CA ANSWERS

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Should Corporate Plan Sponsors Continue to Hedge Liability Interest Rate Risk?

Yes, maintaining a well-hedged pension plan is prudent risk management. Global economic uncertainty, pressure on US interest rates from dovish Federal Reserve policy, as well as difficulty in predicting the path of interest rates suggest that hedging interest rate risk is appropriate. However, plan sponsors that expect rates to rise—and are willing to take additional interest rate risk—could employ a tactical under-hedge in the short term. Having a clear strategy and framework will be essential for a tactical approach to be successful.

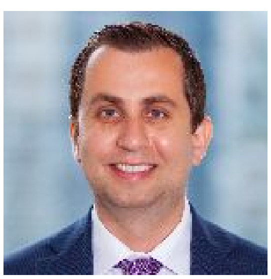
With long Treasury rates falling to around 2%—a decline of more than 140 basis points since 2018 highs—some plan sponsors may question using long-duration fixed income to hedge pension liabilities. This hesitation is understandable; a rise in rates offers the temptation of funded status gains. However, plan sponsors should recall the benefits of hedging interest rate risk in the post–Global Financial Crisis world. A prolonged low-rate environment, accounting rule changes, and a rise in PBGC premiums has led to a new mindset that interest rate risk is generally not compensated. Many investors' expectations for long-term interest rates have fallen far below the 5%+ levels seen prior to 2008, further supporting the case to maintain high interest rate hedge ratios.

Plan sponsors wishing to rely on a rosy rate outcome should understand that the world is now different. Accommodative economic policies around the world have resulted in historically low interest rates. Currently, there is almost $17 trillion in negative-yielding bonds globally, which has supported high US Treasury demand. While the US bond market remains a beacon in the world, it is not without risks. The Fed recently cut its benchmark rate for the first time in a decade, and more cuts are expected. With escalating trade tensions and slowing economic growth, it is not implausible to imagine US rates falling to 0% or even below. Indeed, the bond market has been anticipating this economic stress, with the yield curve recently inverting for the first time since 2007.

Given these uncertainties, we believe in a robust pension risk management policy, which at its heart involves a well-hedged pension plan. However, we recognize that plan sponsors have varying needs, risk appetites, and views on rates. As such, plan sponsors that expect rates to rise and wish to develop a tactical under-hedge relative to their strategic target should consider not only the reward, but also the risks of such a policy. In particular, if interest rates remain unchanged or decline, a plan's funded status will deteriorate. In addition, without a framework to unwind a tactical approach, any funded status gains may be short-lived.

Plan sponsors willing to take the risk need to develop a well-designed strategy to improve the chances of a favorable outcome. One strategy would include determining the size of the tactical under-hedge, the level of interest rates when the under-hedge would no longer apply, and a time period for the approach. A framework could then be developed to return to the long-term strategic hedge position if interest rates go back to a particular level, a certain amount of time period has elapsed, or a funding level has been achieved. For instance, a plan sponsor with an 80% strategic hedge may determine that a 3% yield on the 30-year Treasury is "normal" and the time period for position is 18 months. The plan sponsor could lower the hedge ratio to perhaps a 50% level and incrementally increase their hedge ratio back to 80% as interest rates rise, time has passed, or funded status improves.

Overall, a combination of all triggers could be considered to increase the likelihood of the strategy performing as expected. Plan sponsors should keep in mind that over the long term, hedging a pension plan with long-duration fixed income results in a better outcome. Consequently, any tactical approach should generally be short lived in nature.



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