggregate pension deficit at 2018 end was \$265bn or 86% funded
- Pensions have been fighting a losing war with bonds for two decades
- In S&P 500 pension-asset allocation, equities are down to 34% from 63% in 2006
- Corporate DB pension plans closed to new employees adopt LDI strategies
- The shift in pension-asset allocation is minor to equities, but material to IG credit
- Corporate sponsors should act to ensure big pension deficits never return

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## Americas CIO View

### S&P 500 pensions exit equities as funding status improves

#### S&P 500 aggregate pension deficit at 2018 end: \$265bn or 86% funded

At 2018 end, the aggregate pension deficit at S&P 500 companies was \$265bn. The total funded status, or assets to liabilities ratio, was 86%. This is the best funding ratio for S&P defined benefit (DB) plans since 2013, only better in 2007. After hitting 103% at 2007 end, funding plunged to 78% at 2008 end and then slowly improved to 85% at 2017 end. Funding improved slowly over the last ten year's equity bull market with a two-steps forward, one-step back pattern owing to multiple mini rallies in long-term bond yields that repeatedly failed, requiring lowered pension discount rates. Lower discount rates raise the present value of pension liabilities. Funding improved at 2018 end vs. 2017, despite some investment losses, owing to a small discount rate increase. Funding should be about 90% now given strong equities in first quarter.

#### Pensions have been fighting a losing war with bonds for two decades

Pension discount rates have been trending downward for two decades. In the late 1990s, the discount rate was about 7.5%, in 2006-2007 it was about 6%, and at 2017 end it bottomed at 3.6%. It climbed to only 4.1% in 2018, half from higher long-term Treasury yields and half from wider investment-grade (IG) corporate credit spreads. Current conditions suggest a discount rate just under 4%. Every 50 basis point (bp) decrease in the discount rate raises pension liabilities by about 5%. A decade ago, the sensitivity to a 50bp discount-rate change was more, owing to longer duration liabilities. Thus, declining discount rates have been a big headwind to improved pension funding.

#### S&P 500 pension-asset allocation: Equities down to 34% from 63% in 2006

Over the last dozen years, equity allocation at S&P 500 company-sponsored DB plans declined nearly 30 percentage points. Plan sponsors have reduced equity allocation as their funding status improved, in favor of higher fixed-income allocation, owing to shorter duration liabilities and thus shorter investment time horizons. This is the result of most DB plans being closed to new employees in favor of defined contribution (DC) plans many years ago. Closure to new participants causes the plan's liabilities to eventually come due, as active employees covered by the plan approach and enter retirement.

## **Corporate DB pension plans closed to new employees adopt LDI strategies**

Closure of many corporate DB pension plans to new employees cleared the future for a trend toward Liability Driven Investment (LDI) strategies for these plans. LDI strategies focus on reducing investment risk to sponsors by locking in the plan's funding status by matching assets to liabilities. If plan assets are investment-grade corporate bonds with equal duration as pension liabilities, then the plan's funding status is immune to changing interest rates. Reducing investment risk, by moving from equities to liability-duration-matched fixed income, appeals to sponsors of such mature plans when funding status is good or if the plan is large relative to the sponsor.

## **Shifting pension-asset allocation: Minor to equities, but material to IG credit**

We estimate that S&P pensions sold nearly \$400bn of equities over the past decade. At 2018 end, total S&P pension assets were reported at \$1.7trn. If the allocation to equities is reduced to 10% at 2028 that would imply about \$500bn more to sell. However, \$500bn is only 2% of aggregate S&P 500 market cap. So such sales spread over a decade shouldn't affect S&P performance. But, \$500bn is near 10% of the US IG corporate bond market. Thus, pension demand could be a material influence toward keeping spreads tight in low-default-risk or non-recession environments.

## **Corporate sponsors should act to ensure big pension deficits never return**

Pension deficits relative to company value are small for most S&P pension sponsors. The total S&P pension deficit is 1.2% of its aggregate market cap. Putting the troubled status of many plans in 2002 and 2009 behind. We are constructive on the economy and equities, but we think it prudent for plans with decaying investment time horizons to reduce their risk. The window is now open to reduce risk at a good funding status. If the funding headwinds of lower long-term interest rates blow it again, it could be difficult for equity returns to overcome them. Remaining deficits could be plugged with corporate borrowing and this would leave overall net corporate liabilities unchanged. Extra funding contributions reduce insurance premiums paid to the Pension Benefit Guarantee Corporation<sup>1</sup> and allow earlier use of pension-related deferred-tax assets.

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<sup>1</sup>The Pension Benefit Guarantee Corporation (PBGC) is an independent federal corporation that insures private defined-benefit plans. It also regulates the termination of these plans and guarantees payment to participants in the event that the plan's trust fund fails or is inadequate. All articles are available on <https://go.dws.com/cio-view-articles>

## Glossary

### Basis point

One **basis point** equals 1/100 of a percentage point.

### Duration

**Duration** is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

### Investment grade (IG)

**Investment grade (IG)** refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

### Spread

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

### Treasuries

**Treasuries** are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

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