Kamp Consulting Solutions, LLC

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Fireside Chat

Your Monthly Update from KCS

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You Can't Manage What You Don't Measure!

In the April 2015 *Fireside Chat* titled, "Pension Plan Liabilities: See Me, Feel Me, Touch Me", we discussed the idea that plan sponsors need to focus on their fund's liabilities, as much as, if not more than, their plan's assets. It shouldn't be a shocking statement since the only reason that the plan exists is to fund a promise (benefit) that has been granted. Yet we often get strange looks and frowns every time we mention this concept.

Why? Well, for over 50 years, pension sponsors and their consultants have been under the impression that if the return on assets (ROA) objective is achieved or exceeded, then the plan's funding needs shall be sated. Unfortunately, this is just not true. If the last 5 years (ending 9/30/15) have proven anything, a plan can achieve the ROA and then some, only to have the Funded Ratio decline and the Funded Status deteriorate, as liability growth exceeded asset growth (source: Ryan ALM).

We place liabilities - and the management of plan assets versus those liabilities - at the forefront of our approach to managing DB plans. Pension America has seen a significant demise in the use of DB plans, and we would suggest it has to do with how they've been managed. It will only get worse if we continue to support the notion that only the asset side of the pension equation is relevant. Focusing exclusively on the asset side of the equation with little or no integration with the plan's liabilities has created an asset allocation that can be completely mismatched versus liabilities. It is time to adopt a new approach before the remaining 23,000 DB plans are all gone!

Our Suggestion

As this article's title suggests, to manage the liability side of the equation, one needs a tool to measure and monitor the growth in liabilities, and it needs to be more frequent than the actuarial report that is an annual document usually available 3-6 months following the end of the calendar or fiscal year.

Inside This Issue

Such a tool exists - it is readily available, yet under-appreciated and certainly under-utilized! KCS can provide this tool to DB plan sponsors; namely, a **Custom Liability Index (CLI)**. This is a real time (available monthly or quarterly) index based on a plan's specific projected liabilities which are found in a standard actuarial report. Furthermore, the output from this index should be the primary objective for a DB plan ***and not*** asset growth versus some hybrid index.

Importantly, the CLI will provide to a plan sponsor (and their consultant) the following summary statistics on the liabilities, including:

- Term-structure, Duration and Yield to Worst
- Growth Rate of the Liabilities
- Interest Rate Sensitivity
- Present Value based on several discount rates

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Different discount rates are used depending on the type of plan. GASB allows the ROA to be used as the discount rate for public plans, while FASB has AA Corporates (ASC 715) as the primary discount rate for corporate plans. Although we think that we are likely only a few years away from having mark-to-market requirements for all plans (IASB regulations), the accounting standards are certainly moving in that direction. In addition, if necessary, we can use PPA Spot Rates and MA 21-3 segments to value the liabilities, as well as the risk-free rate (Treasury STRIPS).

Having the ability (transparency) to see a plan's liabilities at various discount rates ***with*** projected contributions, is an incredible tool for both contribution management (both employer and employee) and asset allocation, which we will discuss later on in this piece.

With the regular production of the CLI, a plan will have more frequent insight into both the Funded Ratio and the Funded Status, which should be used to drive asset allocation and asset allocation changes. A plan with a poor Funded Ratio should have a very different asset allocation (aggressive) from one that is well funded (conservative), but more often than not it is the ROA and not the Funded Ratio that is driving the overall asset allocation.

Furthermore, with this new tool, we can provide insight into how much your plan's assets need to outperform liability growth in order to fully fund the plan over the modified duration of the liabilities. This is critical information because the objective is no longer the 7.5% ROA (49% of public plans have this as their objective), but specific annual liability growth, which averages about 4% - 4.5% with no interest rate moves or benefit formula changes.

Should we finally see the U.S. Federal Reserve raise short-term interest rates because the U.S. economy is getting back on track, longer-term rates might just rise, too. In a rising interest rate environment, plan liability growth is likely to be flat or negative. How nice it would be to have the primary objective have negative growth as opposed to a static ROA? A pension plan could get back to fully funded in a relatively reasonable period of time under these conditions.

So Our Plan Has a CLI – Now What?

If your garage / shed is like those among the KCS team members, you will have a number of tools that you purchased for any number of reasons, but to date they haven't been used. We can assure you that the CLI is one tool that you will consistently use, and rightfully so.

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Traditional asset allocation in pursuit of a ROA target is difficult over the long-term, and nearly impossible in the short-term. The traditional 60% / 40% mix (equities / fixed income) has an annual volatility of roughly +/- 11.5% (since the late '70s). Under these conditions, it is not unreasonable to expect that in 19 out of 20 years (2 standard deviations or 95% of the observations) the performance of a pension plan using the 60% / 40% allocation could be within a 23% range around the return target (7.5% for most plans). Such volatility affects the Funded Ratio and contribution costs. Would you be comfortable knowing that your plan could see that kind of volatility on a regular basis?

Given the potential volatility in performance, consider charting a new course. Instead of managing asset allocation decisions relative to a ROA target, which realistically doesn't reflect liability growth, manage your plan assets against your plan's liabilities. By becoming more "liability aware", we believe that overall asset allocation and risk control can be significantly improved.

Your New Game Plan

The new game plan proposes an alpha / beta approach to asset allocation, as opposed to a single asset allocation, with the allocation being dictated by the plan's Funded Ratio. In this approach, the Beta portfolio is similar to old time football: 3 yard gain and a cloud of dust, in which the allocation is designed to match and fund liabilities. The Alpha portfolio is your wide open passing game designed to outperform the opponent (liability Growth).

The purpose of the Beta portfolio is threefold: first, cash match near-term liabilities. This can be easily accomplished by converting the current active fixed income portfolio into a liability Beta portfolio. Importantly, this can be done at significantly reduced fees (10-15 bps. versus 30 bps. average active fee). Second, liquidity is enhanced, as bonds are used to match net monthly cash flows. The "Great Financial Crisis" highlighted the lack of liquidity in many plans, which ultimately was the springboard for the secondary market for alternative investments, as investors needed liquidity to meet payouts. Finally, the use of a Beta portfolio to match liabilities chronologically buys time for the Alpha assets to perform. This allows less liquid securities / investments to capture the liquidity premium that exists. Time is one of the most important investment tenets.

With near-term liabilities secured through a liability Beta portfolio, the Alpha assets will now focus on outgrowing the plan's liability growth as their primary objective and not the ROA, ***as liabilities don't grow at the ROA***. The Alpha assets will likely mirror most current asset allocations minus traditional fixed income.

"Start the liability conversation within your organization. Through greater transparency of the plan's liabilities, a sponsor can put their plan on the path to an improved funding level and a progressive reduction of investment risk. Current and future retirees will be grateful that they did!"

As the performance of the Alpha assets exceeds liability growth, a sponsor can transfer this excess growth over to the Beta portfolio, extending the liability match and further reducing risk in the overall portfolio. ***This activity will improve the Funded Ratio, and de-risk the plan while stabilizing contribution expense***.

Final Thoughts

By installing a custom liability index (CLI), your organization gains greater knowledge and transparency of plan liabilities. With this enhanced clarity comes an improved approach to asset allocation. Traditional asset allocation is difficult under any scenario. Why not adopt a new approach that will help improve funding and liquidity management, while reducing the need to use traditional active fixed income management in a low rate environment?

Vision + Liabilities = Viability

Start the liability conversation within your organization. Through greater transparency of the plan's liabilities, a sponsor can put their plan on the path to an improved funding level and a progressive reduction of investment risk. Current and future retirees will be grateful that they did!

Kamp Consulting Solutions LLC 34 Third Street Midland Park, NJ 07432
Office: 973-509-4616 www.kampconsultingsolutions.com Fax: 201-670-4454