

NAVIGATING MARKET CRISES

INSIGHTS AND RECOMMENDATIONS FOR US PLAN SPONSORS



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With the COVID-19 pandemic wreaking havoc in capital markets, pension plan sponsors are faced with critical investment and management challenges, involving multiple stakeholders and extending beyond the pension itself. Working in partnership with clients, we have found that four key issues are common among single-employer plans in particular.¹

- 1. LIQUIDITY.** March 2020's combination of a sharp equity drawdown and bond market illiquidity have recast how many plan sponsors may need to raise cash and manage liquidity, involving new thinking around cashflow planning, transaction costs, and transaction timing.
- 2. REBALANCING.** While market dynamics have pushed many plans' asset allocations away from policy targets, course correction calls for a judgment-based rather than a mechanistic approach—one that considers investments, enterprise risk, practical operational concerns, and opportunities presented by market dislocation.
- 3. IMPLEMENTATION.** In volatile times, delays in making and acting on investment decisions compound risks, especially for plan sponsors with complex governance structures. Revising established governance policies, process, and even specific roles or areas of accountability may help to counteract these risks.
- 4. COMMUNICATION.** In times of crisis, effective information sharing is especially important for the success of the plan and the enterprise itself, with the frequency and nature of the communication tailored to the specific needs of different stakeholders, including the board, corporate leadership, treasurer, and other fiduciaries.

While each plan sponsor's unique situation requires its own solution, this paper sets forth some of our observations and recommendations. It also addresses not only those with day-to-day plan oversight responsibilities, but also the committees, executives, and other constituents involved—or affected by—plan management.

Although our comments speak to the issues from the perspective of single-employer plans, many of these insights are applicable to multi-employer and public plans, with appropriate modifications. Our intention is to help plan sponsors prudently and effectively manage their pension plans in the context of their overall enterprise risk management in this time of crisis and beyond.

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¹ Single-employer plans include corporate and healthcare institutions, and some non-profits, such as universities and foundations.



LIQUIDITY

Issuing benefit payments on time is top of mind for every plan sponsor, but liquidity is also critical for risk management, particularly for asset class rebalancing and private investment capital calls. With a sharp equity market drawdown, coupled with temporary bond market illiquidity not seen since the Global Financial Crisis, liquidity has rapidly become a paramount concern for plan sponsors. Bond mutual funds, ETFs, and even individual long-duration Treasury bonds suddenly became very expensive to liquidate as bid/ask spreads widened dramatically and actual execution in this over-the-counter market became difficult. In some instances, the cost to sell a 30-year Treasury bond skyrocketed from mere basis points to as much as 2 to 5 percentage points! While, thanks in no small part to the US Federal Reserve, bond market liquidity is improving, plan sponsors may need to re-evaluate their liquidity needs and sources, as well as their cash-raising processes.

Plan sponsors should first determine whether to reconsider their contribution plan for 2020, including potentially deferring remaining 2020 minimum required contributions until January 1, 2021, as permitted by the Coronavirus Aid, Relief, and Economic Security (CARES) Act. While deferring would heighten liquidity requirements and likely lead to a reduction in funded status over time, it may be a welcome—and in some instances even necessary—move from an enterprise-wide risk management standpoint. Corporate cash needs may also call for the re-evaluation of lump sum windows and pension risk transfers planned for the remainder of 2020.

In the near term, plan sponsors also should quantify the amount and timing of their cash needs, building appropriate cushions when necessary. For example, plan sponsors going through layoffs may expect a potentially larger number of retirements and higher lump sum take-up rates, thereby increasing expected benefit payments as soon as next month. On the other hand, administrative expenses and Pension Benefit Guaranty Corporation (PBGC) premiums will likely remain consistent with prior estimates. For those with private investment programs, distributions are likely to decline and capital calls, although not expected to accelerate, could become less predictable in timing and magnitude, with some strategies experiencing higher levels (e.g., distressed debt) and others potentially declining (e.g., venture). Either way, the typical recycling of private investment distributions into capital calls may be diminished, requiring additional sources of cash.

Once capital needs are identified, the cash-raising process will vary by organization, its governance structure, and its investment vehicles. We recommend the following best practices, which may differ from an organization's "default" process:

- ☑ Avoid selling depressed assets unless absolutely necessary.
- ☑ If not already present, ensure that there are some daily-liquid bond and equity vehicles that settle within one to two days, including mutual funds, some collective trusts, and separately managed accounts (SMAs) with Treasuries.

- ☑ Raise cash gradually to average out market movements and optimize transaction costs. For collective vehicles, this means executing a sale over several days; for SMAs, this means giving managers at least several days' notice in advance of the cash needs.
- ☑ Do not “hoard” cash. Excessive cash has an opportunity cost, potentially causing the plan to miss out on market returns and to pay higher transaction costs today than in the future.
- ☑ Revisit transaction costs regularly with investment managers as markets evolve.

With respect to the last point, it's important to remember that not all bonds trade the same. Typically, corporates are less liquid than Treasuries; longer-duration bonds are less liquid than shorter-duration bonds; STRIPS are less liquid than coupon-paying Treasuries; and small corporate issues are less liquid than large ones. However, in times of market stress, due to erratic supply and demand, these relationships may no longer hold, either in general or for specific trades. While these trading dislocations may be short-lived, they may also be quite painful. In this environment, frequent communication with investment managers may help to minimize transaction costs.

REBALANCING

Market volatility in response to the COVID-19 pandemic created another challenge for plan sponsors: an imbalance relative to investment policy targets between the growth portfolio and liability-hedging portfolio and, potentially, within each of those portfolios.

To address these imbalances, we recommend that plan sponsors evaluate the current environment from both investment and enterprise risk perspectives and use expert judgment (while staying within investment guidelines and guarding against behavioral biases), rather than follow a glide path or target asset allocation mechanistically. For example, since equity valuations and credit opportunities are more attractive and interest rates are much lower than before the crisis, there may be an opportunity to slightly re-risk the portfolio and potentially de-emphasize interest rate hedging. This approach may be strategically consistent in an environment of lower funded status and lower plan contributions. However, given the uncertain economic climate and challenging enterprise-specific conditions for many plan sponsors, this decision is neither straightforward nor easy to make.

Once rebalancing targets are determined, it is important to note that the threshold for rebalancing should be higher than usual due to greater uncertainty in the market-to-market estimates of assets and liabilities, higher transaction costs in periods of illiquidity, and the time lag between the decision to rebalance and the execution of that rebalancing.

The former point bears further explanation. First, intra-month estimates of market values in asset classes with lower liquidity, higher concentration, and greater manager dispersion (e.g., emerging markets equities and hedge funds) may diverge more than

usual from the market indexes. Second, estimates of pension liabilities, which are valued using corporate bond yields, also exhibit greater uncertainty as price discovery in bonds is diminished, leading to more variation in bond yield estimates. Taken together, this means that not only is the asset market value more uncertain, but so is the funded status. For example, a funded status estimate of 82% may imply a confidence interval of 81%–83% in normal times versus 79%–85% in times of market volatility. As a result, mechanistic rebalancing, de-risking, or re-risking along a glide path may not be indicative of the actual funded status of the plan.

As for the rebalancing itself, developing a logical and robust process that balances the risk management benefit of rebalancing with its practical and operational implications is important. Needless to say, trying to time the market bottom or successfully trade based on large one-day (or intra-day) market movements is extraordinarily difficult. In general, however, decades of market history have demonstrated that sharp sell-offs are often followed by meaningful rallies, and those who bought into equities after the sharp sell-off were able to capitalize, at least in part, on recovery.

We recommend the following best practices for the rebalancing process:

- ☑ Review the portfolio more frequently, perhaps weekly rather than one to two times a month, to ascertain misalignments without dwelling on the daily “noise.”
- ☑ Rebalance not only between growth and liability-hedging portfolios, but also *within* the two portfolios, after taking into account sub-asset class valuations (e.g., growth versus value, credit versus Treasuries), transaction costs, manager-specific performance, and manager- and vehicle-specific terms.
- ☑ Optimize transaction amounts and timing, recognizing that execution may take longer, opportunity cost of cash is higher, and markets may move significantly between decision and execution, potentially causing the rebalancing to miss the mark.
- ☑ To mitigate sharp daily market movements, consider using derivative overlays to put on or take off exposure quickly, while seeking best execution in physicals.

We recognize that adopting all of these recommendations may not be possible for all plan sponsors. However, implementing even one or two, though they could require more diligence and planning than usual, may make a material difference to plan outcomes.

Rebalancing also enables plan sponsors to “play offense” by adding strategies and managers that were previously unattractive and/or unavailable. For example, given the distress in credit markets, certain mortgage strategies and closed-end bond fund strategies may now be attractive as part of the growth fixed income portion of the growth portfolio. Alternatively, certain long/short hedge fund strategies that may have cushioned the drawdown in equities could now be less attractive and serve as a source of liquidity.

A number of active managers that have been closed to new investors are accepting new capital, allowing plan sponsors to upgrade certain parts of their portfolio. Taking advantage of new strategies and managers that may have been on the “bench list” requires swift action, meaning that plan sponsors and/or their advisor will have already completed the appropriate due diligence (or are able to do so quickly). At times, these decisions can add as much value as traditional rebalancing.



IMPLEMENTATION

Delay in the investment decision-making and execution process is a significant risk that should not be underestimated in this highly volatile environment. While determining the right investment decision may often be challenging and time-consuming in the coming months, a significant additional hurdle is the ability to execute upon any decision in a timely fashion. In other words, when equity markets or funded status move by several percentage points each day, a given recommendation or decision to rebalance may become obsolete only a few days later. In fact, especially now, not investing in time once that decision is made—or, conversely, selling out of a position too late—could be more detrimental than doing nothing at all. Moreover, missing deadlines to add capital to asset classes that have experienced tremendous dislocations or to high-quality managers can deprive the plan of much-needed excess returns for years to come.

All investors today must struggle with the speed at which circumstances are changing. But for plan sponsors, the challenge is even greater due to the number of parties involved in the governance process and the fact that pension plan management is typically not these constituents’ sole, or even primary, responsibility. An unfortunately common delay is in obtaining committee approval for even a relatively small rebalancing, as committee members may be focused on other important corporate responsibilities. Indeed, investment committee members may not typically be involved in pension plan management between regular committee meetings and may not fully realize that action cannot be taken without their authority. Execution delays incurred at other stages of the plan management process, such as incomplete legal reviews, missed wires, unsigned letters of direction, or lost trade tickets, may also occur. Put together, the potentially damaging consequences of delay can have real investment implications on the portfolio.

These challenges could be mitigated by delegating some investment decision and execution authority (within policy guidelines), either to internal staff or external advisors. Potential steps to reduce bottlenecks and streamline the existing process include:

- ☑ Identify specific individuals involved at each step of the governance process and ensure that they understand their role in executing the plan’s strategy.
- ☑ Specify expectations and timelines at each step of the process.

- ☑ Delegate some decision-making authority from the committee to an individual staff member responsible for day-to-day plan administration, such as rebalancing decisions up to a certain percentage.
- ☑ Consider delegating some implementation responsibility to a third party, including preparing letters of direction and trade tickets.

Steps such as these can make implementation more efficient while still adhering to the spirit of the plan's governance framework.



COMMUNICATION

As discussed in a previous publication,² pension plans by their nature can have far-reaching impacts on an organization's financial and operational resilience. In addition to affecting balance sheets, income statements, and ongoing cash flows, there may also be implications for shareholders and employees. Consequently, during any period that is especially complex or challenging—whether prompted by a market crisis, pandemic, or an organization-specific crisis—effective communication is critical. This is true not only for the success of the plan but also for the overall organization.

Though it may seem obvious, it is essential that communications are clear, relevant, and sufficient for all parties, from the corporate management responsible for strategic and capital decisions for the organization as a whole, to the human resources department managing employee relations, to day-to-day plan managers in treasury and investment functions. In this way, contributors to plan activities and outcomes can be most responsive and effective when called upon, and those impacted by plan dynamics can be armed with the resources they need to make informed decisions for the larger enterprise. Every plan is unique, as is the plan sponsor and its organization's structure, so it is important to adapt information delivery and frequency to each stakeholder's specific needs and interests:

- ☑ A CEO or CFO is likely to be focused primarily on cash contributions, PBGC premiums, and balance sheet funded status, information that can be typically provided by the treasury or investment staff.
- ☑ The treasury or the investment function prioritizes portfolio management and monthly cashflows, which are informed by the CFO (contributions) and the HR department (benefit payments).
- ☑ The HR department is monitoring potential spikes in the number of new retirees and lump sum activity, relaying information to the investment team.
- ☑ In some situations, such as union-heavy plans or partnership plans, information may also be relayed to plan participants or their representatives, in addition to company management.

² Jeff Blazek, Alex Pekker, et al., "A Balancing Act: Strategies for Financial Executives in Managing Pension Risk," Cambridge Associates LLC, 2017.

Creating unique information “dashboards” and communications schedules for each audience can be very helpful. Balance also is key. While information is critical during periods such as this, too much or too frequent communication can be counterproductive by overwhelming or confusing recipients, or even providing an unintentionally distorted picture. Finally, it is also important to recognize that having all answers and information at any point in time is not realistic. In these situations, having even only 80% of the picture generally is better than having none—though it is then important that all parties understand what gaps do exist. If a communication framework was established before this crisis, only slight adjustments may be needed today; if not, establishing one, including key metrics and dashboards, may be well worth the effort involved.

Conclusion

With the initial chaos of the COVID-19 pandemic somewhat behind us but much uncertainty and potential volatility ahead, plan sponsors will be well served by focusing on—and possibly recalibrating—some core plan management elements that have always been key to their success. These approaches include liquidity management, rebalancing processes and opportunities, governance, and communication. Just as managing transaction costs and prudently rebalancing are crucial for pension risk management, investing in newly attractive strategies and/or previously closed managers is critical to generating strong asset returns. These activities require clearly defined and efficient governance and implementation processes that work for the plan sponsor and allow it to act swiftly. That, in turn, requires preparing a game plan for multiple market, enterprise, and liquidity scenarios, maintaining a “bench list” of potential strategies and managers, and monitoring the plan’s funded status and market conditions. Effective communication rounds out the overall management process.

Achieving these objectives, both in this current crisis and in challenging periods still to come, will require some form of evaluation and preparation for many plan sponsors. Depending on each unique situation, that preparation may include implementing relatively modest changes to existing internal procedures, or more significant alterations to the governance structure, such as potential outsourcing of day-to-day investment oversight to a discretionary manager.

While this report addresses recent- and near-term challenges, the implications of the past few months will likely be felt throughout this year and beyond. In particular, plan sponsors should analyze the “big picture” impact of the new economic environment on their specific enterprise and the subsequent implications for the pension, stress-test potential market and contribution scenarios, and ultimately re-underwrite their investment strategy, including key return objectives and risk metrics. We have found that having a pre-defined strategy and plan to navigate around these issues positions a plan sponsor well to play good defense and good offense in times of crisis. ■

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