Stars Aligning For Corporate Plans to Take De-Risking Actions

Executive Summary

A confluence of factors – rising interest rates, robust US equity markets and tax reform-driven contributions – have contributed to a significant rise in US corporate DB funded levels. In particular, plan sponsors have benefited in 2018 from the dynamic of both rising interest rates and equity prices. A continued rise in long-term interest rates may prompt a more tepid equity market environment. In this short note we provide our most recent thoughts on the US corporate DB market and how plan sponsors may be thinking about de-risking today.

1. Funded Status at Highest Level Since the Financial Crisis. Our work would indicate that the aggregate system-wide funded level hit 91% at the end of September, the highest level since the financial crisis. This represents a 5 percentage point improvement in funded status YTD and a 10 percentage point increase since the end of 2016. Further, almost 25% of US corporate DB plans are likely now in a fully-funded or over-funded position, which should certainly put many in a position to take further de-risking actions. Even for plans that are not at fully funded status yet, the increase in funded ratios over the past year has likely caused many to hit triggers on their glide paths that call for decreasing equity exposure and increasing allocations to long duration fixed income. 1

Exhibit 1: System-Wide Funded Status Exceeds the “Taper Tantrum” Levels Of 2013

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Source: Goldman Sachs Asset Management, company reports; based upon the US plans (when specified) of S&P 500 companies; as of September 2018; for illustrative purposes only. The 2018 YTD estimate is subject to potentially significant revisions over time.

Past performance does not guarantee future results, which may vary.

1 Based on GSAM observations. The economic and market forecasts presented herein are for informational purposes as of the date of this presentation. There can be no assurance that the forecasts will be achieved. Please see additional disclosures at the end of this presentation. Past performance does not guarantee future results, which may vary.
2. **30-Year US Treasury Yields Have Increased About 65 Basis Points (bps) Year to Date.** In addition, they are up about 45 bps in the last 3 months alone. Some sponsors, in particular those that have glide paths tied not only to funded levels but also the level of interest rates, may have been waiting for interest rates to rise before increasing allocations to long duration fixed income. The recent upward move in yields should provide greater incentive for these sponsors to effectuate allocation shifts towards better asset/liability matching.

3. **Many Equity Valuation Metrics at the High End of Their Historic Ranges.** All of this is occurring when the S&P 500 has returned about 9% during 2018 and is close to its all-time high. Consequently, many equity market valuation metrics, as well as metrics for other risk assets, are at the high end of their historical ranges (see Exhibit 2). If interest rates continue to rise, this may have a negative impact on equity valuations, as has been evident over the first few trading days of October. Consequently, the present period may represent a window of time when sponsors can seek to lock in gains from both higher interest rates and equity valuations. This may provide further impetus for sponsors to consider taking incremental de-risking actions within their portfolios.

Exhibit 2: The Solid Macro Backdrop is Largely Reflected in Risk Asset Prices

4. **Contribution Activity Has Helped to Augment Funded Ratios as Well.** Some of the funded status improvement is also attributable to the notable contribution activity we observed ahead of the (generally) September 15 tax deadline. While there was a deadline for sponsors to make a contribution in order to potentially benefit from a tax deduction at the higher, 2017 rate, it is possible that some sponsors did not immediately invest those proceeds in fixed income. For example, we suspect some sponsors may have waited to allocate some of those contributions to fixed income until their valuations were deemed to be more attractive (see point 2). Much of the voluntary contribution activity we have seen in 2018, whether explicitly tax reform motivated or not, was sizable, representing on average about 5% of a plan’s Projected Benefit Obligation. As such, we believe many sponsors will be motivated to take actions within their portfolios to secure those recently contributed funds through better asset/liability matching investment strategies.
5. **History May Not Repeat Itself, But It Often Rhymes.** We have seen periods of time in the past when funded levels have risen, but plan sponsors did not move quickly enough to lock in those gains and subsequently lost that improvement when interest rates fell, credit spreads tightened or equity markets corrected. A quick glance back to Exhibit 1 reveals the dramatic drop during the financial crisis in 2008. But even other periods, such as 2011 and 2014, also saw notable declines in funded levels (although the latter was also influenced by mortality changes enacted at that time). Taking de-risking actions today is not about having to make a call on interest rates, credit spreads or equity valuations. Rather, it is about sponsors choosing to take appropriate risk management actions given the recent rise in their plans’ funded levels. Prudent risk management practices suggest that corporate plans may want to consider the potential benefits of taking some risk off the table today.

De-risking strategies should not be construed as providing any assurance or guarantee that as a result of applying the strategy an investor will reduce and/or eliminate risk, as there are many factors that may impact end results such as interest rates, credit risk and other market risks.
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