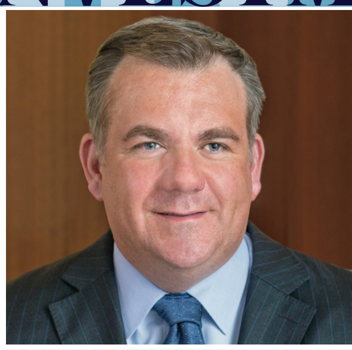
INVESTMENT INSIGHTS



Gary Veerman
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Getting ahead of the downgrade is a key to successful pension plan management

With market conditions ripe, and many defined benefit pensions closing in on becoming fully funded, more plan sponsors are discussing liability-driven investment programs with their consultants and money managers. Part of the discussion, however, should include more around the issue of credit downgrades and how those may impact an LDI portfolio.

"The market environment has created a strong tailwind," said Gary Veerman, head of LDI solutions at Capital Group. "Particularly for plans that have gone from, say, 80% to 90% funded, it's that combination of capitalizing on the market environment and reducing funded-status volatility while limiting variable-rate Pension Benefit Guaranty Corp. premiums. But it's also that people still just want to get back to running their core businesses and not a pension plan, which takes a lot of time and energy."

On its face, an LDI program is simple: have enough assets to cover the liabilities, or the benefit payments promised to plan participants. But of course there are many layers to an LDI program, not least of which is having the right mix of the right assets. To get there, plan sponsors face some challenges, the first of which, according to Veerman, is not having a plan.

"That plan might be explicit: As funded status increases, and as you have the assets to cover the liabilities you promise your plan participants, you systematically move in a derisking direction. From a governance perspective, that is a great starting point to begin thinking of the other aspects that go into developing an LDI program. Some of those things would include when you have a lot of equity exposure, what do you want the composition of your fixed-income portfolio to be?"

In many cases, a plan sponsor will have a high-quality corporate bond discount rate, long-duration credit and an equity portfolio. The problem, according to Veerman, is that often the credit and equity exposures are investments in the same companies.

"We believe LDI is a total-plan, holistic asset allocation exercise, but ultimately, your goal should be focused on risk management," he said. "We think it is extremely important to add value via the credit allocation. However, beyond the strategic asset allocation decisions about how much credit you need, you really want those credit managers to have a balance between alpha generation and downside risk management."

Here is where plan sponsors often ask about credit downgrades, or a manager's ability to avoid them. That, according to Veerman, is an important but perhaps incomplete question.

"The fact that they are asking, 'How successful have you been at avoiding downgrades?' says to me that there are opportunities to think more deeply about downgrades during the manager-selection process," he said. "I would argue that avoiding a downgrade is not a bad subject to raise, but it really should only be one dimension of successful LDI investing."

The question addresses the manager's fundamental research process well before a credit downgrade is announced by a major rating agency. "The deep fundamental research that should get ahead of a downgrade is what really matters," he said.

The issue is critical because it can have a direct impact on a plan's funded status. Veerman offered a simplified example:

Consider a hypothetical pension plan that is 100% funded with $100 of assets and $100 of liabilities. Assume the plan is invested entirely in high-quality corporate bonds and that it owns just two bonds that form the basis of the discount rate used to measure the liabilities. If the plan is perfectly matched on duration and credit quality, and one of the bonds is downgraded, the assets lose value because investors require a higher yield on that bond to compensate for the increased risk. The plan's position in the bond declines in value — in this case to $40 from $50 — and so whether the plan retains or sells that downgraded bond, its overall asset value has fallen to $90 from $100.

The plan is now effectively 90% funded.

"You lose $10 and you move on with life," Veerman said. "But the problem here is liabilities. Following a downgrade, they are valued assuming that the bond never existed in the universe. But you don't pay less in benefit payments because there is a bond that has been downgraded in your discount-rate universe. So, in this simple example, you now have fewer assets than liabilities because of the mechanics and the impacts downgrades can have on your portfolio."

One of the problems is that by the time a credit rating agency downgrades a company's bonds, the market has already priced in the company's situation. Even selling the credit one day before the downgrade — technically avoiding it — might not help because by then the plan sponsor holding the bond would have suffered the majority or all of the capital loss.

So the key to preventing losses from credit downgrades comes back to fundamental research, understanding the risks embedded in a corporation and getting ahead of these company-specific events.

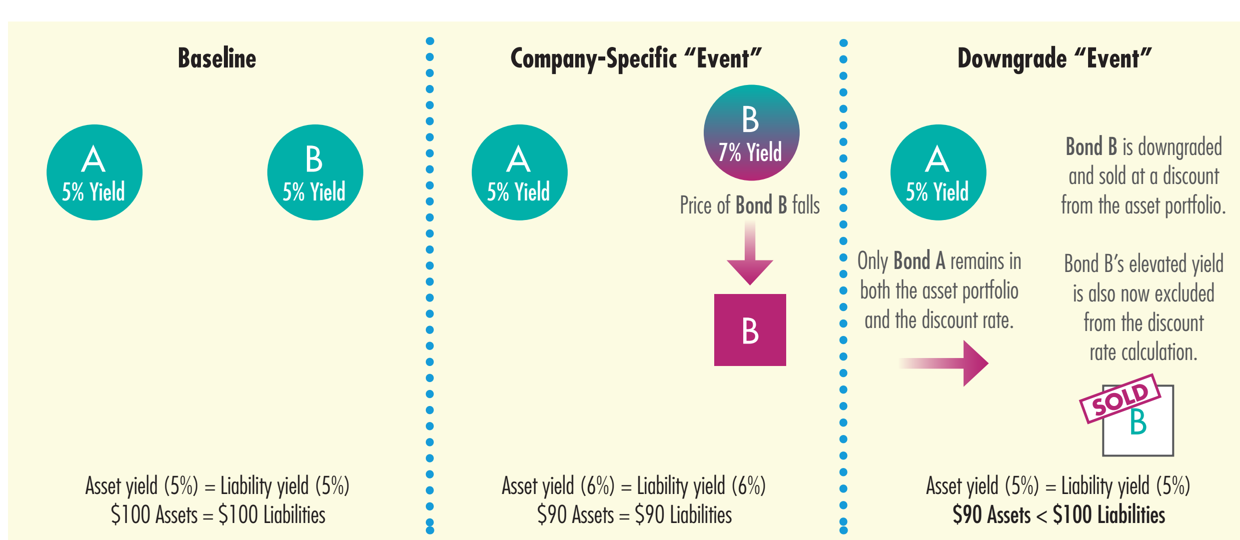
But that's not the end of the story. Veerman said that fundamental research could find a credit worth buying even after an event that might lead to a downgrade.

"When there is a market event for a company, we might actually buy that bond because the market has overreacted to the news," he said. "That's a relative value decision. If we expect high risk-adjusted returns, we would absolutely consider taking on the position."

And from a risk management perspective, a plan sponsor that holds a downgraded bond should be sure that revised value is reflected from an overall risk budgeting perspective, "because holding a high-yield bond doesn't necessarily mean your overall portfolio is more risky than it was before you held that high-yield bond," Veerman said.

So plan sponsors who are thinking about corporate downgrades should take a deeper dive, including asking managers not just how successful they've been at avoiding downgrades, but also taking a closer look at their research process and getting a fuller understanding of credit-downgrade impacts on their LDI portfolios.

"I don't think education should ever stop," Veerman said. "I think large plans are very sophisticated in their implementation methods. When you start to get to the mid-market and smaller plans, that's where they just don't have the resources to think through all these issues. So here is really where their consultant, their asset managers and other partners should work together to come up with the best solution given their unique circumstances. Given the tailwinds in the marketplace, these considerations are especially important today." ■



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