TOP 10 DB AREAS OF FOCUS FOR 2018

Despite substantial contributions from plan sponsors, as well as strong equity markets, lower interest rates and increasing longevity, gains have left funded positions largely unchanged in 2017. At the time this paper was written, in late 2017, the average pension plan was only 83% funded, up just 1% over the past year. Plan sponsors continue to actively look at a wide range of opportunities across the pension balance sheet to increase returns, reduce the size of their liabilities and manage risk. Compounding their challenges is the new corporate tax policy, which we believe will have a significant impact on pension funding strategies and risk transfer activities. Given this highly active but uncertain environment, Mercer's team of defined benefit (DB) experts has prepared a list of key topics for plan sponsors to focus on in 2018.

1 TAX REFORM COULD BE A GAME-CHANGER

Tax reform has important and time-sensitive implications for pension funding strategies. Approximately 75% of plan sponsors[1] are already accelerating pension funding or considering doing so in 2017 with the prospect of lower taxes. Other key funding drivers include reducing PBGC variable rate premiums and funding over a shorter period to meet specific funding thresholds. Tax reform includes a reduction in the headline corporate tax rate from 35% to 21%. This makes pension pre-funding for many tax-paying sponsors more compelling than ever before. We believe many will take the opportunity to realize a higher deduction sooner, rather than later, and also realize the potential benefits of improved earnings, reduced PBGC premiums, neutralized impact on any deferred tax asset and acceleration of movement along an existing glide path. With corporate taxes reducing next year, if provide sponsors have a limited window of opportunity to contribute cash, borrow to fund or repatriate cash-generated outside the US. In conjunction with funding decisions, plan sponsors should also think about the downstream implications on investment policy, pension risk transfer action and the overall DB destination.

[1] Based on Mercer's 2017 CFO survey administered in partnership with CFO Research/Argyle Executive Forum. Report available at https://www.mercer.com/content/dam/mercer/attachments/private/gl-2017-cfo-research-pension-risk-survey-mercer.pdf.

2

RISING INTEREST RATES? PREPARE FOR THE TRANSITION FROM QUANTITATIVE EASING TO QUANTITATIVE TIGHTENING

Since the global financial crisis, we have seen monetary and fiscal policy essentially work together to provide stimulus and liquidity to the market. In the US, this has resulted in a strong and sustained bull market for both equities and bonds. However, the levers of monetary and fiscal policy are now working against each other — the Fed is gently tightening monetary policy, in tandem with a relatively new administration that is seeking to expand fiscal stimulus, primarily through changes to the tax environment. Although we saw an initial "pop" in interest rates after the November 2016 presidential election, pension discount rates have drifted down due to a combination of the market re-pricing expectations of legislative changes; a growing demand for long-duration fixed-income assets by insurers and pension plan sponsors moving down the risk curve; and a persistent tightening in spreads.

The impact for DB sponsors is a perplexing conundrum — funded status will likely have fallen, or moved sideways, at year end despite the very strong markets. And pension liabilities are going to be highly sensitive to movements in discount rates.

Looking ahead to 2018, the market will likely see very modest interest rate rises in the coming years, and market-implied inflation will remain very low.

3

ENSURE THE BONDS IN YOUR FIXED INCOME PORTFOLIO ARE FIT FOR PURPOSE

We believe that the US is now approaching the late stage of the credit cycle, as the economy is growing strongly, unemployment is very low, credit spreads have hit pre-crisis lows, leverage is rising and equity markets are moving into expensive territory. The late-cycle environment tends to be a more challenging period for investment returns, as emerging inflationary pressures may prompt more aggressive action from the Fed. As pension plans de-risk and fixed income allocations increase, it becomes increasingly important to construct bond portfolios carefully and tailor them to a plan's specific liabilities and investment strategy. As cyclical conditions evolve across the global economy, we believe the following issues warrant discussion:

- Investors should be wary of reaching for yield in credit markets, which offer historically low levels of compensation for default risk. Total credit exposure should be evaluated, and credit risk above the liability level should be reviewed.

- Reduced levels of liquidity in markets may increase the magnitude of any sell-off in markets, as illustrated by the Flash Crash in 2014 and the market decline in early 2016. DB sponsors should monitor the liquidity of their bond portfolios, as many of the higher-yielding investment grade credits come with low liquidity.

- Plans often manage their interest rate risk by increasing the duration of their bond portfolios, often through interest rate futures. This strategy can increase the “bang for the buck” in fixed income through the use of assets with a longer duration than the liability, resulting in a greater hedge on funded status than the nominal investment amount. However, such a strategy assumes that the yield curve moves in parallel shifts — if the curve significantly steepens or flattens, a mismatch in duration may result in more funded status volatility than was expected.

- Investors may consider building out their bond portfolio early, before they are ready to reduce investment risk, by using equity futures or similar instruments to maintain equity exposure, while building a portfolio of physical bonds that are consistent with the liabilities.

4

THE BEST OFFENSE MAY BE A STRONG DEFENSE

Against a backdrop of rising equity markets and falling bond yields, portfolios dominated by equities and long-duration bonds have produced exceptional returns over the last eight years. In addition, investors have enjoyed a long period in which equity and bond returns have been negatively correlated, providing a powerful diversification effect. However, on a forward-looking basis, investors need to be prepared for an environment of lower returns from equities due to declining optimism, the end of the economic cycle or economic/political shocks.

Pension plans may consider potential actions at multiple levels:

- Explicit hedges: Defensive exposures — such as options strategies, government bonds, synthetic hedges and tail-risk hedging strategies — can provide explicit protection against one or more economic/market outcomes.

- Implicit hedges: Multi-strategy hedge funds and “all weather” portfolios can dynamically shift asset allocation to protect portfolios in times of shock more quickly than may be possible with more traditional strategies.

- Accelerated glide paths: Jumping ahead a step or two on a glide path will decrease equity exposure and increase the interest rate hedging contained in the total portfolio. Just be sure you can afford the accompanying decline in EROA from the move away from equities.

- Defensive tilts: Recognizing the return drag typically associated with explicit hedges, also consider "tilts" that might improve robustness in scenarios to which the investor is sensitive and potentially exposed. This could include allocations in defensive hedge funds, senior private debt or real assets with contractual income streams.

- Additional flexibility: High-quality cash may have a role to play in reducing the risk of having to crystallize losses to meet cash outgo or collateral calls in stressed conditions, while also acting as dry powder, offering the ability to re-deploy assets at more attractive levels.

5

CONSIDER FACTOR PORTFOLIOS FOR DELIVERING TARGETED EXPOSURES WITH LESS RISK AND LESS COST

Traditional performance evaluation is the foundation to keeping your investment strategy and manager performance on track. Over the last several years, performance attribution analysis has continued to improve and now can incorporate a wide variety of "tilts" (wanted or unwanted style exposures) in the analysis. This expanded analysis can help determine whether a portfolio's returns relative to the market are due to manager skill/luck or to persistent biases in a portfolio. At the same time, factor investing strategies have become widespread to the point where the number of indexes available for tracking equity markets exceeds the number of actual equities.

For those unhappy with active management and concerned about costs, the ability to replicate some portion of manager returns at a low cost via factor-based strategies increases with each new strategy. Systematic biases to the usual manager themes of "quality," "value," "momentum" and so on can be replicated at very low cost.

Factor strategies are offered as both indices and active (factor) strategies. Factor strategies vary widely and should be considered a form of active management, even when offered in an index format. Some factor strategies can play a useful role in building robust equity structures, bringing cost and transparency benefits. However, as with all active approaches, investors need to ensure that they have a full understanding of each strategy's characteristics, pitfalls and expectations. Although some factor exposures have worked well in the recent past, an excessive reliance on continued outperformance of that factor can lead to significant style bias and the potential for divergent performance from the broader market.

Setting up a portfolio construction framework that sits alongside a risk, liquidity and fee budgeting process will help analyze portfolio return drivers and achieve the investment objectives.

6

ARE YOU EFFECTIVELY MANAGING PRIVATE ASSET CLASSES?

Alternatives and private assets can add value to a long-term investor like a pension plan, since the plan may be willing to accept illiquidity if it results in an expected long-term return premium relative to liquid investments. However, illiquidity can create challenges as plans move along a de-risking glide path or make substantial distributions. Although some alternative assets, such as many hedge funds and some real estate investments, have reasonable liquidity, others, such as private equity, offer very limited ability to redeem an investment. For truly private illiquid investments, trying to sell an interest to another investor is likely to result in a meaningful markdown in value. This means that plans should evaluate their illiquidity budgets (they may be larger than expected) and test those budgets throughout their strategic timelines.

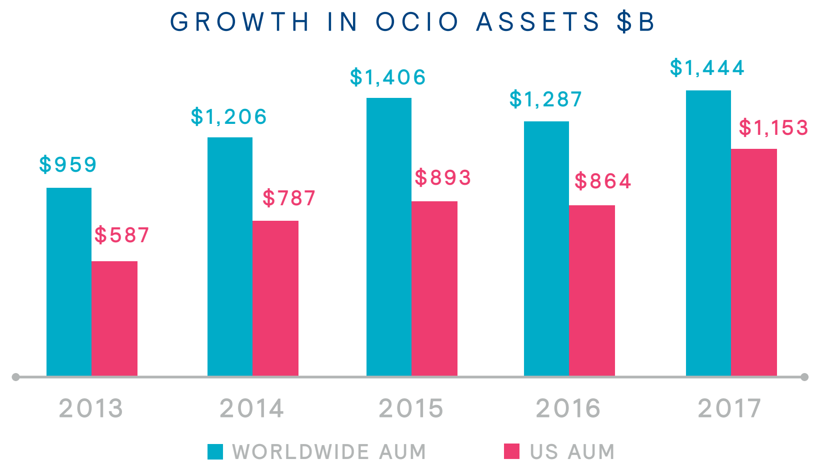
Some particular considerations:

- Investors should incorporate liquidity considerations into their plans for executing their glide paths.
- Sponsors whose long-term plans are to settle significant liabilities on a set schedule should plan ahead and begin reducing their commitments well before the settlement events are anticipated.
- Plans should develop “illiquidity budgets” to ensure they are utilizing their ability to invest in illiquid assets while also ensuring they are able to execute their long-term strategies.
- Plans with higher liquidity needs could consider the more liquid approaches to private investments, such as private debt instead of private equity, open-ended real estate instead of limited partnerships, and hedge funds with less restrictive liquidity covenants.

7

CONTINUE TO DEVELOP YOUR INVESTMENT GOVERNANCE MODEL

Over recent years governance models have been developed to assist fiduciary committees with their responsibilities. One approach that has grown rapidly is the OCIO, or delegated, investment management model. The chart below shows the growth rate in worldwide and US assets under management (AUM). Over the period, compound annual growth has been 18%.



Source: Cerulli Associates

The key reasons[2] cited by fiduciary committees for moving to an OCIO framework have been:

- Lack of internal resources — 58%
- Improve governance framework — 58%
- Seeking improved performance — 31%
- Cost efficiencies — 25%

Given this is a rapidly developing area, we recommend that clients review their governance model and determine any potential benefits in moving to a new one.

8

WHAT RISK TRANSFER STRATEGY IS RIGHT FOR YOUR PLAN?

Pension risk transfer activity has experienced robust growth over the past five years. The business case has become increasingly compelling considering dramatic increases in PBGC fees, on top of existing financial risks and operational complexities. Understanding the plan sponsor's unique financial implications and impact on the pension journey will help determine the ideal conditions for launching new activities. Market and plan dynamics will have an impact on relative pricing, and engaging the insurer marketplace early in the process will help bring clarity to the potential financial outcomes and sensitivities. Articulating the business case, and working through many of the readiness steps in advance, will enable plan sponsors to move quickly to promote efficient execution if and when a transaction is compelling.

[2]Cerulli Associates. *The Cerulli Report – U.S. Outsourced CITO Function 2017.*

In some cases, plan sponsors are considering partial or phased approaches with an initial focus on smaller-benefit retirees, where the financial trade-offs are most compelling. With a vibrant insurance market underwriting both retiree-only and termination annuity contracts, many sponsors are seeing favorable pricing despite current interest rates. This trend is expected to continue in 2018, and we believe tax reform — if passed — will accelerate activity. Keep in mind that a significant uptick in activity could impact insurer capacity and pricing, especially late in the year, and we encourage sponsors to prepare accordingly.

9

CHECK YOUR HIBERNATION PORTFOLIO

In our April 2017 paper *DB Pensions and the Emergence of the Big Bang Strategy*,[3] we described a confluence of factors that may drive many plan sponsors to accelerate risk transfer actions, such as lump sums and annuity buyouts, with many terminating their plans entirely. As a result of this acceleration, bulk annuity capacity — capital, corporate bonds and people — will take more time to adjust, and we are already seeing some strains based on current demand as we near the end of 2017.

As more marketable obligations — such as those for in-pay retirees — are transferred to insurers, residual DB plans will have unusual and idiosyncratic features that make them more difficult to manage. This latter challenge of steady-state pension management will drive pension investing to a "hibernation" focus for many.

A hibernation portfolio is one designed to maintain a fully-funded plan for the long term, with minimal chance of cash injections. Given the future scenario described above, where residual plans have more idiosyncratic benefit structures, we anticipate that hedging strategies will have to respond to this complexity. In addition, we anticipate a continuing place for growth assets in the case where residual plans have elements that are essentially "unhedgeable."

We recommend that plan sponsors start to analyze their plan's benefit structure to determine which parts of the liability could potentially be difficult to market to insurers. This will determine the future residual plan that may have to be placed in hibernation for a period of time. Depending on the characteristics of this residual plan, the risk/return requirements might vary, but, for example, illiquidity consideration can dictate an appetite for alternative asset classes.

[3] Mercer. "DB Pensions and the Emergence of the Big Bang Strategy," 2017, available at https://www.mercer.com/content/dam/mercer/attachments/private/gl-2017-retirement-db-pensions-and-the-emergence-of-big-bang-strategy-mercer.pdf.

10

HOW RELIABLE IS YOUR DATA?

Reliable data is a critical part to any de-risking strategy. Incomplete and inaccurate data adds time and complexity into the process, and may raise challenges to successful execution. Our recent CFO surveys tell us that 85% of finance executives believe their data is in sufficiently good shape to execute a transaction in a matter of weeks.[4] However, our vast experience with conducting transactions on behalf of clients reveals that data readiness presents a much more significant risk to a transaction than may be appreciated – less than 85% of firms engaging in a transaction actually have sufficient data to proceed. Because of the uncertainty, timing may be slowed, opportunities missed and pricing impacted. Consider data quality and cleanup needs as early as possible so that the most efficient plan can be built to resolve issues. A data assessment will provide you the necessary information to build a data-readiness plan that is personalized to your needs. With data gaps and challenges addressed early in the process, sponsors will be able to monitor the market and make quick decisions to begin de-risking projects. In addition, they will reap the benefits of a smoother administration process while awaiting the next steps in their journey.

[4] Based on Mercer's 2017 CFO survey administered in partnership with CFO Research/Argyle Executive Forum. Survey report available at www.mercer.com/content/dam/mercer/attachments/private/gl-2017-cfo-research-pension-risk-survey-mercer.pdf.

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