

Markets Update: Exchanges at Goldman Sachs: The State of U.S. Corporate Pension Plans

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Jake Siewert: Welcome to our Exchanges at Goldman Sachs Markets Update for Friday, March 19th. Each week we check in with a leader across the firm to get a quick take on what they're watching in markets.

This week we're looking at how the rising interest rate environment has affected corporate pension plans and what that means for participants in those plans.

I'm Jake Siewert, Global Head of Corporate Communications here at Goldman. And today, I'm joined by Mike Moran, Senior Pension Strategist in Goldman Sachs' Asset Management division. Mike, welcome back to the program.

Mike Moran: Thanks Jake. Good to see you.

Jake Siewert: So, you every year do a study on pensions. This is its 19th year, which is remarkable. And the study this year revealed yet another year when funded levels didn't really change that much despite strong financial asset returns last year. So, in 2021, asset levels, again, rising quite dramatically. What have you found so far in your research this year?

Mike Moran: So, Jake, we have completed our annual review of US corporate pension plans. And 2020 was another year when financial asset returns were very strong. Yet, funded levels didn't really rise. With both equity and fixed income markets delivering strong returns last year, many plans posted actual asset returns across their entire portfolios of around 12 to 16 percent, so, quite strong. Yet, despite that, many plans actually saw their funded status fall last year. And for some that did post a year over year increase, it was only due to a large contribution that was made by the sponsor. And the main factor causing this dynamic of strong asset returns, yet funded status not improving, is that low interest rate environment that increased the value of pension liabilities.

Now, this has reversed in 2021. 30-year bond yields have risen about 70 basis points this year. And that has brought down

the value of pension liabilities, increasing the funded level of the system. And this has been welcome news to many corporate DB plans, and something that they have been waiting for for quite a long time.

Our work would suggest that in aggregate, corporate pensions are now about 94 percent funded, which is up over 15 percentage points since the debt of the COVID crisis last March. So, that really has been quite a dramatic improvement.

Jake Siewert: So, markets are pretty volatile. Can change any time. What steps are companies taking, if any, to lock in some of the gains they've seen in their plans?

Mike Moran: So, Jake, you've really hit on the key issue here, and that is, what do plan sponsors do now to take advantage of these increases in funded levels? And we would recommend that sponsors review their asset allocation and investment strategy, in particular, potentially better aligning plan assets with plan liabilities. Pension obligations are bond like in nature. They represent a stream of future cash flows, the value of which rises and falls as interest rates rise and fall. So, the best way to match that is to grow a duration-matched fixed income portfolio. By shifting asset allocation now in that manner, it reduces the chance of large drawdowns and funded levels in the future.

Now, we've seen periods of time like this in the past when funded levels rose, either because interest rates went up, equities went up, or both. If we go back to 2013, the taper tantrum led to a spike in yield and funded levels rose accordingly. During parts of both 2018 and 2019, we saw funded levels increase due to movements in both the equity and fixed income markets. And some plans did adjust asset allocation at those times to take advantage of those increases, but others did not. And we think this is an opportune time to, again, revisit asset allocation with the goal of reducing funded status volatility and avoiding large drawdowns in funded status like we saw in March of 2020.

Jake Siewert: So, you know, pensions have evolved quite a bit over the past several decades. Give us a sense of how many individuals are still covered by traditional pension plans or defined benefit plans, and what this improvement means for them.

Mike Moran: It's no secret that US companies have been moving away from defined benefit plans for several decades now. And in

some cases, that has involved not admitting new employees in the plan when they join the company. So, when somebody new joins the company, rather than being covered by the defined benefit plan, they're only covered by a defiance contribution plan.

In other cases, companies have completely frozen the accrual of new benefits. So, nobody in the plan is earning benefits anymore. So, even if you're in the plan today, you've accrued a benefit from your prior service, but you're not accruing any new benefits going forward.

But keep in mind, those actions, while they slow the growth of pension obligations don't end the plan. The plan and the obligation to participants still exists. And in many cases those liabilities will live on for many, many decades. So today, despite this movement away from defined benefit plans by many corporations, there are still over 20,000 corporate defined benefit plans in the United States that cover almost 25 million people. So, they are still a very important part of the retirement system here in the US.

The recent improvement in funded levels is good news for participants in these plans because it should give them greater comfort that their benefits are secure. But it is really good news for plan sponsors that in many cases have seen their funded levels remain frustratingly low over the past ten plus years, despite strong financial asset returns. And again, that was really due to falling interest rates and historically low interest rates during that period.

Jake Siewert: Well, finally Mike, given the improved economic outlook, how do you think pension plans might approach or reshape their investment strategies this year? And how might potential allocation changes affect broader asset classes?

Mike Moran: So, for corporate pension plans, as we've discussed, this may involve shifting asset allocation away from equities and towards fixed income to try to lock in some of those higher funded levels. Now, you may ask with interest rates rising and concerns about inflation increasing, why would they buy fixed income today? And we would come back to the reality that for many plans, especially those that are closed to new participants or which have frozen their benefit accruals, this exercise becomes less about investing per se and more about asset liability matching. And that means more fixed income.

When we think about some of our other pension clients, such as

public pension plans, the improved economic outlook is welcome news. But the reality for all investors is that the next few years may be challenging from an asset allocation and returns perspective. We have rising, but still historically low long-term interest rates here in the US, which may lead to a challenging return environment for fixed income investors. Equities here in the US just touched new all-time highs and are in the tenth decile evaluation, potentially leading to lower returns going forward than what we have seen in the past. And when we take that and put it all together, our work would suggest that a traditional 60/40 portfolio may be hard pressed to achieve even a nominal 5 percent annual return over the next few years.

So, all of this may lead investors to consider different strategies. Or lean more into some strategies that they already have in place. So, this could involve increasing allocations to private assets such as private equity, private credit, real estate. It could involve tilting more of their public equity allocation to active strategies as the environment for active managers appears to be better and the ability to add alpha to a portfolio will become increasingly important if market returns are muted. It could also involve incorporating an opportunistic leave into portfolios to try to be nimble and take advantage of dislocations like we saw in the first half of 2020. And again, this is really applicable toll of our investing clients, not just our pension clients.

Jake Siewert: All right, Mike. Pleasure as always to chat with you. Thanks for joining us today.

Mike Moran: Thank you, Jake.

Jake Siewert: That concludes this episode of Exchanges at Goldman Sachs. Thank you very much for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating or a comment.

This podcast was recorded on Tuesday March 16th, 2021. Thanks for listening.

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