Market insights

Liability-Driven Investment Team

February 2018

The time to fund is now

Andy Hunt, FIA, CFA
Co-Head of WFAM Global Fixed Income,
Head of LDI and Global Credit

Robert McHenry
Product Specialist,
Liability Driven Investment

Jonathan Hobbs, CFA, FSA
Head of U.S. Portfolio Solutions,
Multi-Asset Solutions

Tax legislation offers a limited time opportunity for plan sponsors to act

Recently passed tax legislation (the Tax Cuts and Jobs Act) has reduced the standard marginal rate of corporate tax from 35% to 21% effective 1/1/2018. However, pre-existing pension funding and contribution rules permit plan sponsors to make actuary-approved contributions during the first 9 months of 2018 that benefit from the old 35% tax deduction. This means that contributions up to September 2018 will be able to benefit from up to a $0.35 tax shield for each dollar contributed versus those made after that date offering a tax shield of only up to $0.21. We think the limited time availability of this gift within the tax code is cause for plan sponsors to reconsider their existing glidepath strategies and accelerate contributions.

The argument to delay contributions rests mainly upon assumptions that market forces will continue to cooperate and ultimately provide a lower cost means of pension funding. Average funding levels have improved to 85% due in large part to higher interest rates, which have reduced the present value of liabilities, and to a significant run-up in equity markets that have positively impacted plan assets. Glidepath triggers have recently prompted a move toward hedging assets, yet most baseline glidepath assumptions still make meaningful allocations to risk as a source of pension funding. We believe this over-reliance on continued asset performance may present both plan sponsors and plan beneficiaries an unfavorable risk exposure to their pensions. Below we highlight why time is not on their side:

- **Return seeking assets are richly valued**

The strength and length of the bull market in equities have stretched valuation multiples to historic highs across a number of closely watched metrics. While few can predict shorter-term market moves, return expectations over the medium to longer term are dampened by high valuations. Importantly, it is longer term asset return expectations that figure most prominently within glidepath assumptions. A tactical decision to fund and de-risk fits well with the availability of the extended tax deduction.

- **Borrowing rates remain near record lows**

Credit conditions are still favorable for accessing capital necessary to accelerate pension funding. Some resist the notion of instigating a liability hedge when discount rates are low. However, if hedging assets can be contributed at the low carrying cost afforded by still exceptionally low credit spreads and absolute rate levels, the hedge can be made with cheap capital. Notwithstanding financing considerations, plan sponsors should also consider the link between increasing interest rates and the ultimate impact on risk asset performance.

- **Pension Benefit Guarantee Corporation (PBGC) premiums are on the rise**

Variable-rate PBGC premiums, which are determined by levels of pension funding shortfall, will rise significantly in 2018 and again in following years. For example, ignoring any per participant caps, each dollar of underfunding in 2019 will be assessed a $0.042 insurance premium, or $4.2M for $100M in delayed contributions. The decision to fund-up the plan can avoid this tax which is scheduled to increase annually. Coupling a funding strategy with the offer of lump-sum buyouts for low-balance participants will also avoid escalating flat-rate PBGC premiums.

- **Financial Accounting Standard Board (FASB) guidance will change reporting of NPPC**

In 2018, NPPC expenses that are reported in operating income on plan sponsors' income statements will reflect only accrual of plan benefits earned during the period. Legacy pension costs that are part of the current NPPC calculation will move to non-operating income, and importantly, the plan sponsor's estimate of Expected Return on Assets (EROA) will therefore no longer directly act as an offset of pension expense. In most situations, this is likely to increase the pension-cost component reported within operating income, thus reducing operating income. We believe a dollar of operating income is given greater weight by investors than a dollar of non-operating income, and hence there may be a reason to review the plan's investment strategy.

Each of the above suggests that a decision to delay pension funding will likely impose significant explicit costs, and/or opportunity costs on underfunded pension plans. These costs are avoidable. The concrete availability of a tax benefit that was likely not considered within baseline assumptions of most glidepath strategies is reason enough to revisit them now. Wells Fargo Asset Management has considerable expertise in partnering with plan sponsors and their consultants to achieve optimal outcomes for plan sponsors and plan beneficiaries. Please contact us to take advantage of today's opportunity.

Your LDI Team

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

Wells Fargo Asset Management (WFAM) is a trade name used by the asset management businesses of Wells Fargo & Company. WFAM includes but is not limited to Analytic Investors, LLC; ECM Asset Management Ltd.; First International Advisors, LLC; Galliard Capital Management, Inc.; The Rock Creek Group, LP; Wells Capital Management Inc.; Wells Fargo Asset Management Luxembourg S.A.; Wells Fargo Funds Distributor, LLC; and Wells Fargo Funds Management, LLC.

Wells Capital Management (WellsCap) is a registered investment adviser and wholly owned subsidiary of Wells Fargo Asset Management Holdings, LLC. WellsCap provides investment management services for a variety of institutions. The views expressed are those of the author at the time of writing and are subject to change. This material has been distributed for educational/informational purposes only and should not be considered as investment advice or a recommendation for any particular security, strategy, or investment product. The material is based upon information we consider reliable, but its accuracy and completeness cannot be guaranteed. **Past performance is not a guarantee of future returns.** As with any investment vehicle, there is a potential for profit as well as the possibility of loss. For additional information on WellsCap and its advisory services, please view our website at wellscap.com or refer to our Form ADV Part II, which is available upon request by calling 415-396-8000. Wells Capital Management does not serve as an independent advice fiduciary during the sales process to any investor.