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Vanguard Pension Advisory Solutions

Corporate pension trends 2023

Innovative risk analytics technology

Focused pension expertise from a dedicated pension team

Disciplined investment management process

A year of mixed results for corporate pension plans

Why median funding levels increased despite negative asset returns

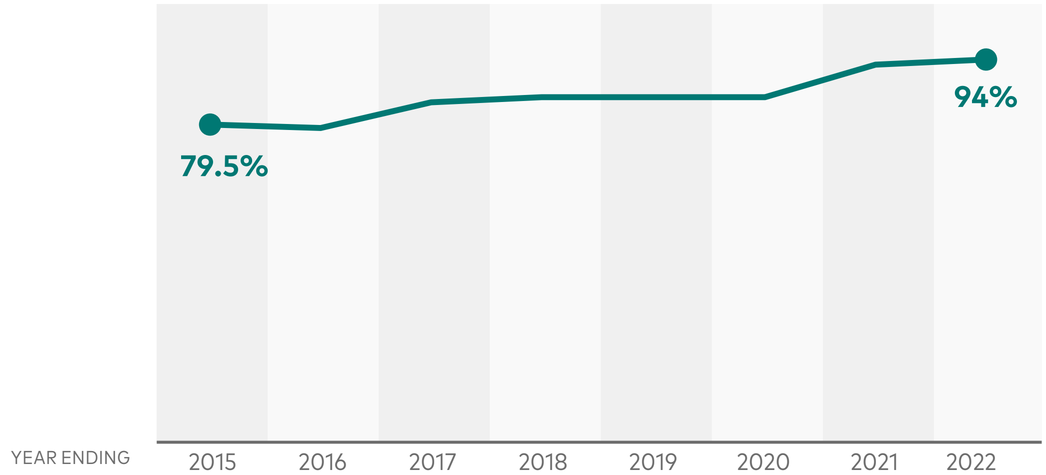
Funding status showed small increase in 2022

Negative returns across global equity and long duration fixed income caused asset values to fall in 2022. However, significant increases in corporate bond interest rates decreased liability values. This decrease was enough to offset asset losses and increase funding status by about 1%. Pension plan sponsors used this opportunity to continue their derisking strategies through increased allocations to fixed income and further risk transfer activity.

Capital markets posted losses in both equity and fixed income for the first time since 1974

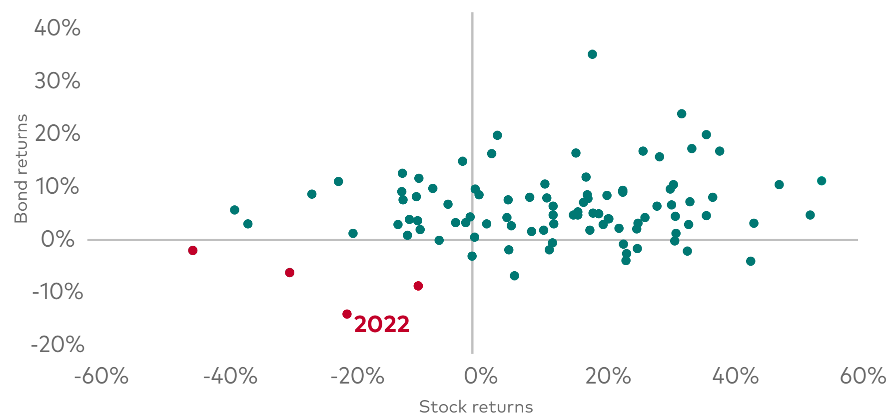
Pension fund asset losses in 2022 were offset by large increases in corporate discount rates, decreasing the value of plan liabilities. Corporate discount rates rose 225 basis points, from 2.74% to 4.99%, primarily due to the Federal Reserve policy of raising interest rates to control the level of inflation. Corporate bond spreads stayed relatively unchanged throughout 2022.

Pension plan funding status



Source: Vanguard, using data from FactSet, 2022.

Annual stock and bond returns 1926 through 2022



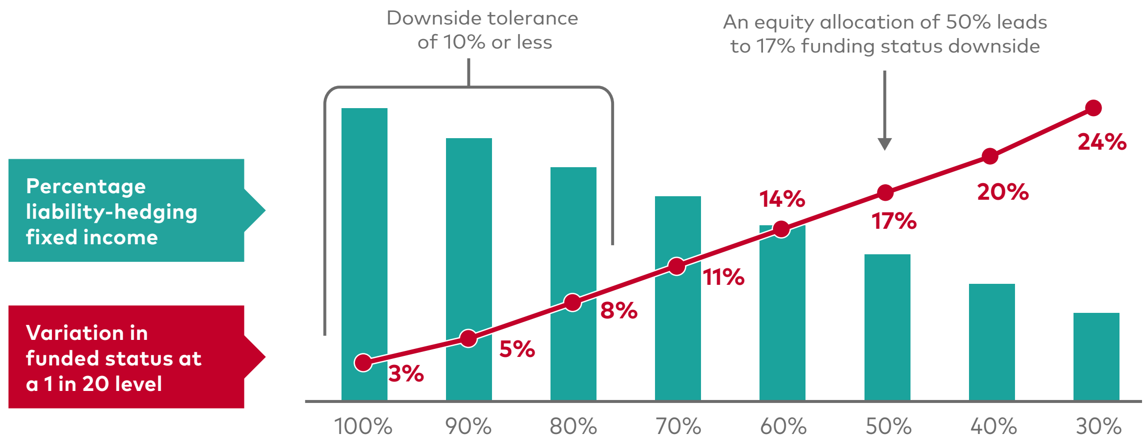
Source: Annual stock and bond returns are represented using broad market indexes. See back cover for details.

Past performance is not a guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

Misinterpretation of risk

Should asset allocation or risk tolerance be adjusted?

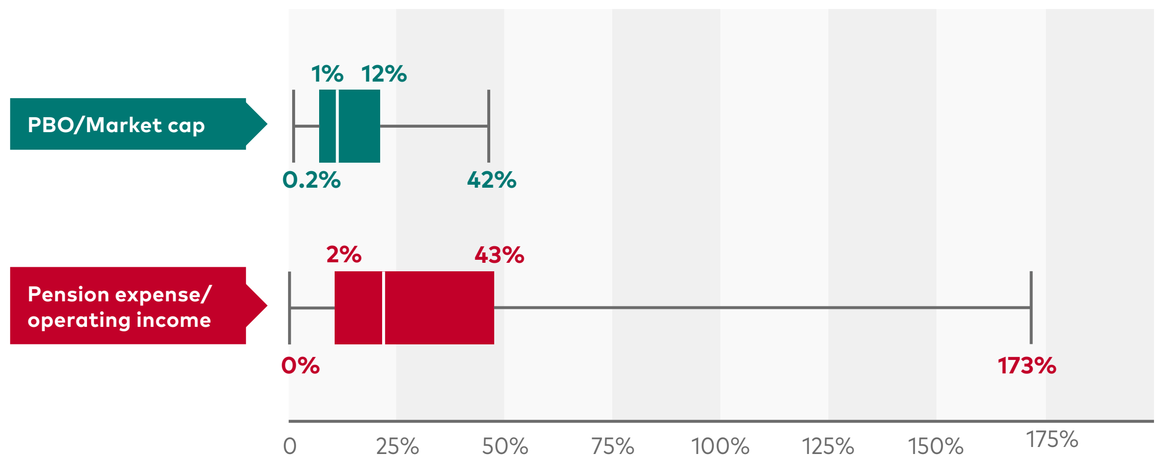
In Vanguard's 2022 survey of pension plan sponsors, 91% of plan sponsors reported a funding status risk tolerance of 10% or less. However, only 16% of pension plans have an asset allocation in line with that risk tolerance. In addition, the average pension plan has a 50% allocation to equity, meaning that many plan sponsors are taking on more risk than their stated risk tolerance.



Sources: Vanguard 2022 Pension Sponsor Survey and MSCI Barra One risk model. See back cover for important information about the MSCI Barra models.

Pension risk and corporate finances: Key metrics remain relatively flat

Effective risk management requires an understanding of the pension plan's potential impact on corporate finances. Assessing plan size relative to company size is key. Metrics to watch include pension benefit obligation (PBO) versus market capitalization, unfunded PBO versus market capitalization, and pension expense versus operating income. For companies with results in the higher quartiles, carefully managing pension risk should be a high priority.[1]



Source: Vanguard, using data from FactSet, 2022

[1] For more on managing pension risk, see Jim Gannon, *Managing and Mitigating a Pension Plan's Impact on Financial Statements*, September 2021.

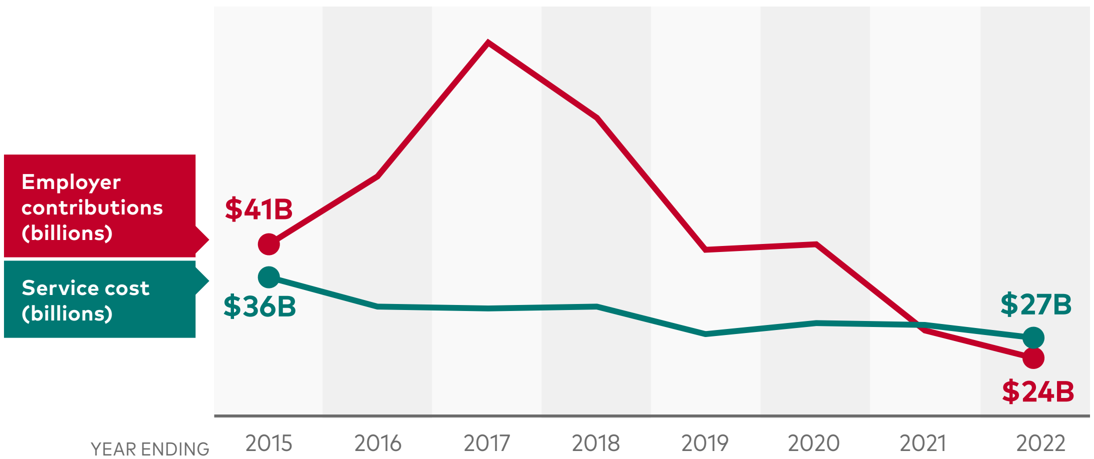
How plan sponsors are managing pension risk

Negative returns from both equity and fixed income were offset by large increases in discount rates, leading to a small increase in funding levels and allowing plans to continue to manage risk.

❶ Benefit policy

Annual benefit accruals, or service cost, continues to decline

The trend of declining service cost is expected to continue due to the closed or frozen state of many pension plans. Future pension liabilities, net of any discount rate changes, are expected to decrease as benefit payments and liability transfers exceed service cost and interest cost.



Source: Vanguard, using data from FactSet, 2022.

❷ Funding policy

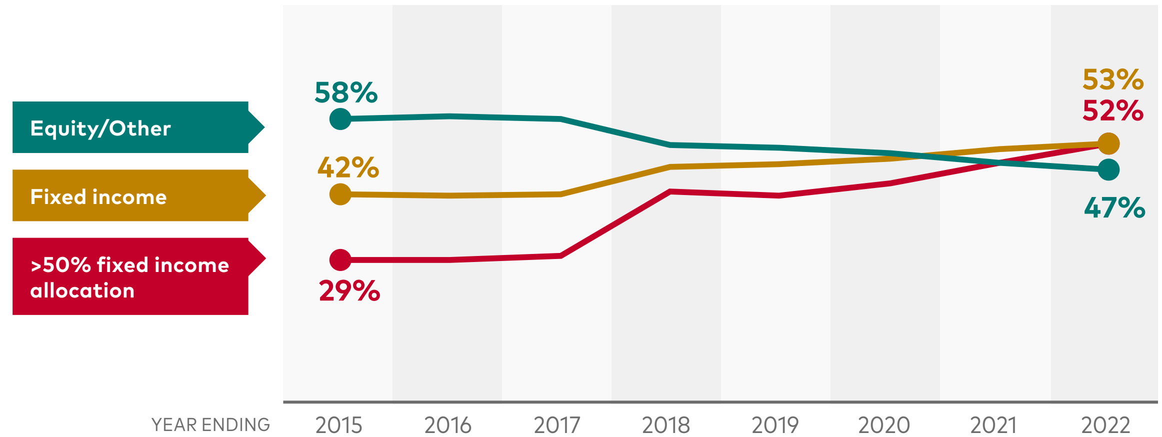
Contributions fell to their lowest level in a decade due to funding relief and increased funding status

With current funding levels at their highest in more than a decade, combined with pension relief legislation, corporations were able to reduce contributions and conserve cash. In the near term, interest rates have risen to the point that pension relief legislation is expected to be less impactful. However, fully funding a pension plan reduces Pension Benefit Guaranty Corporation (PBGC) premiums and creates additional flexibility when considering derisking strategies.

❸ Investment policy

Fixed income allocation exceeds equity allocation

Increased funding status over the last several years has allowed for further movement along derisking glide paths, reallocating investments from equity to fixed income, thereby reducing pension risk. Fixed income investments in pension portfolios now exceed equity investments, both in aggregate and for most pension plans.

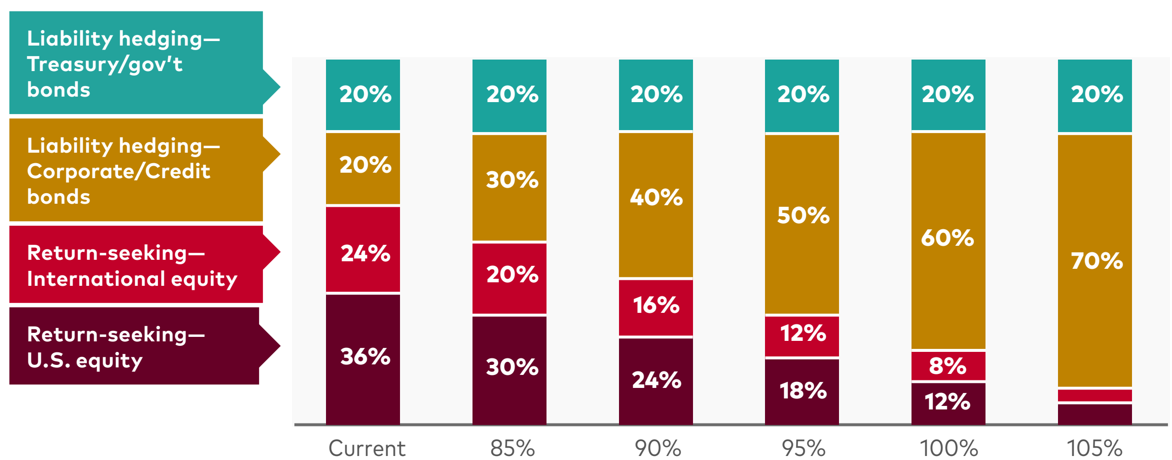


Source: Vanguard, using data from FactSet, 2022.

Dynamic investment policies

When using a derisking glide path, plan sponsors adjust their asset allocation to reduce risk after the plan's funded ratio improves.

Funding status triggers



Asset progression for illustrative purposes only. Not based on any particular portfolio.

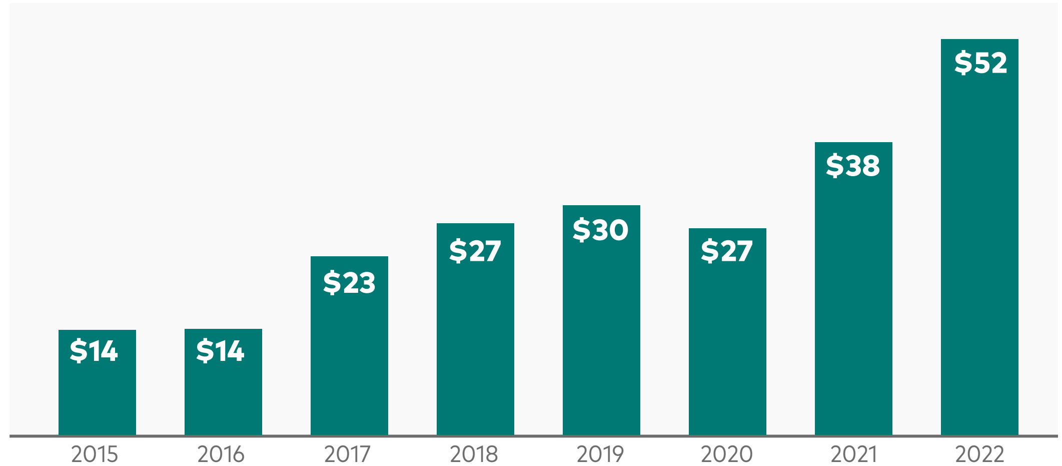
❹ Liability transfer policy

Pension risk transfer activity reached its highest amount on record at $52 billion

The volume of annuity purchases increased by 37% from 2021 to 2022 and continues to show rapid growth in the amount of total liabilities transferred, the number of individual deals happening, and the number of insurance companies currently in the pension risk transfer market. Full or targeted retiree group annuity purchases, as well as lump-sum payments to terminated vested participants, remain the primary options for reducing the size of pension liabilities, PBGC premiums, and other administrative pension costs.

However, the decision on risk transfer should not rely solely on the benefits of the immediate risk transfer transaction but should consider the effect on the remaining pension plan, which still needs to be managed into the future.[2]

Group annuity sales, U.S. (in billions)



Source: LIMRA, 2023.

Liability transfer events require careful planning including evaluation of the impact to the remaining pension plan

	Before the event	During the event	After the event
Lump sums	• Estimate amount. • Determine interest rate lock month.	• Move to cash or short-term bonds during interest rate lock month. • Rebalance as needed.	• Adjust duration of remaining assets. • Consider impact on investment strategy.
Group annuity purchase	• Estimate amount (insurer bids). • Plan for potential in-kind transfer.	• Maintain target allocation as long as possible before annuity purchase date. • If an in-kind purchase, work with insurer to establish the process.	

[2] For more on pension risk transfer, see Valerie Dion and Jim Gannon, *Evaluating Pension Risk Transfer: Is Risk Being Transferred? Or Just Shuffled Around?*, January 2023.

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For annual stock and bond returns 1926 to 2022 shown on page 2, US Stocks are represented by Standard & Poor's 500 (dividends included) from 1926 through December 31, 1970; Wilshire 5000 Index from 1971 through April 22, 2008; MSCI US Broad Market Index through June 2, 2013; CRSP US Total Stock Market Index thereafter. Fixed income is represented by Standard & Poor's High Grade Corporate Index from 1926 through 1968; Citigroup High Grade Index from 1969 through 1972; Lehman Brothers U.S. Long Credit AA Index 1973 through 1975; Bloomberg U.S. Aggregate Index 1976 through 2009; Spliced Bloomberg U.S. Aggregate Float Adjusted Index thereafter. (BloomBarc U.S. Aggregate Bond Index through December 31, 2009; BloomBarc U.S. Aggregate Float Adjusted Index thereafter.)