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Recent Market Volatility — Impacts on Retirement Plans

Financial markets have been experiencing extreme volatility since the middle of August, with substantial losses that could significantly impact both the funded status of defined benefit pension plans and employees' defined contribution balances. Additionally, bond yields have also fallen resulting in lower discount rates for valuing defined benefit plans — which increases plan liabilities. When combining recent significant asset losses and higher liabilities, we believe plan sponsors should take a focused look at their overall pension plan risk profile and asset allocation.

Impact on Plan Costs and Budgets

With the budget season approaching for many plan sponsors, we recommend sponsors proactively review year-end projections of their plans' funded status and impacts on their balance sheet, 2016 accounting expense, contribution requirement and PBGC premiums. Depending on the funded status at year-end, it's also possible other important items could be triggered, such as benefit restrictions on accelerated forms of payment. Plan sponsors likely will want to review these outcomes under a variety of possible year-end asset return and discount rate scenarios to have a better understanding of what to budget for and how volatile results can be under the current market conditions.

With regard to the impact of volatility on defined contribution balances, plan sponsors should also review asset fund options provided in their plans and possible educational opportunities for employees on overall investor education and retirement readiness strategies.

Asset Allocation Impacts

Any action should be considered in consultation with a plan's investment advisor. Sponsors that sell off equities run the risk of "locking in" losses that will be difficult to overcome without making additional plan contributions. Sponsors considering buying equities because they are attractively priced should consider their overall risk budget and whether the additional equity exposure would keep the sponsor within that budget. In addition, sponsors must consider whether any contemplated action would keep their pension fund within the mandates of their Investment Policy Statement.

Detailed Analysis of the Market Volatility

Investors in US markets suffered losses late in the week of August 17 that eliminated most or all of the gains during 2015. The Dow Jones Industrial Average fell 1,018 points for the week of August 17-21. Then on Monday, August 24, the US stock markets experienced significant losses early in the trading day. The Dow Jones Industrial Average fell over 1,000 points right after the opening bell. The Dow recouped much of that loss during the trading day, then fell again late in the day to close down 588 points, or about 3.6 percent. Losses continued on Tuesday, August 25th despite the market indices being higher for most of the day.

Much of this erosion of the value of US stocks can be traced to turmoil in the Chinese financial markets, where the Shanghai Composite Index and Dow Jones Shenzhen Index had nearly doubled in value during the first seven months of 2015. The major losses in the Chinese markets wiped out all of those gains. Additionally, US markets were affected by the continuing plunge in crude oil prices (down over 60% from its all-time high) and uncertainty about future Federal Reserve moves with respect to interest rates.

Defined benefit plan sponsors will want to know what impact these market events are having on the health of their pension plans. They will also want to know what second-order effects there have been on the bond markets because, among other reasons, yields on high-quality corporate bonds (AA or above) are used to measure pension liabilities under both the ASC 715 and IAS 19 accounting standards. Our observations follow.

- After the 10% drop in US stock market over the past week, will investors cut their losses and invest in bonds? Over the past few days, we have seen this happen. As a result, bond prices have increased and yields have fallen. Treasury yields are back to March 2015 levels.
  - This puts added pressure on defined benefit plan sponsors as interest rates drop. Combined with the equity losses, this is a “double whammy” for most sponsors.
  - At some point, if investors on the sidelines identify equity buying opportunities and pull money from bonds, prices will fall and interest rates will increase. It is unclear when this might occur.
- In addition to the turmoil in the Chinese markets, oil prices continue to trend downward, with prices dipping below $40/barrel, around a 60% drop from its all-time high.
  - This could contribute to inflation levels remaining near zero for the time being.
  - To the extent that inflation rates are a building block (together with real interest rates) of nominal interest rates, persistent low inflation may keep interest rates low for the near future.
  - The anticipated rise in interest rates that defined benefit plan sponsors have been hoping for may continue to be out of reach.
- Whether credit spreads will increase may depend on the market’s views on corporate financial health.
  - If the recent shocks to the market lead to credit downgrades and market uncertainty, there may be a “flight to quality” where government bonds are favored over corporate bonds. This would lead to widening credit spreads.
    - The good news is that the AA bond accounting benchmark discount rates would be higher, leading to some balance sheet relief for defined benefit plan sponsors, just as we saw in late 2008.
    - The bad news is that such a scenario would mean poor health for the economy in general.

- Conversely, if the recent shocks to the market are not thought to add risk to corporations, the lower interest rates would manifest in both risk-free and AA bond rates, leading to lower accounting discount rates. This would be bad news for defined benefit plan sponsors as it would result in higher liabilities.

What have we learned from all this?

Some possible lessons learned include:

- Diversification remains as important as ever. Plan sponsors who overweighted equities put themselves at greater risk of larger losses than sponsors whose assets were better diversified.
- Interest rates could still drop in the near term. Sponsors betting on a rising yield curve may have to wait a bit longer.
- It is critical to pay attention without overreacting to every piece of news. In volatile markets such as these, attractive investing opportunities may appear and disappear quickly. Interest rates could rise briefly and then fall back to prior levels. Sponsors and their advisors who are monitoring conditions may identify windows of opportunity to take certain actions, such as rebalancing the portfolios or taking a step down a pre-approved glide path.

In Closing

The recent turbulence in the global markets presented significant challenges to plan sponsors as well as opportunities to learn important lessons from the experience. Concerned plan sponsors should take this opportunity to review their current budget plans and investment strategy and consult with their actuaries and investment advisors to discuss the best course of action.

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