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ASSET MANAGEMENT

LOOKING AHEAD IN 2020: INVESTMENT COMMITTEE CHECKLIST FOR PENSION PLAN SPONSORS

In the first half of 2020 investors were exposed to significantly elevated volatility in the equity markets as well as liquidity constraints in the fixed income space. At some points transaction costs jumped 10x in just a matter of weeks. For defined benefit plan sponsors, the impact of market instability was evident in funded status volatility. In the first quarter, the average funded ratio of S&P ® 500 companies declined 9% from 87.3% to 78.6%. During the second quarter, those same plans realized a 2% recovery, leaving many plan sponsors wondering how to make up for the losses.

In the face of economic, market, and political uncertainty, plan sponsors with fiduciary oversight need to remain vigilant in regards to investment considerations and overall governance for the second half of 2020. This document highlights some of the most pressing topics investment committees should be discussing in preparation for the road ahead.

What topics should be on an investment committee's agenda during Q3 and Q4 meetings?

- Rebalancing Policy and Glide Path Considerations
- Diversification
- Governance Best Practices
- The Legislative Landscape and Fiscal Policy

#1 - REBLANCING CONSIDERATIONS: HOW EFFECTIVE IS YOUR IPS?

When global equity markets fell roughly 30% from their peak in mid-February, setting a historical record for the rate and magnitude of loss, many committees were frustrated by an incomplete or outdated Investment Policy Statement ("IPS") that was absent a robust framework to guide them on important rebalancing decisions. With markets directionally positive for over a decade, updates to these critical rebalancing guidelines could have easily been overlooked. We have found that many plan sponsors either do not have a formal rebalancing policy in place or they utilize very generic rebalancing guidelines which did not provide the guidance needed to face tumultuous market conditions.

Rebalancing a multi-asset portfolio is critical to long-term growth and risk management of the plan as it allows for efficient deployment and diversification of plan assets. There are different approaches to rebalancing. Some of the more prevalent approaches include frequency based, threshold based, and risk-based methodologies. We define these terms as:

1) Frequency based: The portfolio is rebalanced back to a strategic target at a pre-determined, time-based interval. In our example, we'll compare monthly, quarterly and annual frequency.
2) Threshold based: The portfolio is assigned a target asset allocation and is permitted to drift to maximum pre-defined levels (for our example on the next page, we use +/- 4%). In the absolute method, we assume that each time we go over the 4% tolerance, we rebalance fully back to the strategic target. In the "half back" method, we assume that each time we go over the 4% limit, we rebalance back to the midpoint of the allowable range, not back to the strategic target.
3) Risk- based approach: In this approach investors only rebalance if the tracking error of the portfolio drifts to create a certain excess level of tracking error versus the policy benchmark. For our example below we've used 1%.

Note: In the following example, "buy and hold" reflects no rebalancing.

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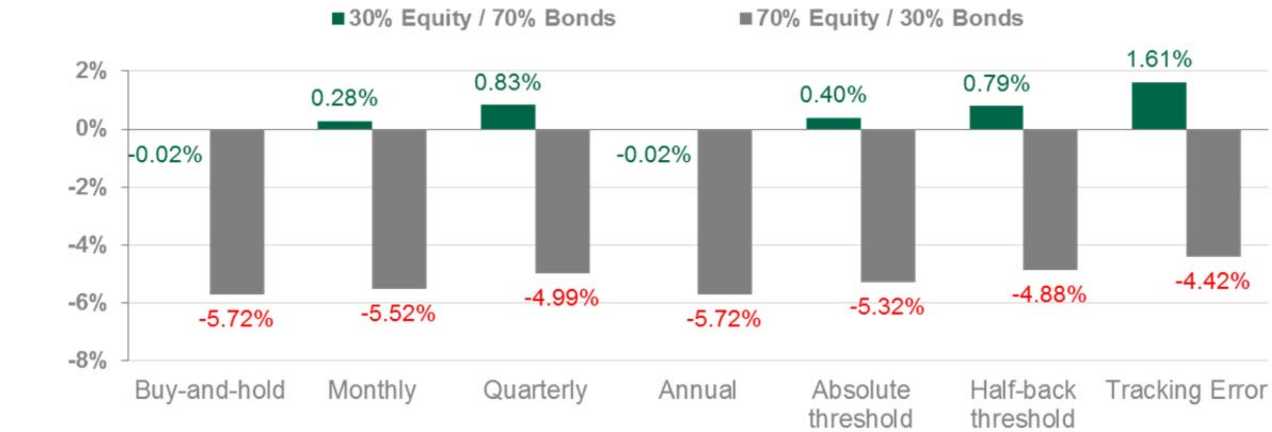
The following chart highlights rebalancing results from February 20th through June 30th of this year. What is evident through this theoretical analysis is that rebalancing during this period likely added value or was net neutral to the buy and hold portfolio. Regardless of the asset allocation, the “Tracking Error” rebalancing strategy performed the best.

VARIOUS REBALANCING TECHNIQUE RESULTS DURING COVID-19 DRAWDOWN



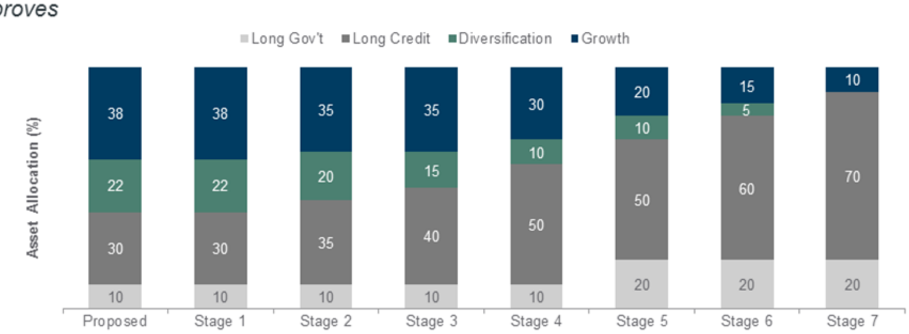
Source: Northern Trust Asset Management, Morningstar. February 20, 2020 to June 30, 2020. Past performance is no guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Please see important information at the end of this presentation.

While extreme volatility can require rebalancing, it also can pose certain practical challenges, such as reduced liquidity in the market. During the first quarter of 2020, for certain fixed income asset types, transaction costs rose sharply over a short time frame. Frequent, almost daily, equity market swings also made trade planning and execution very difficult. In this type of environment, investors must have a strategic approach to raising cash, rebalancing, and the tradeoff between transaction costs relative to the benefit of a rebalancing. An effective IPS provides flexibility around this activity to consider such practical constraints in extreme environments.

#2- GLIDEPATH CONSIDERATIONS: IS RE-RISKING ON THE TABLE?

As previously mentioned, funded ratios for S&P 500® companies fell significantly in the first quarter due to the rapid market drawdown. For those plan sponsors who have instituted a Liability Driven de-risking glide path, these events likely resulted in portfolios moving in the wrong direction on the glide path. As a result, plans likely face the difficult decision of whether or not to re-risk their pension portfolio by increasing return-seeking (diversification and growth) allocations in an effort to increase expected return and try to recover the funding gap. A sample glide path for a closed pension plan is outlined below.

Adopting a dynamic asset allocation glidepath strategy can reduce volatility as the plan’s funding ratio improves



	Proposed	Stage 1	Stage 2	Stage 3	Stage 4	Stage 5	Stage 6	Stage 7
Funding Ratio	< 85%	<85%	85%	90%	95%	100%	105%	110%
Est. Hedge Ratio[2]	~40%	~40%	45%-55%	60%-70%	75%-85%	85%-95%	95%-100%	~100%
Expected Return	5.6%	5.6%	5.5%	5.4%	5.2%	5.1%	4.7%	4.4%
Funded Ratio Volatility	10.0%	10.0%	8.8%	7.6%	5.9%	4.3%	3.3%	2.6%

Source: Northern Trust, For Illustrative Purposes Only. Unique glide paths are designed for each plan sponsor, taking into consideration the liability profile of the plan(s) and the objectives of the plan sponsor client.

There are a number of factors to evaluate when considering whether or not to re-risk investment portfolios. This includes equity market volatility and return expectations, interest rates levels and rate forecasts, contribution plans, the status of the plan, and transaction costs (in particular costs to sell long credit fixed income – which rose dramatically over the last few months), just to name a few.

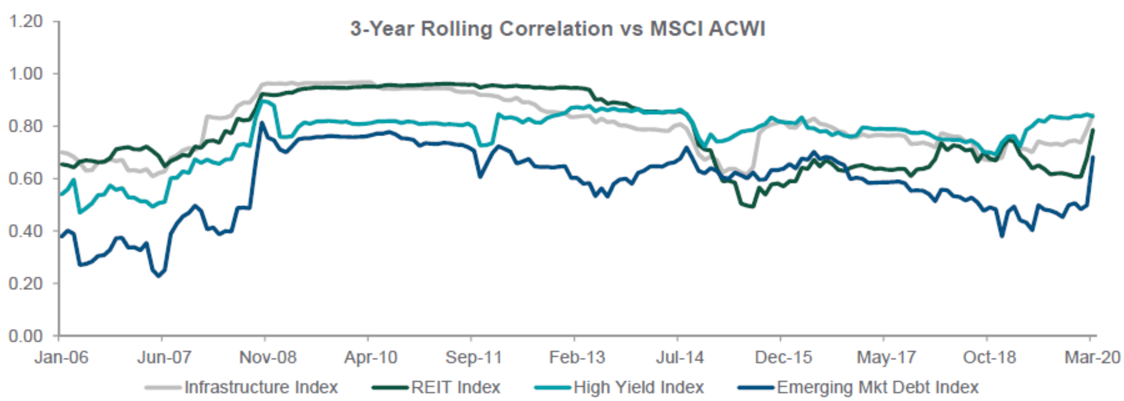
Key questions on this topic include “does your plan have a re-risking policy for your investment program” and “what factors drive the decision to re-risk”? In the case of an Outsourced Chief Investment Officer “OCIO” arrangement, your Committee should be aware if your OCIO provider has full discretion to re-risk if your funded ratio falls below a pre-determined level or if the Committee has to convene in order to decide whether or not to re-risk. We think the discussion is warranted as establishing and maintaining a comprehensive, yet fluid re-risking policy is essential to navigating turbulent market environments.

#3 – IS YOUR PORTFOLIO TRULY DIVERSIFIED?

The volatile first half of 2020 and its lasting effects are a strong reminder about the importance of diversification. Given this backdrop, it would be prudent to evaluate how your asset class exposures performed and whether your current asset allocation is structured to withstand future market dislocations. As is often the case during periods of market stress, asset class correlations typically rise and converge. In other words, asset classes behave similarly during these times due to deleveraging, panic selling, and forced liquidations by investors. As a result, even multi-asset class portfolios that seem diversified can experience severe drawdowns.

Having an intimate understanding of asset class correlations along with risk and return projections is critical for investment committees. Engaging in this process at the outset of portfolio development will help ensure that portfolios balance risk exposures by achieving proper portfolio diversification. Having this information in-hand can help your committee set expectations which will help to support disciplined investment strategies during volatile market environments.

The chart below illustrates the correlations among multiple sub-asset classes and global equities (as measured by the MSCI All-County World Index). During November 2008 and March 2020 asset classes such as Infrastructure, REITs, High Yield, and Emerging Markets Debt all experienced notable correlation spikes. However, over long periods of time the diversification benefits of these asset classes remains intact as the absolute returns for each asset class varied in comparison to the broader market (as illustrated by “Average” correlations in the chart below). Despite the recent spike, these asset classes can provide important long-term return and diversification benefits to your portfolio.



	Infrastructure	REIT	High Yield	Emerging Mkt Debt
Average	0.80	0.78	0.76	0.58
High	0.97	0.96	0.90	0.81
Low	0.61	0.49	0.47	0.23

Data as of 3/31/20. Source: FactSet & Wilshire. Index: S&P Global Infrastructure Net, FTSE ERPA/NAREIT Developed Net, ICE ML US HY Contr Mstr II Index, 50% EMBI + 50% GBI
Index Performance – Index returns are set forth herein as representative of asset class performance and as benchmark rates of return. Index performance is not representative of the returns of any fund, account or strategy. Index performance is presented for illustrative or comparative purposes only. Index returns reflect the reinvestment of dividends or other earnings and do not deduct investment advisory or transaction fees, which reduce actual returns. It is not possible to invest directly in an index. Indexes are the property of their respective owners, all rights reserved.

As investment committees reconvene, it may be worthwhile to evaluate current and potential asset class exposures in relation to plan investment objectives. If the plan is not invested in a particular asset class, does the committee know why that is the case? Are there other asset classes that could assist with achieving long-term goals? This discussion is relevant because despite recent downturns, traditional equities have exhibited strong returns over the last decade. The question now is whether or not the upward trend will continue over the next decade. If the fallout from COVID-19 is longer than anticipated and global growth wanes, the need for more prudent oversight of portfolio risk exposures will likely grow. From that perspective, we have compiled a list of asset classes and sub-asset classes below that are worthy of consideration. Both public and private investment opportunities can be accessed in order to help enhance returns and improve portfolio diversification.

Asset Class	Purpose
Global Listed Infrastructure	▪ Attractive and stable dividend yields ▪ Potential use as an inflation hedge ▪ Expanded opportunities driven by global need for infrastructure improvements
Global Real Estate	▪ A source of income that can keep up with inflation ▪ Diversification and correlation benefits
High Yield	▪ A diversified risk premium – credit vs. equity and term ▪ A source of income in a low interest rate environment ▪ Offers downside protection vis-à-vis other risk assets
Emerging Market Debt	▪ A diversified source of returns ▪ Inefficient market creating investment opportunities ▪ Growing market space
Opportunistic Private Credit	▪ Provides access to the private credit markets ▪ Investments in private floating rate fixed income securities (to help mitigate interest rate risk) ▪ Focus on meaningful current income ▪ Opportunity for higher yields in a low interest rate environment

#4 – HAVE YOU EVALUATED YOUR GOVERNANCE PROCESS?

One of the key components of prudent committee governance is to perform an annual self-assessment. On the heels of 30% equity returns in 2019 and a strong global economy, there were few market indicators that could have prepared investors for the volatile market in the first half of 2020. For the majority of pension plans sponsors, the reality was that investment decisions still needed to be made despite most having to relocate to their home offices. The market environment likely disrupted governance structures, standard practices, and committee continuity. In our view, the need for committees to assess the health and resiliency of their governance process is paramount. Here are a few questions to consider as part of your assessment:

- Did your governance procedures during the quarantine restrictions/shelter-in-place support your committee in implementing timely investment decisions, including the review of investment opportunities and portfolio risk evaluation? If so, how?
- How were the roles and responsibilities of committee members and/or pension staff impacted? Is additional support needed going forward?
- What technological tools were incorporated to maintain communication and how did technology impact your committee's oversight responsibilities?
- Did your consultant/advisor present potential investment opportunities to take advantage of market dislocations? What contingency plans are now in place in the event the need to work remotely continues?

- If you had investment strategies in place to provide down-side protection, did they perform to expectation?
- Were the operational protocols and procedures of your underlying investment managers clear and effective?
- Did operational procedures (e.g. – cash movements, trading) follow standard practices? What changes need to be made on a go-forward basis?

#5 – THE LEGISLATIVE LANDSCAPE AND FISCAL POLICY: HOW IS IT EVOLVING?

Fiscal and monetary policy activity in response to COVID-19 has been swift and far-reaching from both state and federal governments. The most notable has been the Coronavirus Aid, Relief and Economic Security ("CARES") Act, which was signed into law in late March. The Act provided direct stimulus to American workers and businesses, as well as relief to plan sponsors and participants. While many of the provisions in the Act impact defined contribution plans, there are major implications for defined benefit plan sponsors to consider. The key provisions Investment Committees should be aware of are outlined below.

- **Delayed Contributions:** For plans that have required quarterly contributions in 2020, plan sponsors are permitted to defer payment until January 1, 2021. Interest will be charged on the deferred amount.
- **Benefit Restrictions**: Likely impacting plan sponsors with valuation dates after January 1st, plans that have accelerated distribution forms of payment (such as lump sums), are permitted to use 2019 valuation results for purposes of determining benefit restrictions in 2020.

In separate but related news, the Federal Reserve's decisive actions to help support liquidity and fixed income markets have played a major role in the second quarter market recovery. Their plans of keeping interest rates low through 2022, maintaining current asset purchases, while also implementing newer lending programs, such as the Main Street Lending Program, will all be key tools in supporting functioning markets.

Looking ahead to the second half of the year, there is potential for another round of government stimulus as unemployment levels remain significantly elevated. The continued need to maintain social distancing practices could stifle recovery efforts here in the US. As more details arise about additional stimulus and/or potential implications for plan sponsors, it would be prudent to proactively communicate these updates in between monthly or quarterly meeting dates. Additionally, Investment Committees should prepare themselves for the implications of additional regulatory changes.

One such potential change resides in the Department of Labor's ("DOL) recently proposed rule impacting investment duties regulation. This rule is directly related to ERISA retirement plans that currently use or plan to adopt an Environmental, Social, and Governance ("ESG") framework. The proposal aims to provide guidance around the evaluation of such investments in a retirement plan (pension or 401k). Per the proposed rule, fiduciaries may not invest in ESG vehicles when an underlying strategy is understood to provide inferior return or increased risk to the portfolio. Many argue that the due care utilized in the manager selection process already considers such protocol. However, in the current market it is best to be over-informed and speak openly with your Investment Committee on the potential impacts of any proposed regulation. More information on this proposed legislation and others may be referenced at dol.gov.

SUMMARY

As the economic, market, and political landscape continues to evolve, the need for greater investment program oversight will increase as well. Developing and reviewing a quarterly investment committee checklist can ensure that timely and impactful topics are given top priority in meetings. The key investment considerations outlined in this paper are designed to help establish strategic priorities in order to successfully navigate the potentially challenging road ahead.

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