AON
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Executive summary

Executive summary

A not-so distant mirror

Here in the US, in Fall 2019, we watch formerly calm equity markets start to rumble, while Fed easing stirs fears that negative interest rates will spread from Japan and Europe to our shores. Aon's biennial Global Pension Risk Survey gives us a chance to look back at how things have changed, and how they haven't, since our 2009 survey.

Reading through past editions of this survey, we find a remarkable consistency over the past decade:

- Steady shift towards more liability-matching fixed income, leading to rising interest rate hedge ratios
- A concurrent dialing back of equity exposure. In most cases this is part of a policy to reduce equity and interest rate risk as funded status improves, sometimes called a 'glide path.'
- Amid rising valuations and declining return expectations for public equities and bonds, an increase in diversification of return-seeking assets.
- Shift to outsourced chief investment officer (sometimes called outsourced CIO, or OCIO) as the preferred operational and governance structure to implement the desired de-risking strategy.
- Growing comfort with the use of settlement options to eliminate the full spectrum of pension asset and liability risks for some or all of the pension plan.

This year's survey also included some surprises:

- Some respondents have shifted towards a true 'hibernation' strategy, with minimal equity exposure and close to 100% of their interest rate risk hedged.
- Derivatives playing a greater role as delegated solutions give sponsors access to more sophisticated hedging instruments.
- Aggressively settling pension obligations has helped some sponsors retain equity risk for the smaller remaining plan. While overall hedge ratios continue to rise, a significant minority of sponsors still choose to hedge less than 20% of their interest rate risk.
- Sponsors continue to explore diversifying into alternative assets — most often private equity and real estate, but a significant number cite looming plan settlements as a reason to dial back commitments to illiquid alternatives.

While the broader trend towards derisking continues, pension risk management grows increasingly diverse as each sponsor considers their own unique circumstances amid an expanding range of risk management tools. Most sponsors have taken significant steps to materially reduce pension risk. Here in Fall 2019, as interest rates take another leg down and equity markets show signs of fatigue, we note that most sponsors are now better positioned to weather a downturn than they were in 2008.

	October 2009	October 2019
10-year treasury yield[1]	3.4%	1.8%
Moody's seasoned Baa yield[1]	6.3%	3.9%
S&P 500 index	1900	3000
Shiller cyclically adjusted P/E ratio[2]	19	30
Average funded status[3]	85%	85%
Average fixed income allocation[4]	38%, mostly market duration	49%, mostly long duration
Average diversifiers allocation[4]	11%	19%
Average expected return on pension assets[4]	7.8%	6.0%
Cumulative percentage of US corporate pensions settled via pension risk transfer eg, lump sum windows, buyouts	Less than 1%	Around 9%
Percentage of survey respondents that:		
Monitor funded status at least quarterly	12%	76%
Delegate implementation of pension investment policy	15%	38%

[1] Source: St. Louis Federal Reserve [2] Robert J. Shiller, www.econ.yale.edu/~shiller/data.htm
[3] For S&P 500 plans. Source: Aon Pension Risk Tracker [4] For S&P 500 plans

Survey methodology

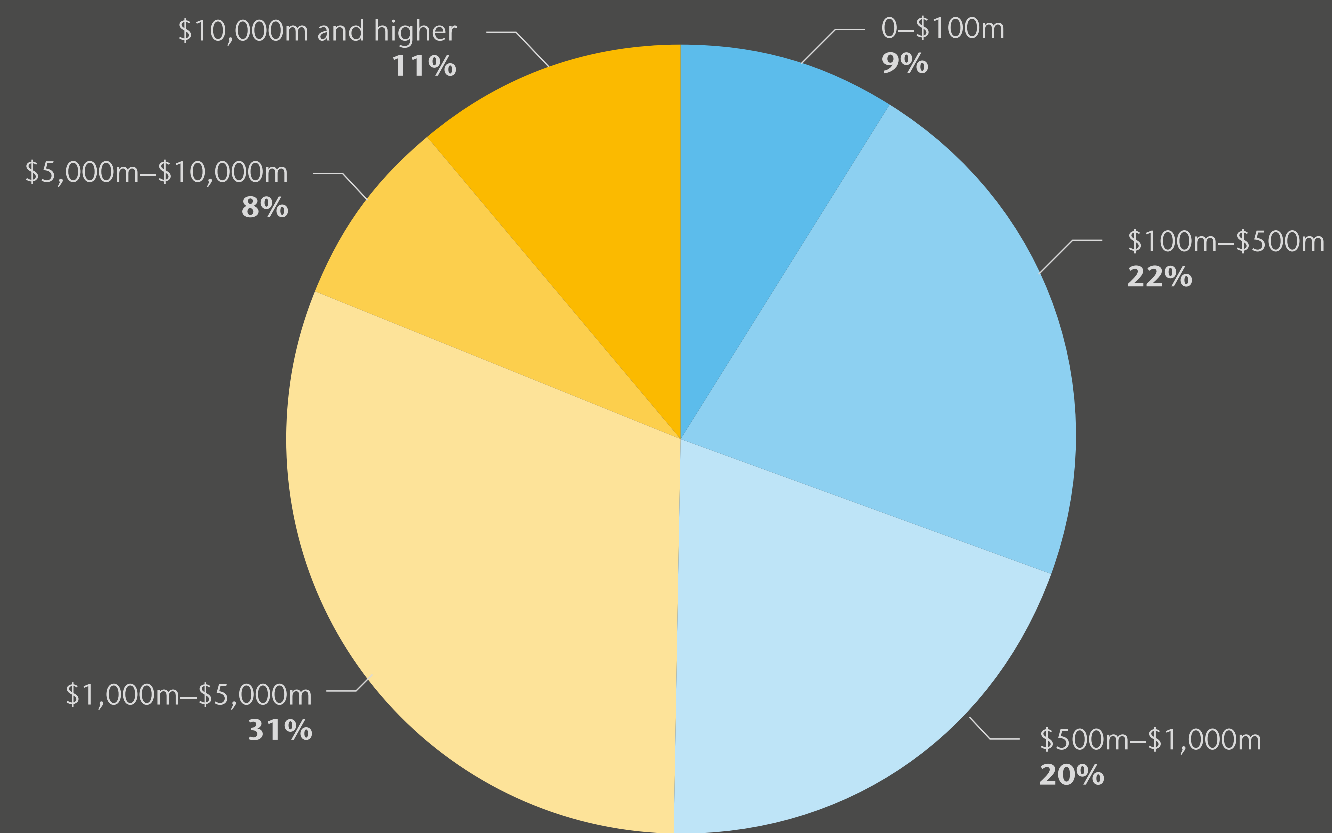
The US Global Pension Risk Survey was carried out in fall 2019.
The findings in this report cover only the US survey, in which approximately 90 people took part, from a range of pension clients, all within the US.
Respondents received no incentive for taking part in the survey.

Respondents

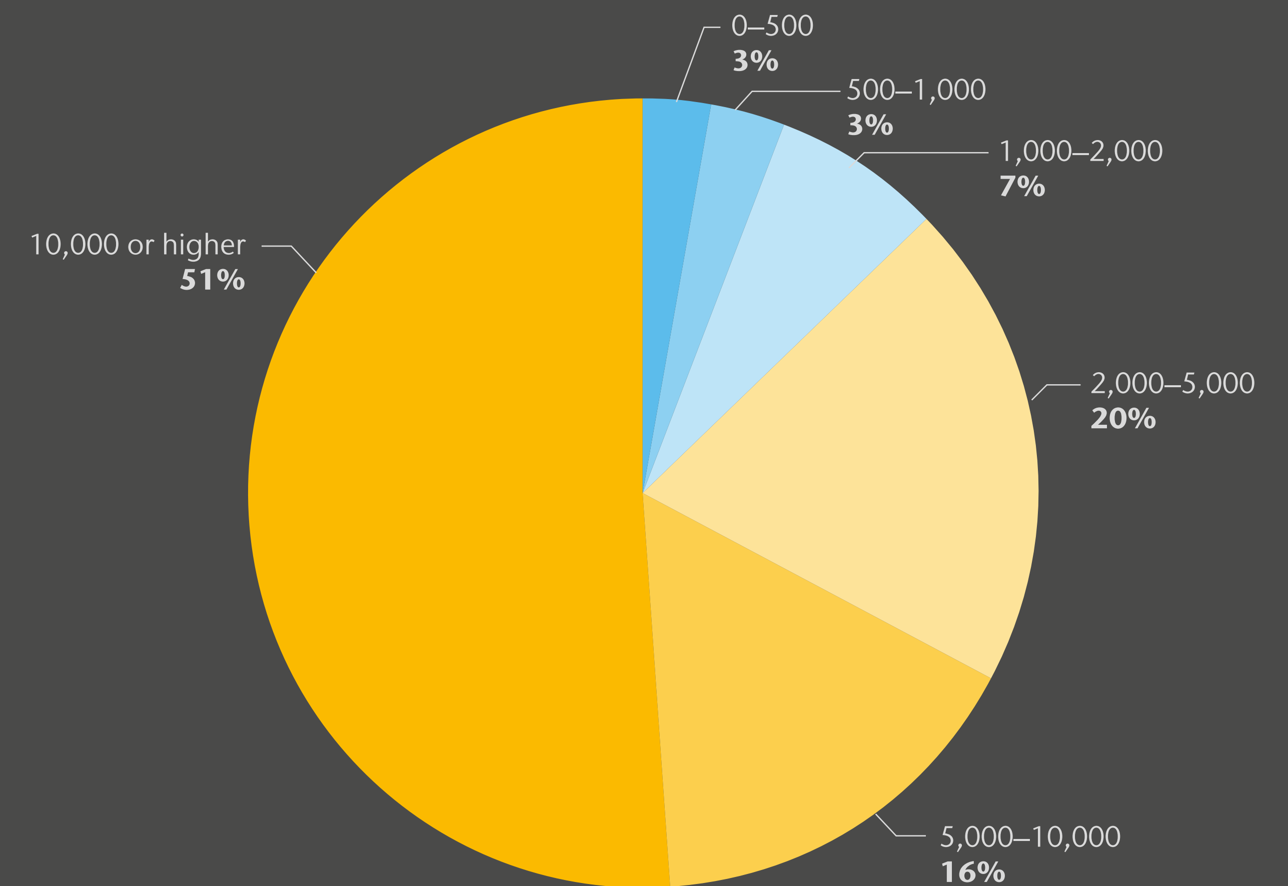
Respondents

We received about 90 responses across all industries, with 51% coming from sponsors with over 10,000 participants and 50% from plans with over $1b in assets.

Assets ($m)



Participants



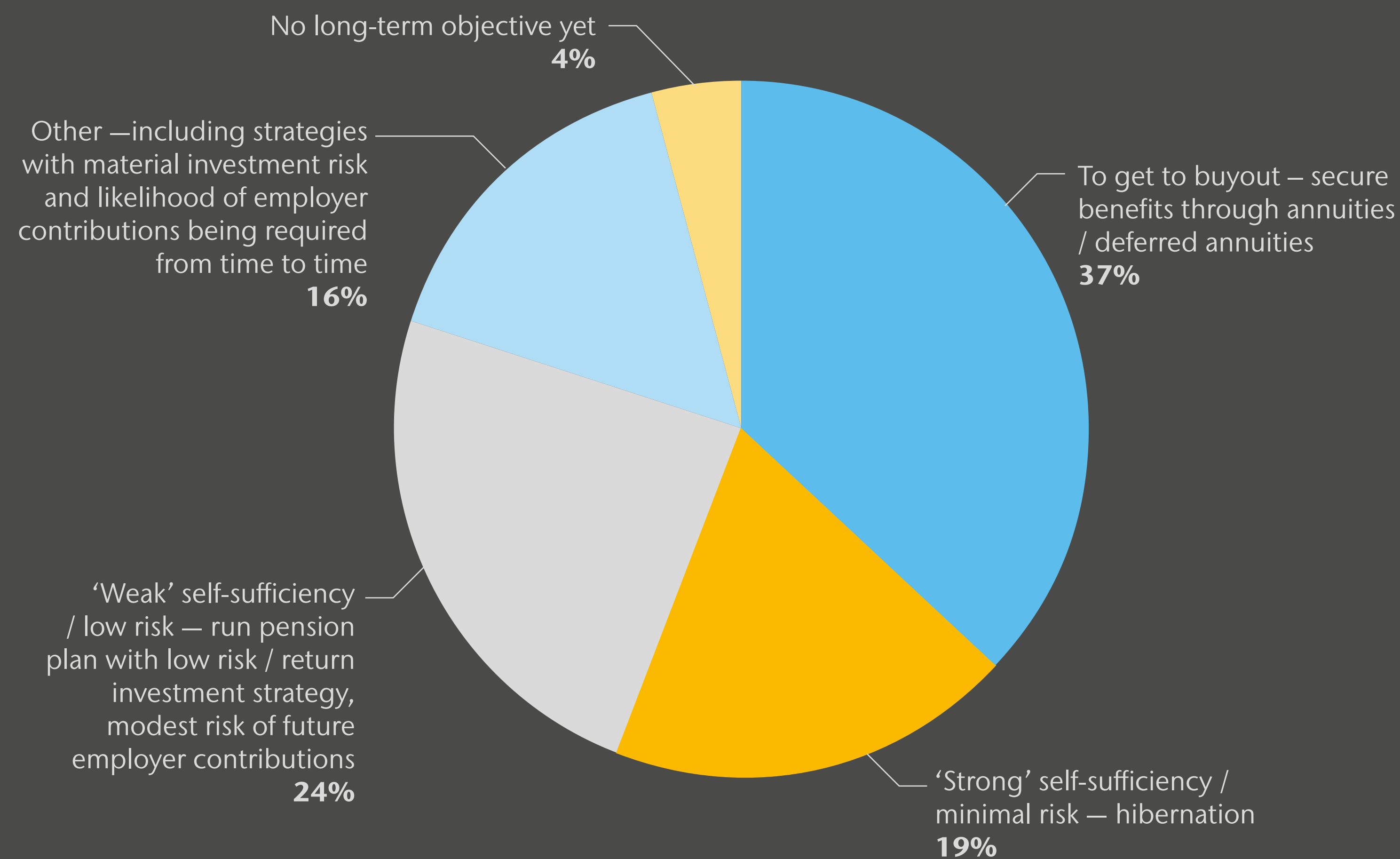
Long-term objectives

Long-term objectives

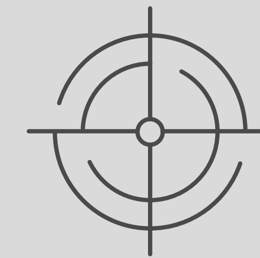
In the sharpest shift from 2017, 37% of respondents report their long-term objective is to settle their obligations, up from just 13% two years ago. Consistent with this observation, Aon's Annuity Placement Team facilitated 55 insured pension risk transactions worth over $10b in 2018, and 2019 got off to a strong start as well. Improvements in funded status over the past two years have put many more sponsors within range of full buyout, and their objectives have shifted accordingly.

Just 3% of sponsors reported having no long-term objective — down from 8% in 2017, and 22% in 2013.

Long-term objective



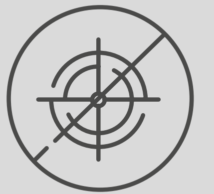
Key findings



37% report their long-term objective is settling their obligations

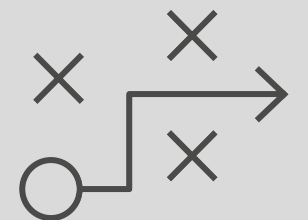
Just 3% have no long-term objectives

Down from 8% in 2017



Almost 50% of respondents see themselves attaining their targets within 5 years

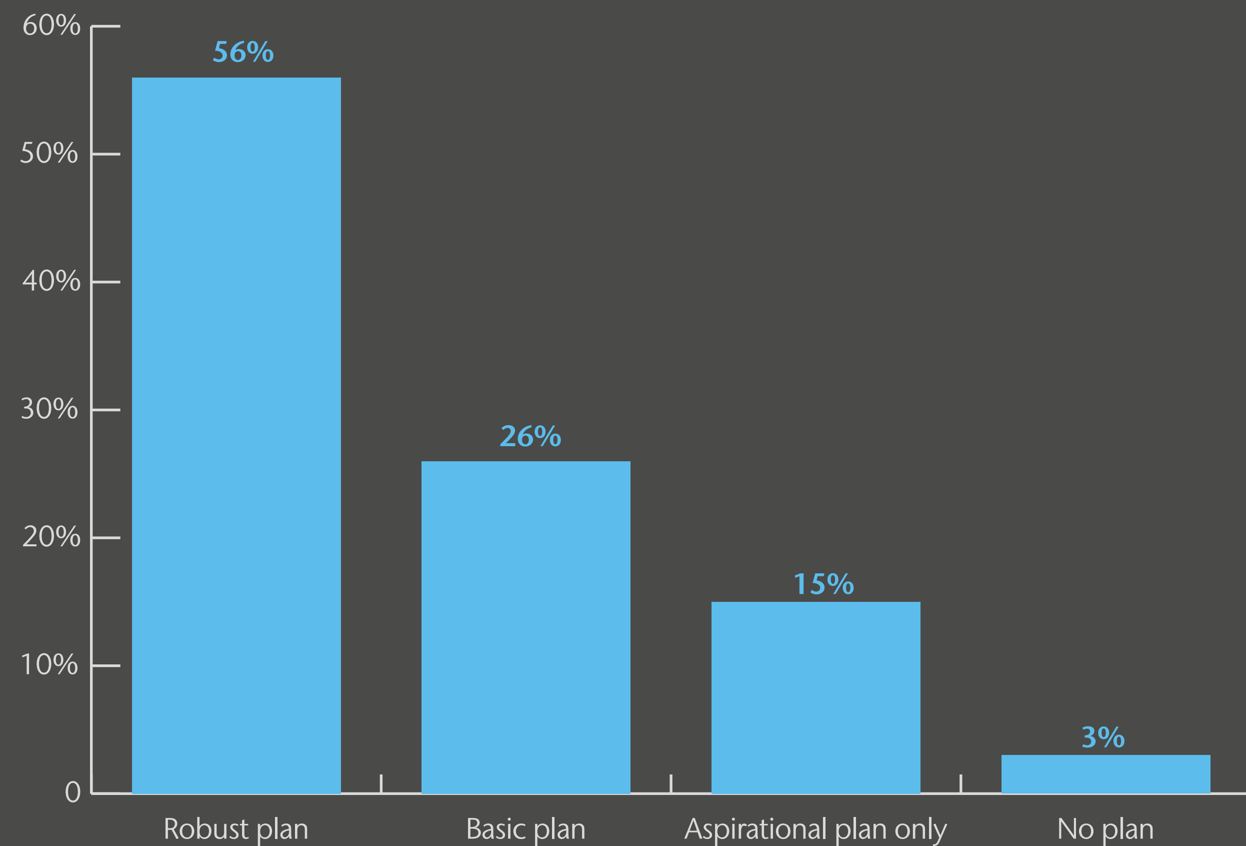
56% of sponsors report a robust plan of achieving targets



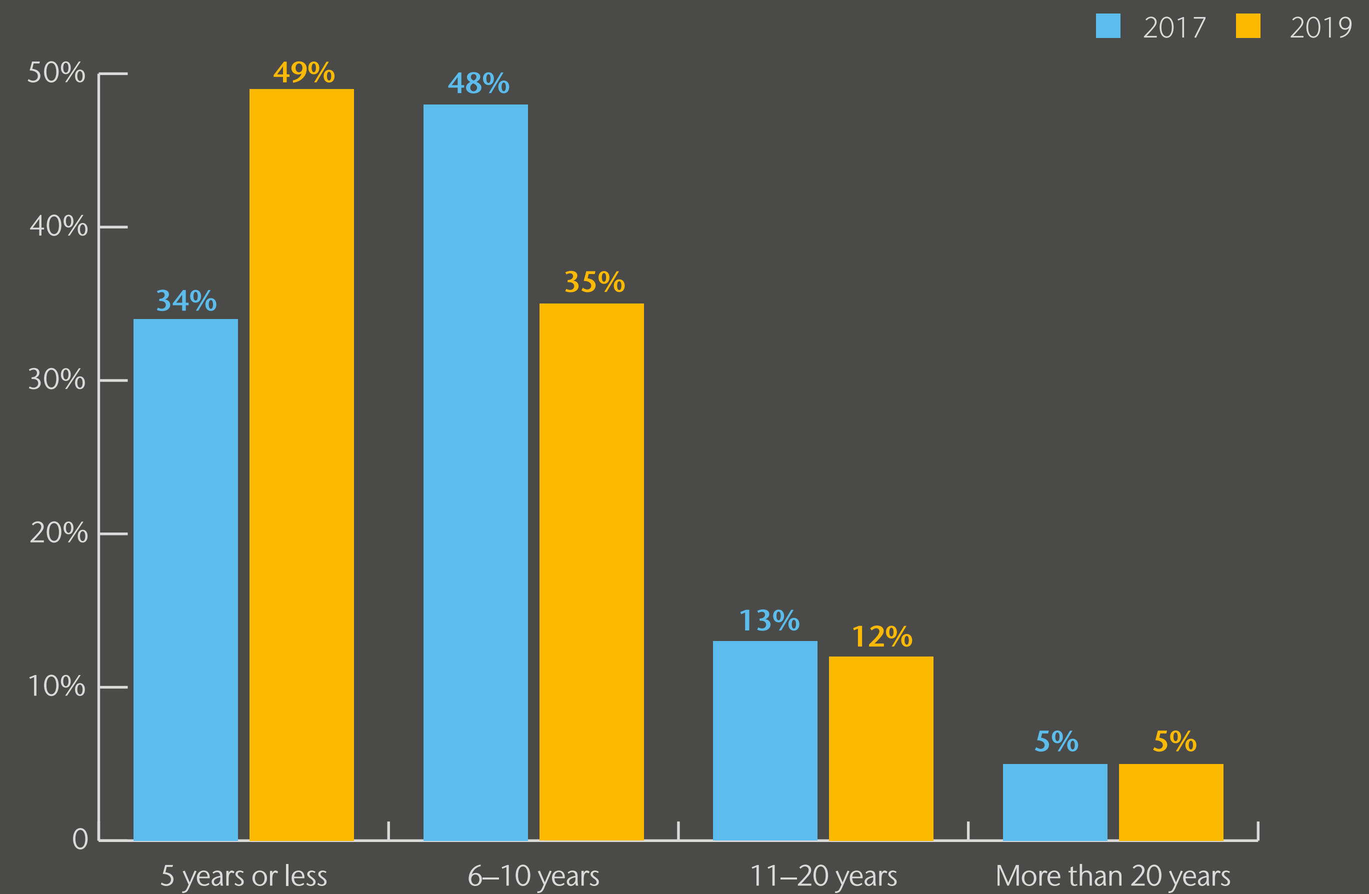
What is the use of having an objective with no plan to reach it? This year, 56% of sponsors report a 'robust' plan with documentation in place and execution underway, up from 38% in 2017.

How close are we to reaching our objective? This year, almost half of respondents see themselves within five years of attaining their ultimate goal, up from 34% in 2017. The 'six to ten years' category shrunk by almost the same amount, indicating that the past two years have seen substantial progress for this group. Indeed, improvements in funded status during 2017 and 2018, driven by volatile interest rates, strong equity returns, and accelerated contributions, drove many Aon clients along their predetermined 'glide paths' to lower risk positions, which has been helpful in late 2019 as interest rates plunge and markets flinch at hurricanes and tweetstorms.

Plan to reach long-term objective



Expected timeframe for long-term objective



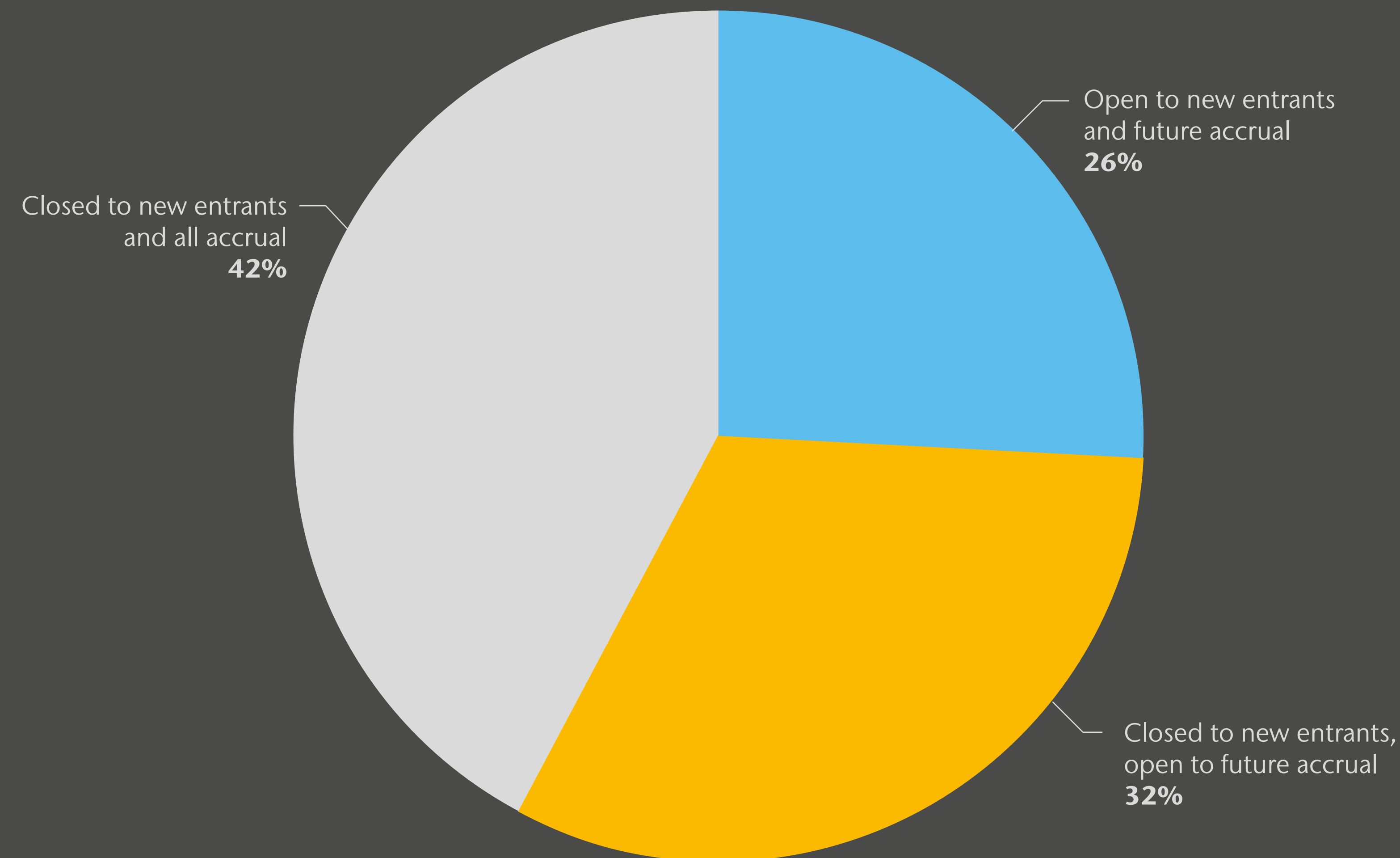
Managing
benefits and
liabilities

Managing benefits and liabilities

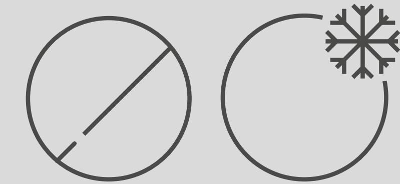
The trend towards closed and frozen plans continues, but many plans remain open.

Once frozen, the next step is often settlement — either partial, or full termination. Our 2017 survey saw a surge of interest in insured settlements. That interest has turned into action, and the 2019 survey confirms growing interest in both liftouts (liabilities partially settled) (33% implemented or very likely) and full terminations (14% implemented or very likely).

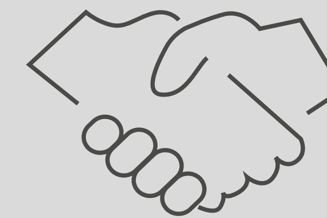
Managing accrual



Key findings



Trend towards **closed and frozen plans** continue



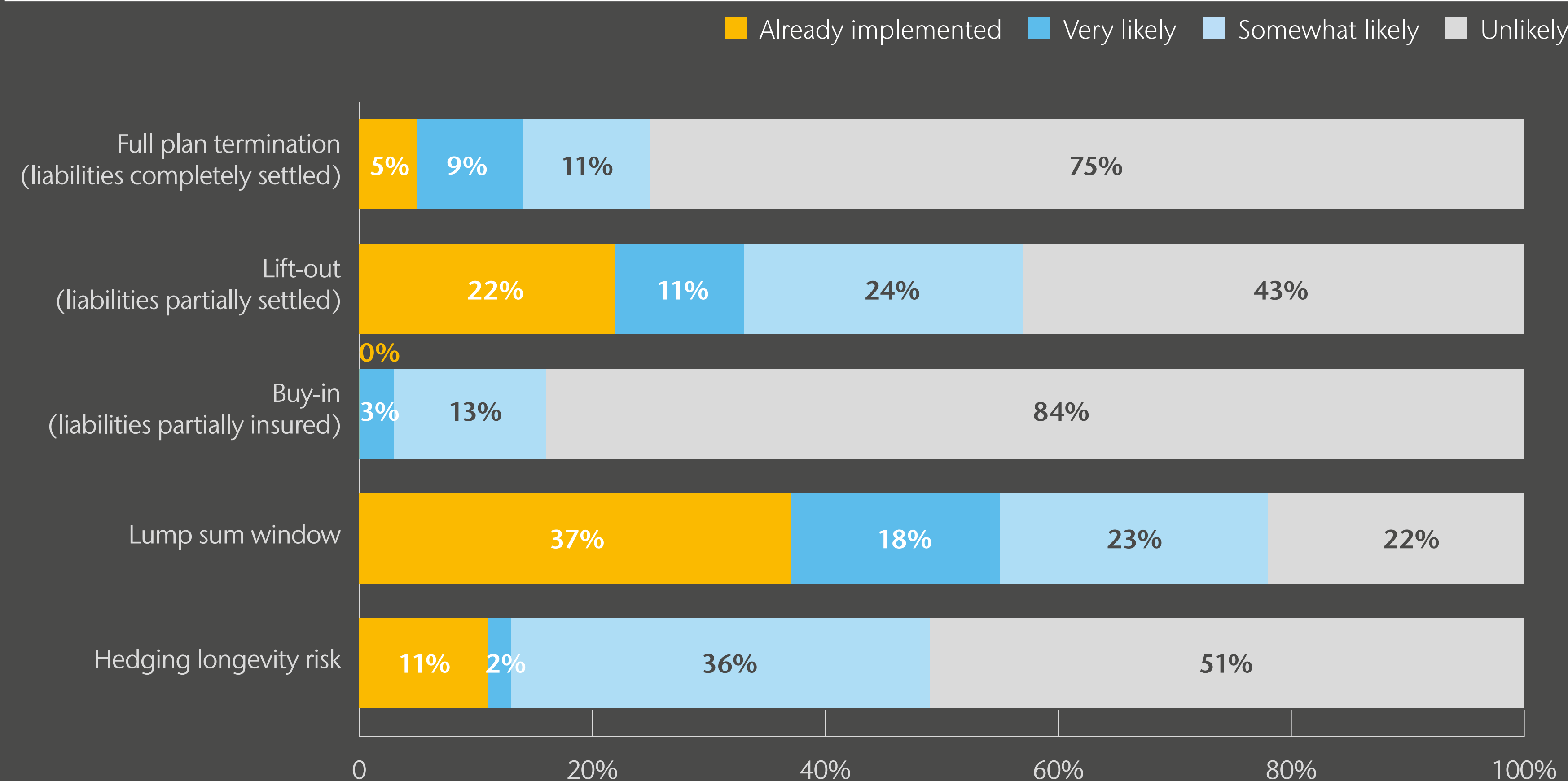
Growing interest in liftouts and full terminations

Only 3% 'very likely' to pursue a buy-in (liabilities partially insured) deal

Buyouts continue to be the dominant form of insured risk transfer in the US, where assets and obligations are irrevocably handed over to the insurer. The UK, by contrast, has seen more 'buy-ins' – where the insurer accepts the risk but the obligations and assets remain in the plan. Lockheed Martin made news in 2018 with their $800m US buy-in deal, but buy-ins remain mostly a niche activity in the US, with just 3% 'very likely' to pursue one. Standalone longevity risk hedging also remains of little interest here, as lump sums and insured lift-outs continue to deliver reliable hedging of all risks, including longevity, at a reasonable cost.

Lump sum windows continue to be attractive, and the recent DOL shift on retiree windows, as well as the recent plunge in interest rates, have given this option a modest boost.

Liability management



Success story

$120 million captured

A Fortune 500 company was concerned about the risk of managing a significant (>$1 billion) pension liability. They took steps to control the risk—froze plan benefits, offered a lump sum window to terminated vested participants, and implemented a glide path investment strategy.

By 2017 they continued to be concerned about PBGC premium costs and the potential for future cost 'surprises' including longer life expectancies. They analyzed the range of potential future pension costs versus the cost of terminating the plan and settling all obligations. After significant analysis, they decided to terminate their plan. Effective portfolio management and tactical decisions in de-risking and hedging added more than $100m funded status improvement in less than 15 months. The company borrowed to fund the remaining deficit and took advantage of a larger tax deduction in advance of tax reform. Insurer pricing was highly competitive, assisted by a custom asset-in-kind portfolio. In aggregate, the company was able to terminate the plan for over $120m less in contributions than expected.

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Investment strategy

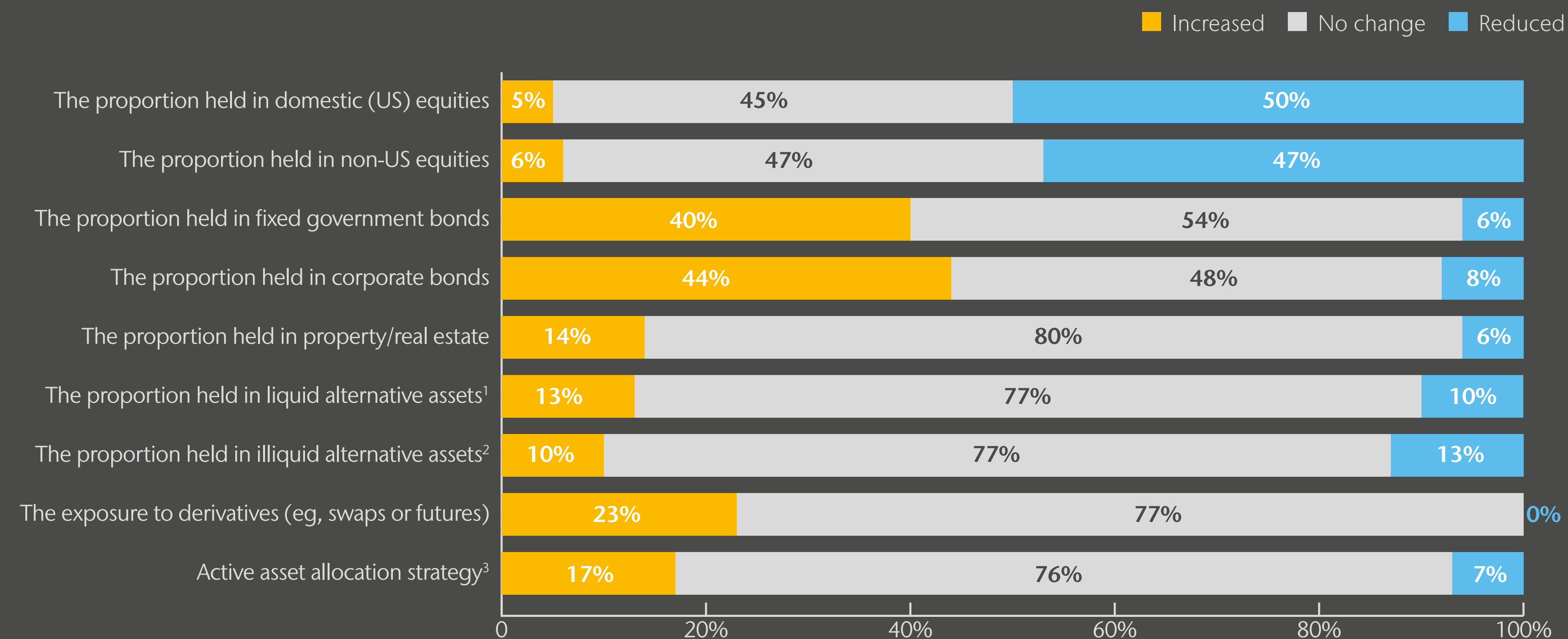
Investment strategy

Respondents continue to reduce their exposure to equities, shifting towards a diversified blend of return-seeking assets along with a liability-hedging portfolio. Evidence of this trend includes the net increase in Treasury bonds of 34% (40% of sponsors increasing less 6% reducing) along with a net increase in corporate bonds (36%) and derivatives (23%). Net reductions in US equity allocations (50% reducing exposure vs. just 5% increasing) and rising allocations to property and liquid alternative assets align with this de-risking trend.

Does more interest rate hedging automatically mean less equities and alternatives? For some sponsors the answer is 'no.' Interest rate derivatives including swaps, futures, and swaptions provide leveraged interest rate exposure, allowing for fine-tuning of key rate durations and, in some cases, leaving ample room for return-seeking assets.

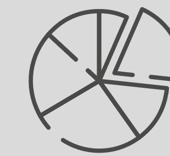
Looking ahead to the next twelve months, we see similar de-risking expectations. But since glide paths are the most common de-risking mechanism, we expect the recent drop in bond yields may pressure funded status and slow the momentum towards lower risk portfolios.

Investment strategy changes made in the last 12 months

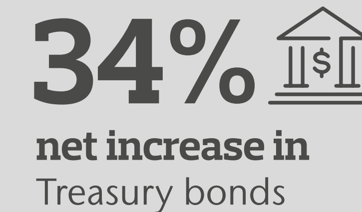


[1] eg, liquid hedge funds, commodities, insurance linked securities. [2] eg, infrastructure, property debt, direct lending [3] eg, dynamic asset allocation or medium-term asset allocation

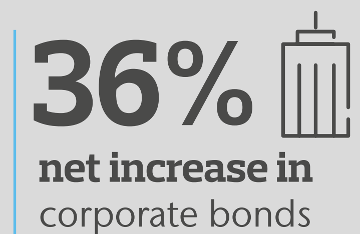
Key findings



Repondents are reducing exposure to equities by shifting to more diverse portfolio



34% **net increase in** Treasury bonds

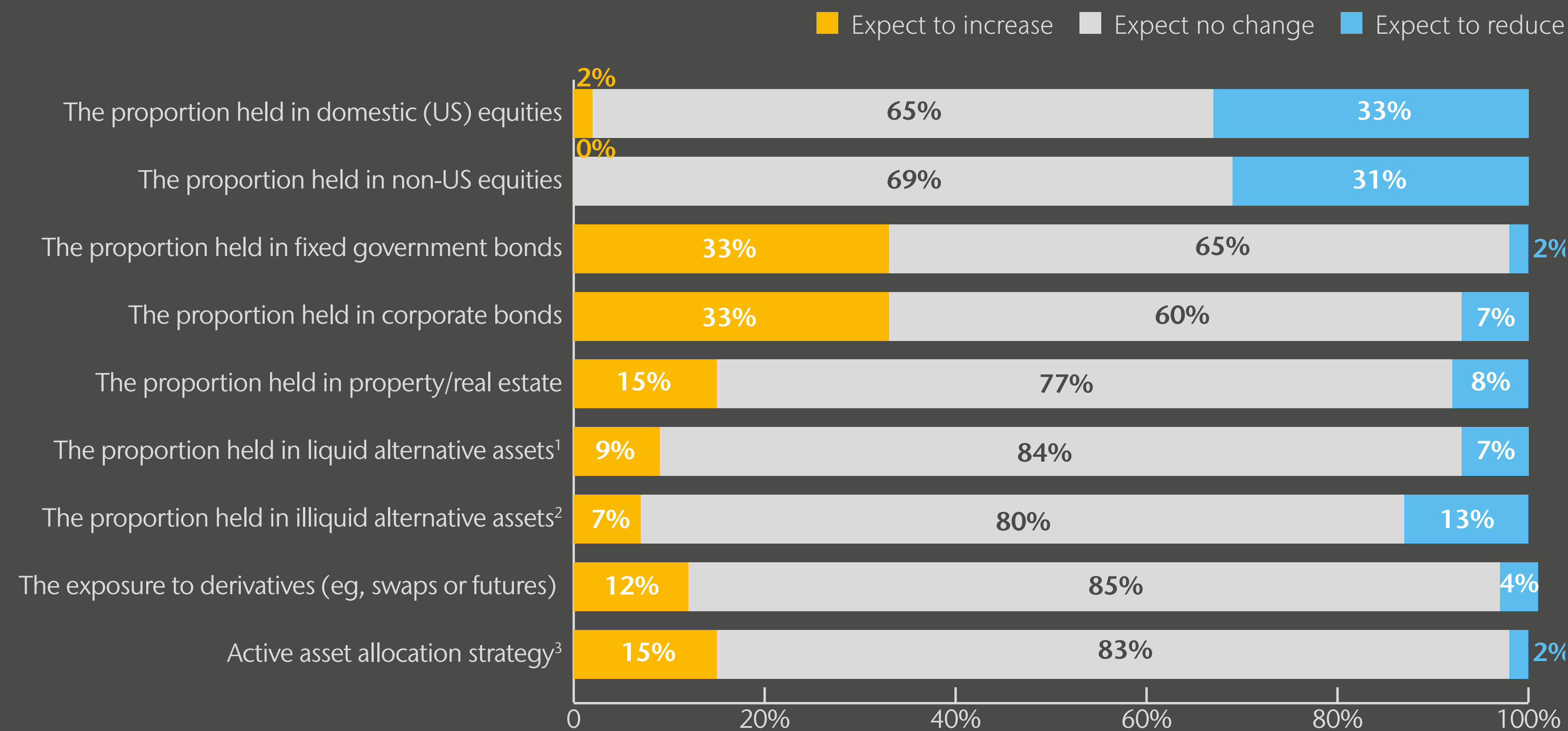


36% **net increase in** corporate bonds

45% **net reductions in** US equity allocations

The late 2018 sell-off and early 2019 recovery in equity markets give us a window into how sponsors respond to market events. Market volatility creates opportunities for tactical 'buy low-sell high' shifts, but rebalancing discipline seems to be the most effective way to accomplish this. Market gyrations in late 2018 forced a sell-off in equities, with valuations moving briefly to more attractive levels. Most sponsors stood pat, while a quarter simply rebalanced to their target allocation. This rebalancing discipline, often executed by an OCIO, was rewarded when valuations quickly recovered in early 2019. A smaller percentage of sponsors actually raised their target equity allocation in response, usually as part of a 're-risking' feature of their glide path design triggered by a declining funded ratio. A bold few (3%) responded to more attractive valuations by ad hoc raising of their equity targets.

Changes to investment strategy — next 12–24 months



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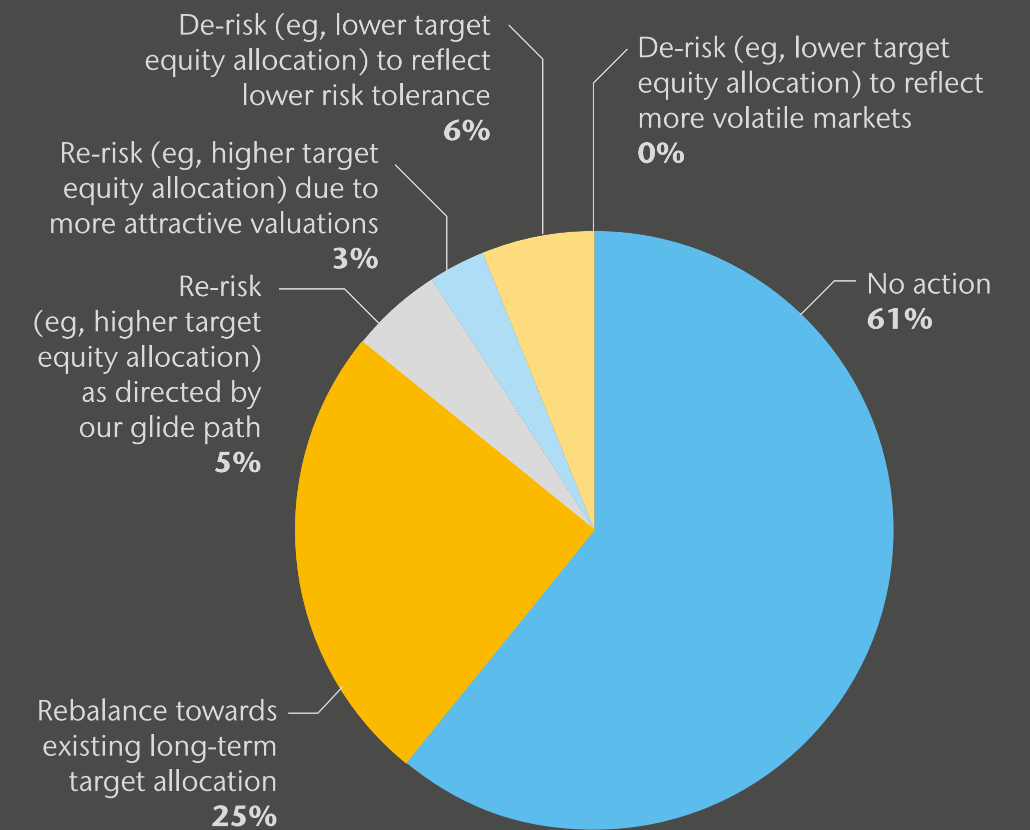
Actions taken in response to late 2018 market sell-off



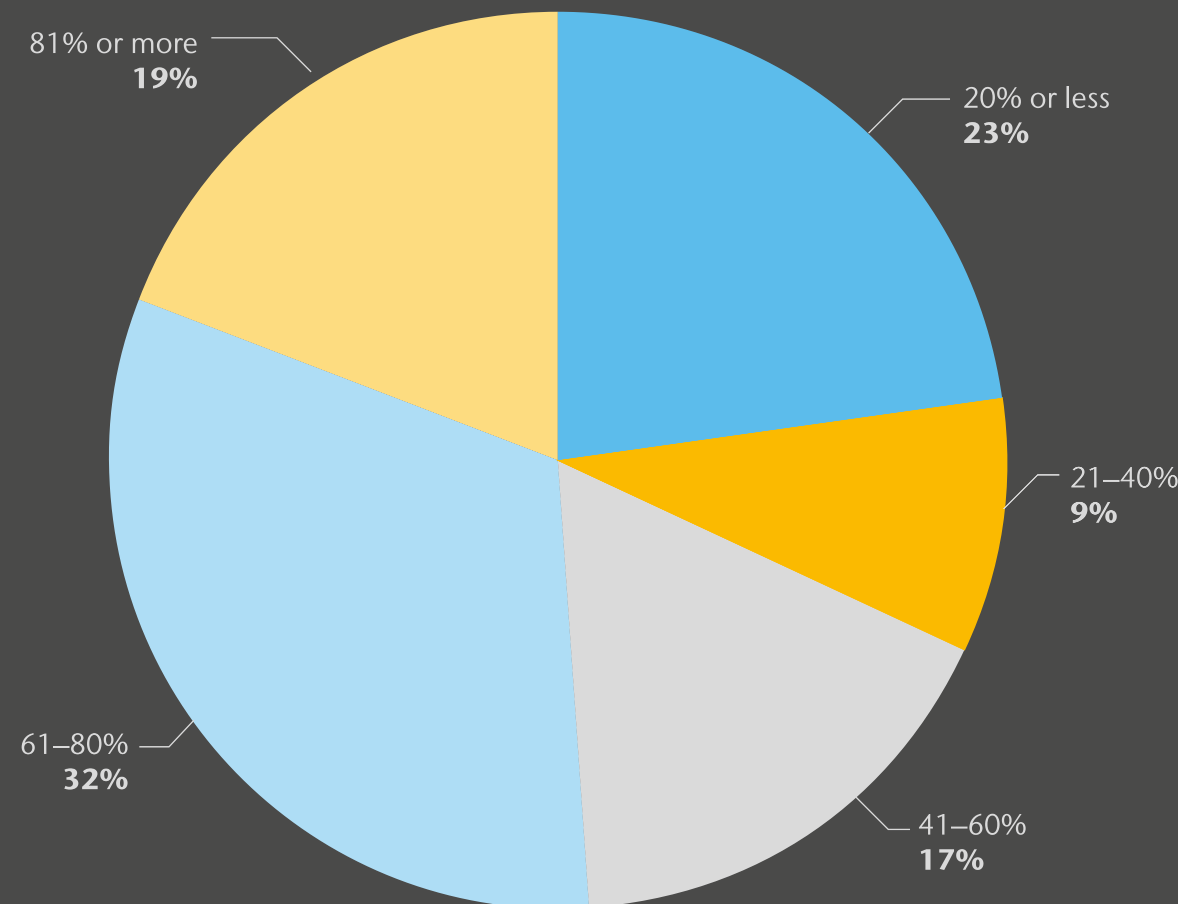
Hedging

Hedging

The findings around changes in asset allocation in the survey suggest that interest rate hedge ratios are rising, and half of our survey respondents reported hedge ratios at or above 60%. Just 23% reported hedge ratios of 20% or lower, down from 41% of 2017 survey respondents.

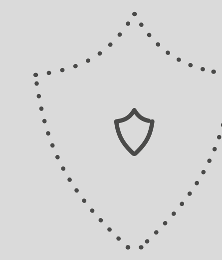
But isn't settlement the ultimate hedge? Remember that we estimate about 9% of pension obligations have been settled since 2012 via lump sum window programs or annuity buyouts. A sponsor that has achieved a 40% hedge ratio after fully settling 20% of their obligations has really hedged 52% of their interest rate risk (100% of the 20% settled, plus 40% of the remaining 80%).

Interest rate hedge ratio



Key findings

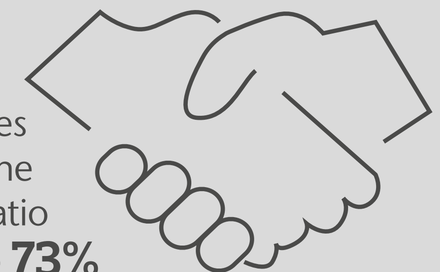
1/2 of respondents have a **hedging ratio of 60% or above**



21% drop in number of respondents with a **hedge ratio of 20% or lower**

Settlement can also increase the hedging level.

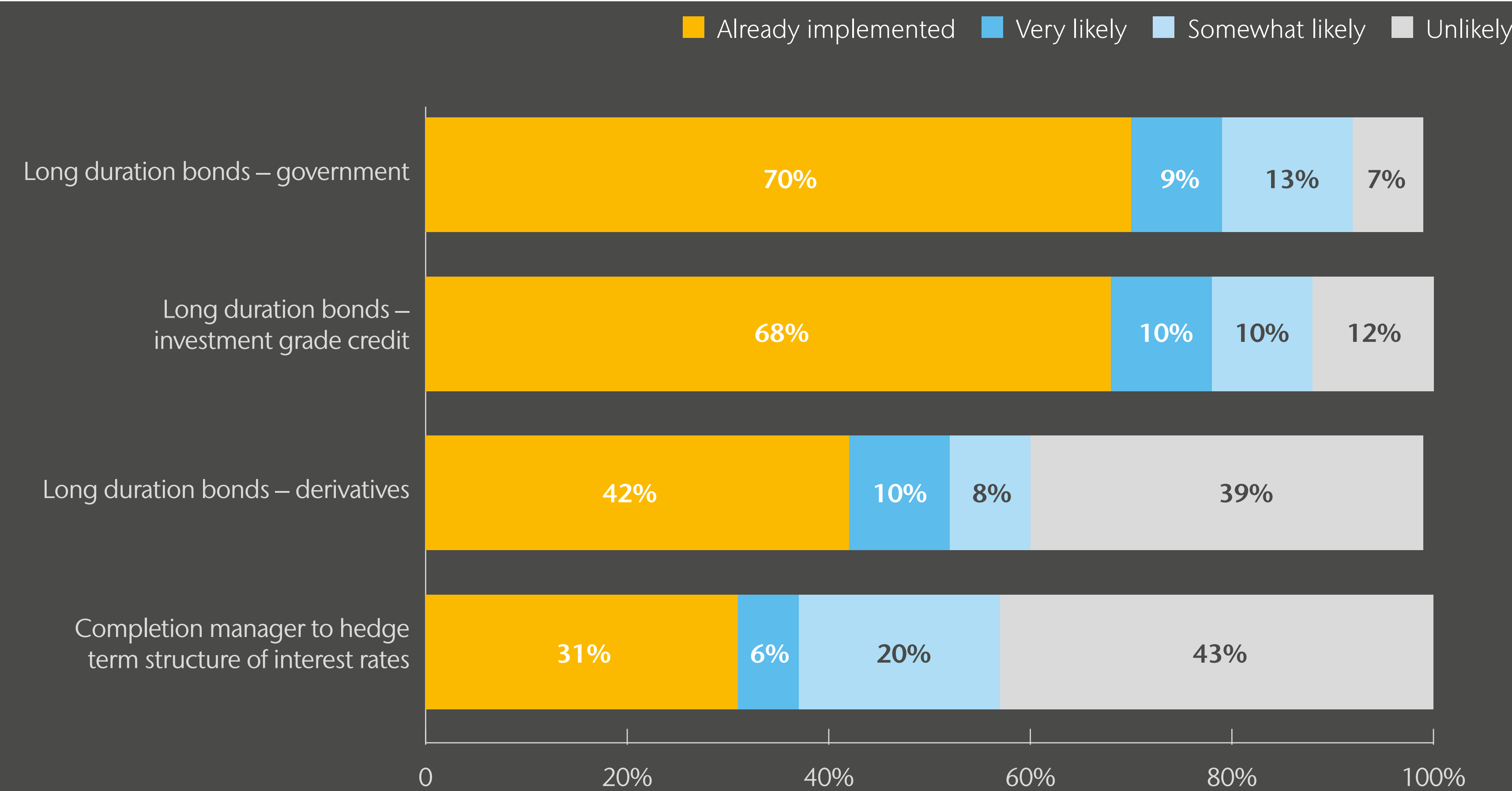
For example, settling 1/3 of the plan's liabilities would increase the average hedge ratio **from 60% to 73%**



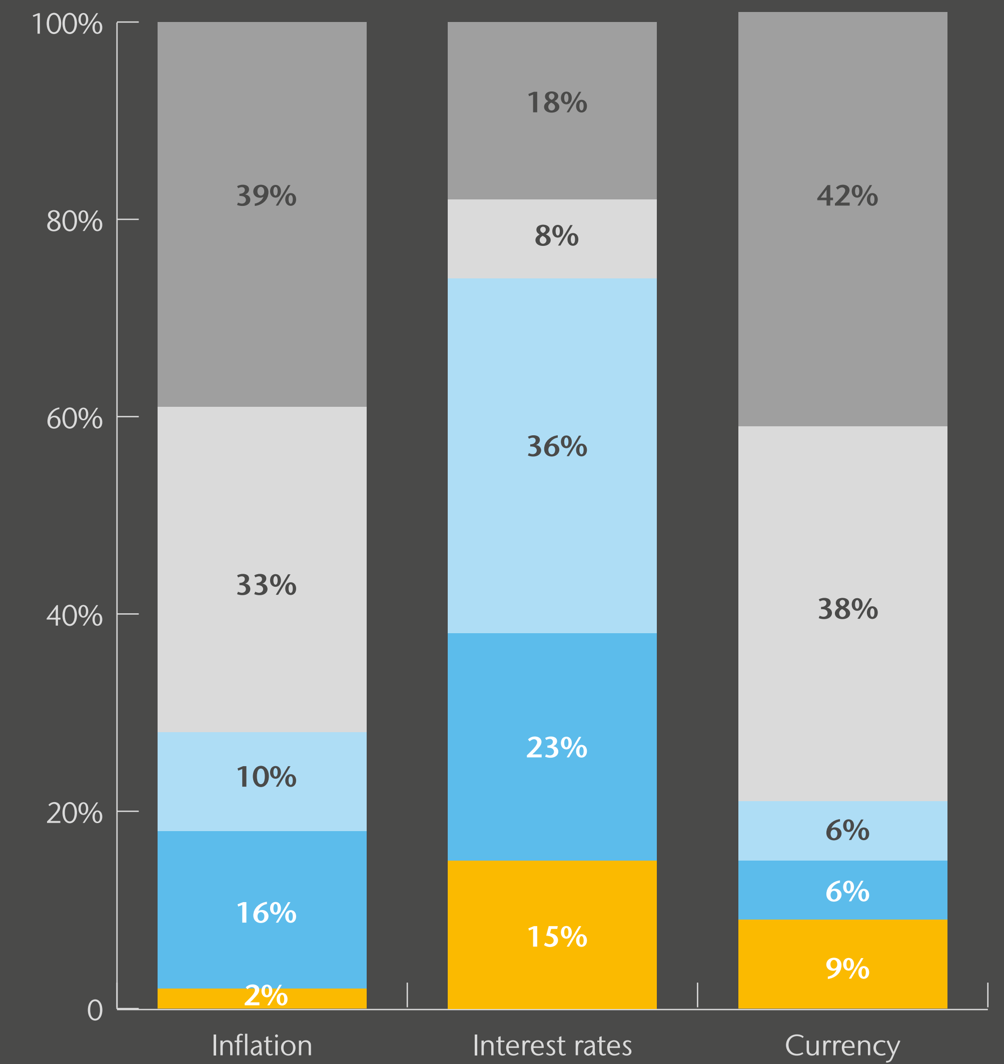
Bonds – both government and corporate – remain by far the most common hedging vehicle, but derivatives are rising as noted above, and a growing proportion of sponsors are using completion managers to fine-tune their hedges.

Here in the US, the predominant hedging focus is on interest rates, while currency and inflation hedging remain relatively uncommon.

Interest rate hedging tools

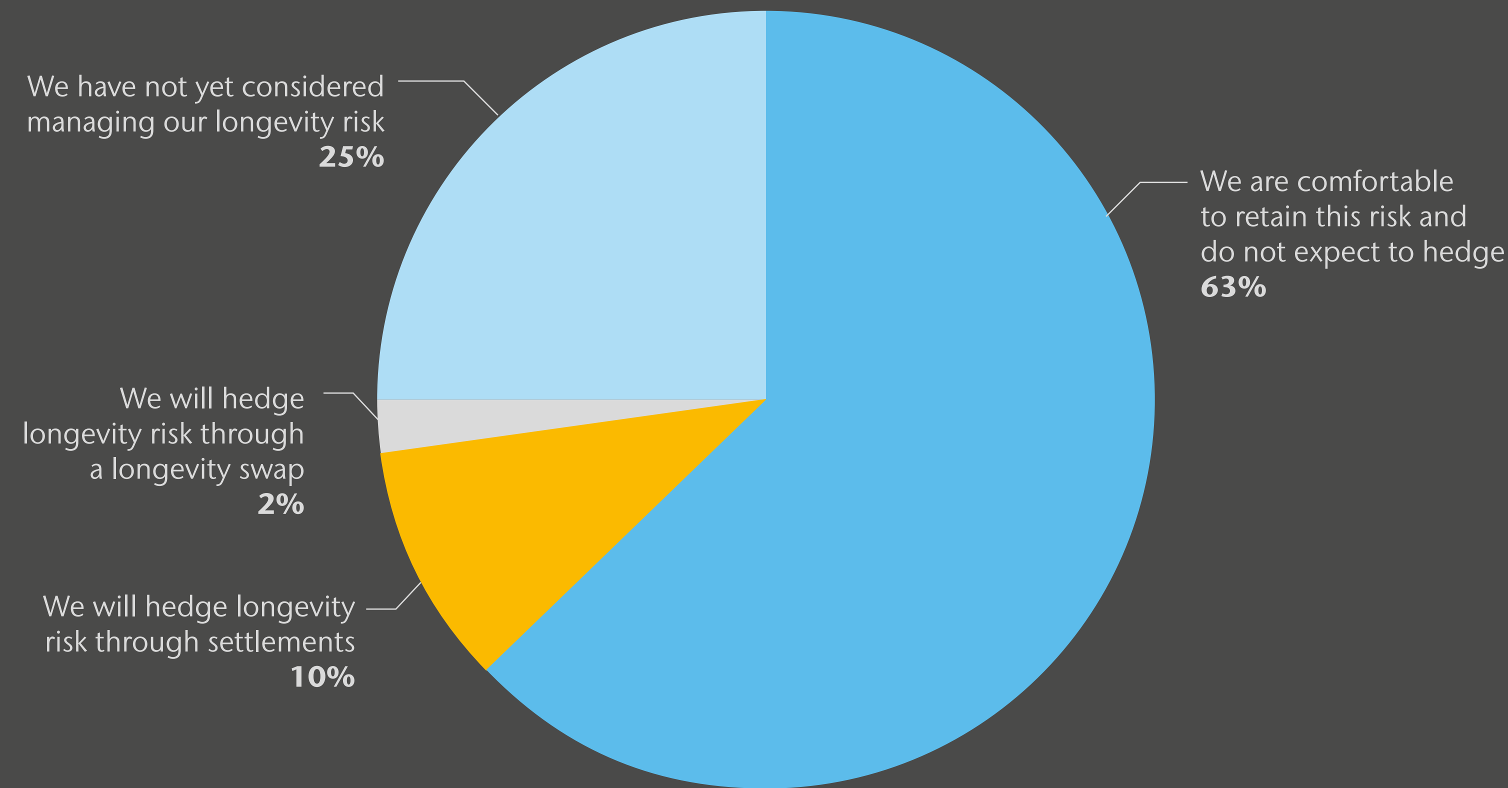


Hedging strategies



As we observed last time, standalone longevity hedging in the US has little appeal since lump sum settlements and insured buyouts remain a cost-effective way to eliminate longevity risk.

Longevity risk management



Success story

Reducing interest rate risk while maintaining equity opportunities

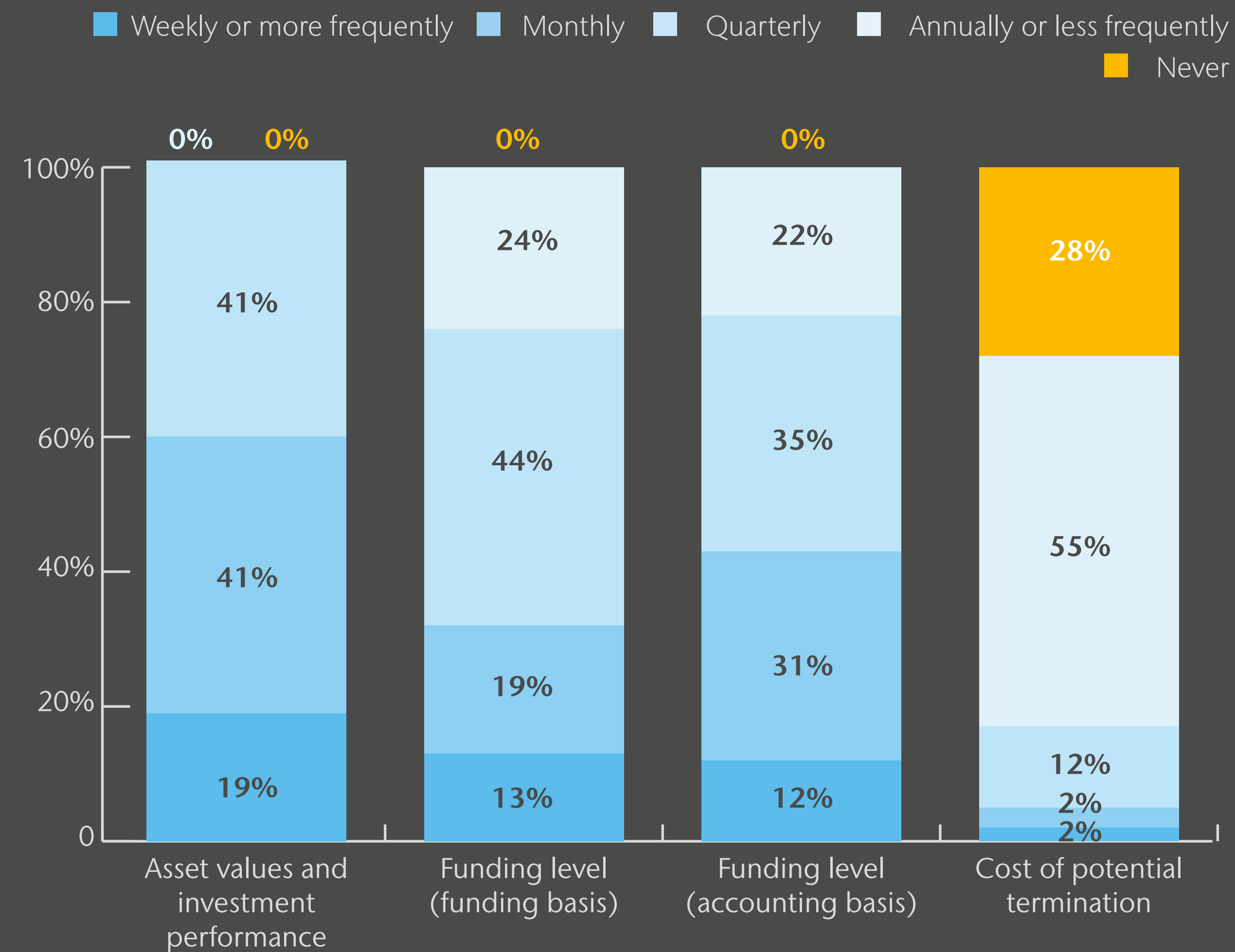
A Fortune 500 consumer packaging company's global pension obligations continued to grow even after they closed their plans to new hires. Aon led their global de-risking efforts, including lump sum windows and annuity buyouts across four countries, while the sponsor maintained a nearly 70% allocation to return-seeking investments. By year-end 2018 they had cut their global PBO nearly in half, effectively eliminating 60% of their global interest rate risk.

Aon helped another sponsor in the same industry implement a glide path to exit their frozen US plan entirely, taking their return-seeking portfolio down from 70% of assets in 2016 to 6% by year-end 2018. This put them in a perfect position to exit their frozen plan in 2019, retaining a much smaller active plan.

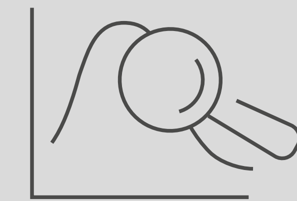
Monitoring pension risk

Monitoring pension risk

Funded status monitoring continues to grow in frequency, with over 70% of respondents monitoring funded status at least quarterly, and over 40% monitoring funded status at least monthly. Sponsors nearing plan termination will monitor this cost with rising frequency as full settlement nears.



Key findings



Frequent funded status monitoring continues to grow

Over 70% monitor funded status at least once a quarter

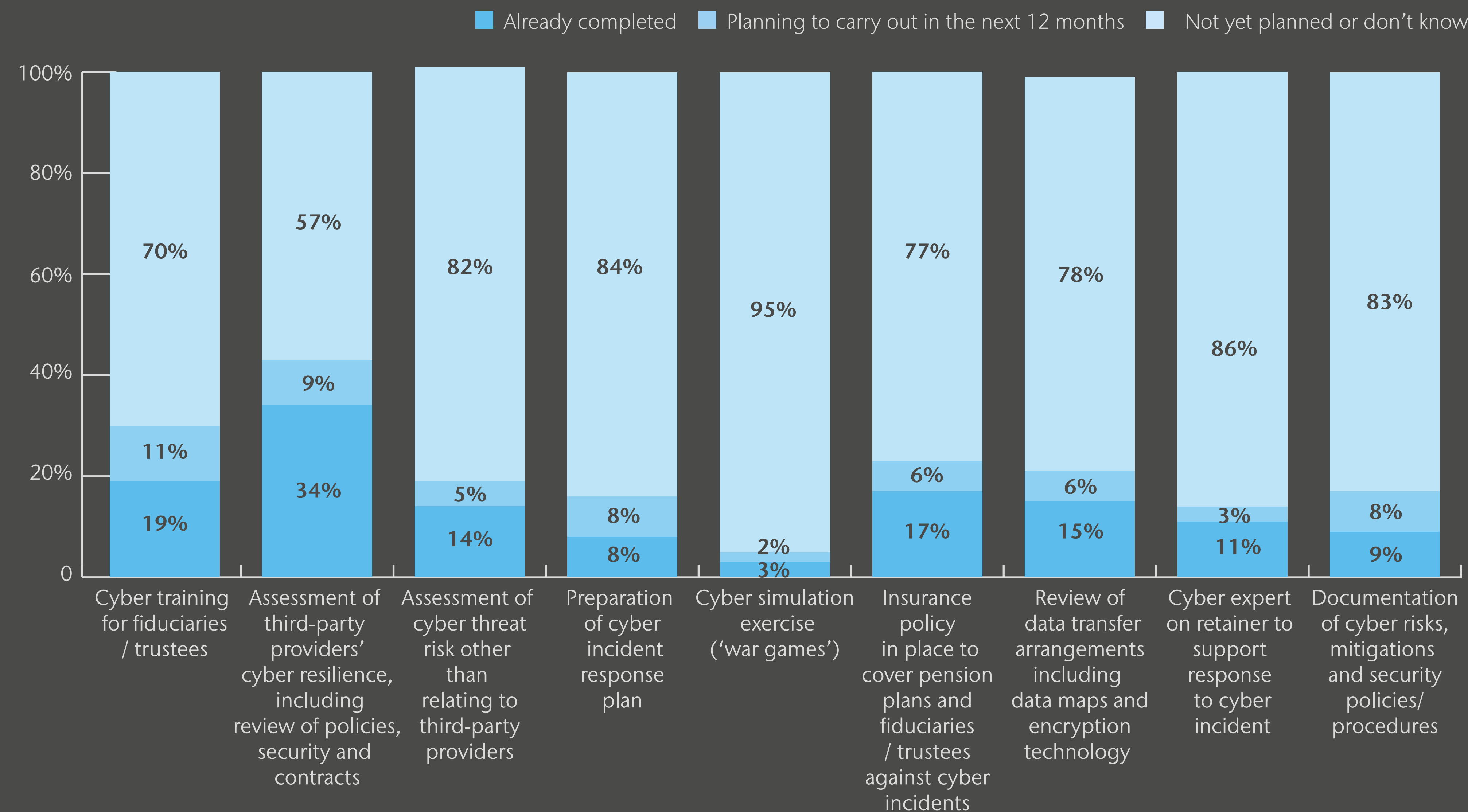
Over 40% monitor funded status at least once a month

Cyber risk

Cyber risk

For the first time we asked about cyber risk management, and found that much remains to be done in this growing area of concern. Third-party risk management appears to have a significant head start on in-house efforts. Live 'war-game' testing has so far seen little activity. We note that cyber regulation directly impacting pension plans has yet to gain much traction in the US. In contrast, sponsors in Europe have made more progress, prodded along by the EU's General Data Protection Regulation (GDPR) and The Pensions Regulator in the UK. The US Securities and Exchange Commission and other national and state-based regulators are beginning to focus on the topic, so we expect movement when we revisit this topic in the next survey.

Cyber risk

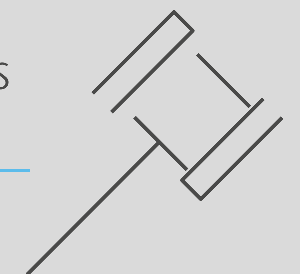


Key findings

Third-party provider cyber risk management currently ahead of in-house cyber risk management

Only 3% have completed any **'war-game' testing exercises**

Cyber regulation directly impacting plans in the US has yet to gain traction.

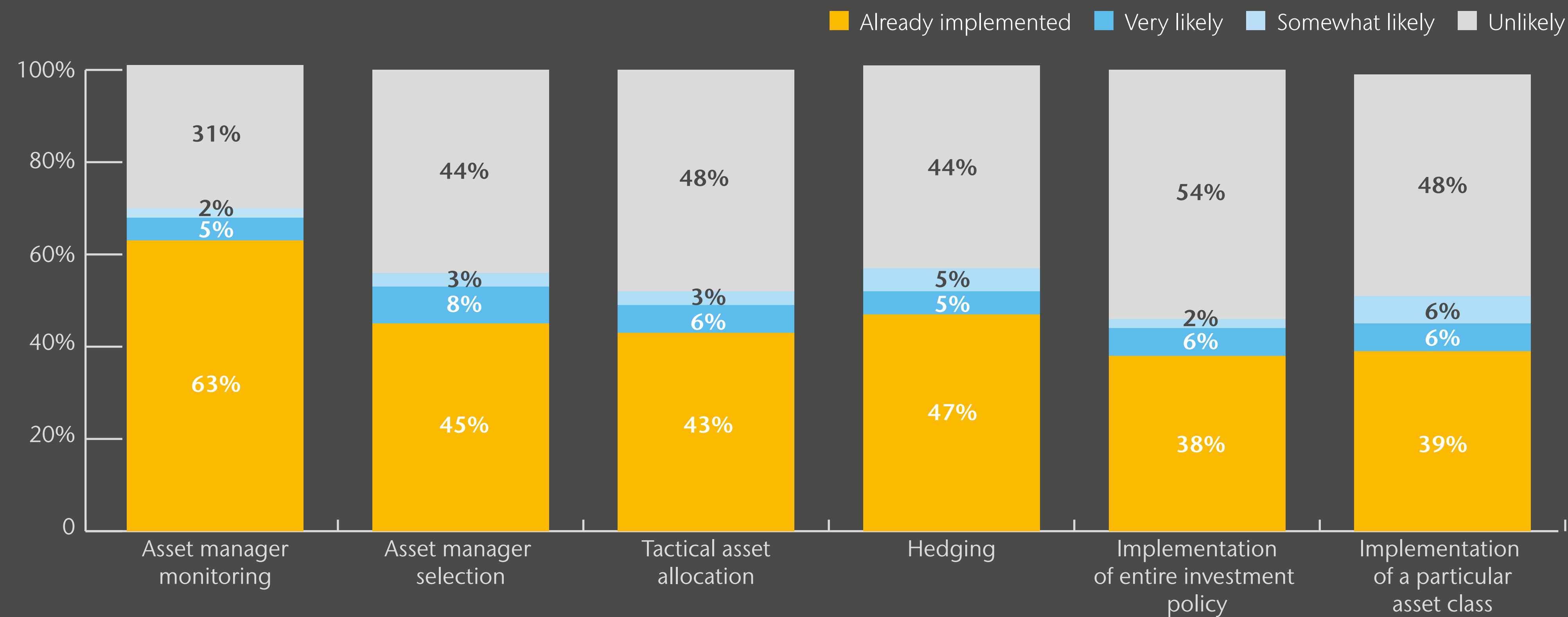


Much greater progress made in Europe

Governance and delegation

Governance and delegation

Delegation



Investment delegation has risen in lockstep with glide path adoption over these past several surveys. Back in 2011, just 23% of respondents were ‘very likely’ to fully delegate implementation of their investment policy or had already done so. Here in 2019, that percentage has nearly doubled, with 38% already in full delegation mode and another 6% ‘very likely’ to follow. What’s behind the trend?

- **Glide path adoptions** Glide path implementation requires additional monitoring and execution capabilities that few sponsors can easily build in-house.
- **Cost savings** Many sponsors actually realize lower investment management fees under a delegated model.
- **Better governance** As more plans are frozen and approach hibernation or settlement, sponsors are looking for a governance model that recognizes the legacy nature of the pension plan. In later stages of the pension plan’s life cycle, the emphasis usually shifts from maximizing total return to controlling risks, costs, and funded status.
- **Better execution** Delegated management is not just for frozen plans. Disciplined and accountable implementation of investment policies can reduce risks and improve outcomes for plans of all sizes and in all stages of their life cycle.

Key findings

Nearly 2x as many respondents as in 2011 were ‘very likely’ to delegate or had already done

27% of sponsors with over $1b in assets have already delegated

This survey also confirms the trend towards full delegation (sometimes called Outsourced CIO, or OCIO) among large sponsors with over $1b in assets, with 27% already having delegated and another 6% at least somewhat likely to do so in the future. Fueled by this trend, Aon continues to outpace the OCIO industry's growth. As of March 31 2019, Aon manages $167b in OCIO assets around the world, up 54% in less than two years.

We expect the next few years will see a slowdown in de-risking if the recent drop in discount rates persists. Otherwise the outlook is for continuing evolution in pension risk management, as 2019's declining interest rates and volatile equity markets drive sponsors to look for even more powerful solutions from their OCIO providers.

Success story

Reduction in liabilities, PBGC premiums and risk

In 2013, a global mining company with $2.2b of US pension liability was just 78% funded. They partnered with Aon to reduce risk and reduce PBGC premiums through a series of pension settlement activities and accelerated cash contributions. So far this program has saved the plan tens of millions in PBGC premiums, and reduced the US pension liability to $0.8b of fully funded obligations.

The high-profile, multi-stage derisking program included three lump sum windows and three retiree annuity buyouts. All told, over 17,000 participants will be settled across $1.4b of transactions.

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About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

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