PIMCO

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Special Financial Assistance for Multiemployer Plans: Bridging the Funding Gap

We believe multiemployer plans could maximize the value of their financial assistance with a dual-portfolio approach.

Many provisions in the American Rescue Plan Act of 2021 (ARPA) have gotten a lot of media airtime since they became law in March 2021. But one element – special financial assistance (SFA) for severely underfunded multiemployer pension plans – has garnered less mainstream attention, despite being hugely important to multiemployer pension plans. After the initial exuberance subsided, dialogue across these plans – which are often jointly administered by employers and industry unions – shifted toward optimizing the value of this much-needed capital infusion. To this end, many of PIMCO's multiemployer clients, and their investment consultants, have engaged us to help address the asset allocation puzzle that will maximize the amount of benefit payments that can be covered by both existing plan assets and assistance funds.

IN A NUTSHELL

The assistance package embedded in the ARPA will enable multiemployer plans that meet certain eligibility conditions (generally related to being in a severely underfunded position) to receive a lump sum of money to help cover benefit payments owed through 2051.

While the Pension Benefit Guaranty Corporation (PBGC) recently issued an interim final rule that sets forth the requirements of this assistance program, some uncertainty remains regarding how funds will be deployed – as the rule may still be adjusted based on submissions received during the 30-day comment period. As currently written, the language of the interim final rule suggests that investment grade (IG) fixed income securities would be the predominant destination for a (very) large chunk of assistance funds. However, existing plan assets would continue to benefit from more flexibility and could be allocated to a wider range of asset classes and strategies beyond IG fixed income.

THE DILEMMA

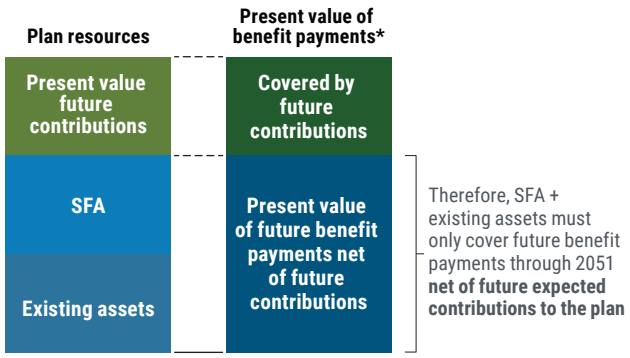
The stated objective of the SFA is to help multiemployer plans cover all future pension benefit payments due through 2051. Therefore, the amount of SFA will be calculated such that, when combined with existing plan assets and expected future contributions, it should be sufficient to cover future pension payments over the contemplated horizon. Future contributions to the plan can be used to directly cover (or partially cover) benefit payments due at

around the same time as those contributions are made (or shortly after). Therefore, in order to achieve the stated objective of the SFA program, the combination of existing plan assets and SFA funds (as well as the returns earned on both) would need to be sufficient to cover future benefit payments **net of future expected contributions** (see Figure 1). Going forward, references to matching future pension benefit payments through 2051 signifies net of future expected contributions.

While the prospect of being able to cover all benefits through 2051 is reason to celebrate, the math to get there is more complicated.

On the surface, IG credit fixed income is the consummate asset class when seeking to construct a portfolio to cover future benefit payments, particularly when a significant amount of those payments are due in the near-to-medium term. When considering allocations for SFA funds, it would be unfortunate if the fresh infusion of capital were invested in higher-volatility securities (such as equities) that experienced a significant drawdown early in the life of this program. As benefits are being paid, a meaningful amount of those losses would be crystalized and the plans may ultimately fall short of the objective of covering benefit payments through 2051, even if the market recovered and delivered attractive results over the long term. Locking in these mark-to-market losses through the benefit payment process could put those plans behind the eight ball.

Figure 1: Combining SFA, existing assets and future plan contributions to cover pension benefits through 2051



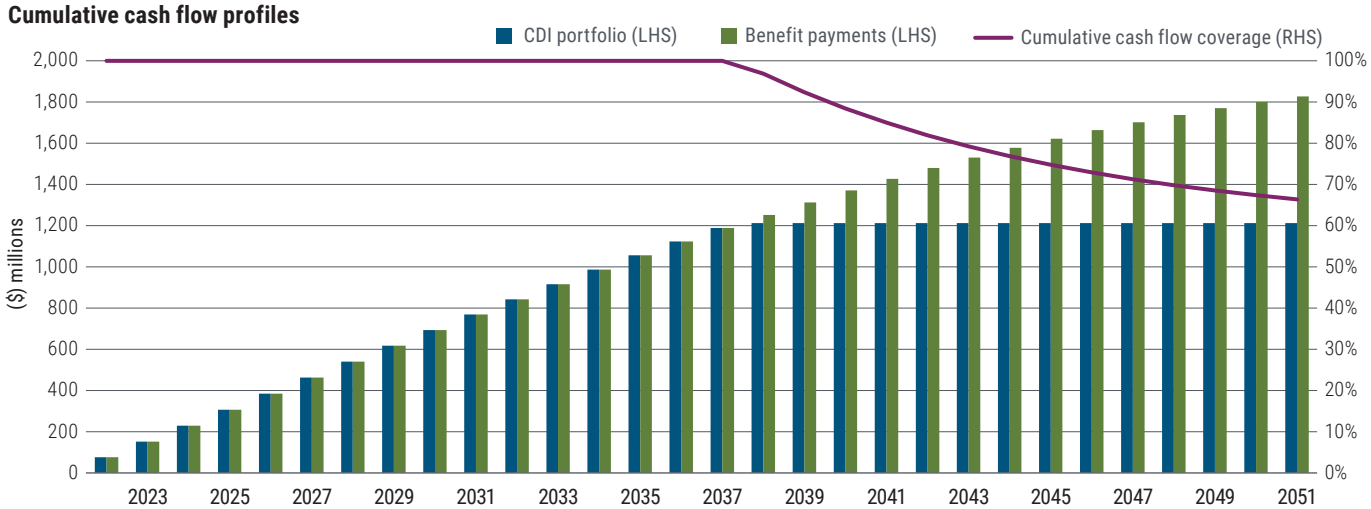
*Through 2051
Source: PIMCO. For illustrative purposes only.

Figure 2: A public fixed income IG credit strategy is likely to lock in a significant shortfall relative to the objective of covering benefit payments through 2051 ...

Assumptions	
Present value of benefit payments (until 2051) at 5.5%	$1 billion
Plan assets (existing + SFA funds)	$1 billion

100% of plan assets invested in a CDI portfolio	
Duration	7.3
Average credit quality	A-
Portfolio expected yield	2.36%
Excess return assumption	25 bps p.a

Cumulative cash flow profiles



Source: PIMCO as of 31 July 2021. **Hypothetical example for illustrative purposes only.** The CDI portfolio is based on a bespoke index derived from the Bloomberg US Credit Index. Excess return assumes an additional yield of 25 basis points generated by active management. The above Figure does not reflect fees and expenses associated with portfolio management and would be lower, if applied. The Figure is provided for illustrative purposes and is not indicative of the past or future performance of any PIMCO product.

Therefore, the idea of putting together an IG fixed income credit portfolio whose future cash flows – from coupons and maturing principal – would more or less match expected benefit payments over the contemplated horizon of about 30 years seems appealing. (We'll refer to this cash flow-matching strategy as "CDI," short for cash flow driven investing.) Theoretically, if a fully funded plan were to invest its entire portfolio (i.e., both existing assets and the assistance funds, but in separate portfolios to satisfy the separate accounting requirement) in a CDI strategy with a yield close to the discount rate used to price future benefit payments, it should more or less ensure that it can cover pension benefits through 2051 (absent defaults, a historically rare occurrence for IG bonds, according to Moody's Investors Service annual municipal default study, which covers 51 years through 2020.)

Well, is this actually the case here? No, not really, due to the differences between the prescribed discount rate used to calculate the amount of assistance and prevailing yields in the IG credit bond market. Specifically, it appears the amount of assistance provided to eligible plans will be calculated using a discount rate of approximately 5.5% (based on the third-segment rates used for minimum funding standards for single-employer defined benefit pension plans covered by the PBGC). However, an IG credit cash flow-matching portfolio covering the next 30 years or so of liabilities would currently yield under 2.5%, according to PIMCO and Bloomberg data. This annual shortfall of more than 300 basis points (bps) would mean that the liability-matching IG portfolio would cover only 66% of expected benefit payments through 2051 (see Figure 2). In other words, the plan would likely run out of assets after 16 years, well short of the objective of covering benefit payments through 2051.

As Figure 3 shows (Option 2), a more typical actively managed IG credit strategy (i.e., no cash flow-matching objective) would provide only a modest improvement by covering 71% of future benefits on average (versus 66% for Option 1) and extending the time until assets run out to 17 years (versus 16 for Option 1). While positive, this improvement is still far from sufficient and would leave this hypothetical multiemployer plan well behind the objective of the assistance program.

How about pursuing a balanced asset mix (60% equity/40% fixed income) more in line with current asset allocations used by

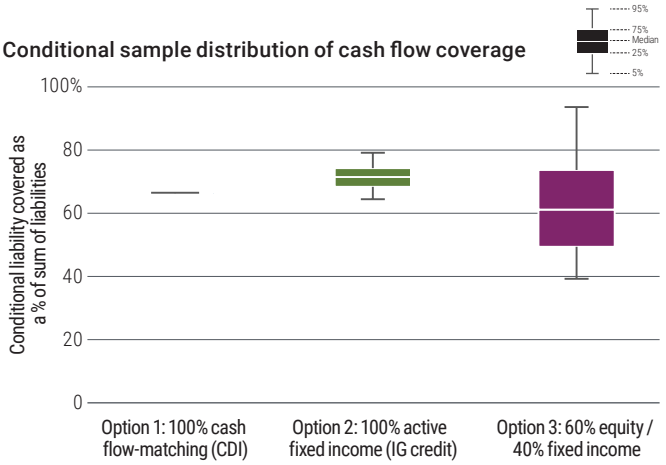
Figure 3: ... and more traditional investment approaches may fare even worse in a majority of scenarios

Cash flow coverage statistics (full sample – across all scenarios)[1]

	Option 1: 100% cash flow-matching (CDI)	Option 2: 100% active fixed income (IG credit)	Option 3:[2] 60% equities / 40% fixed income
Probability of full coverage through 2051[3]	0%	0%	28%
Average survival time[4] in years	16.0	17.4	19.6
Cumulative coverage (median)	**66%**	**71%**	**71%**
Cumulative coverage (25th percentile)	66%	68%	55%
Cumulative coverage (5th percentile)	66%	64%	39%

Cash flow coverage statistics (conditional sample – scenarios failing to meet 100% coverage)

	Option 1: 100% cash flow-matching (CDI)	Option 2: 100% active fixed income (IG credit)	Option 3: 60% equities / 40% fixed income
Cumulative coverage (median)	**66%**	**71%**	**61%**
Cumulative coverage (25th percentile)	66%	68%	49%
Cumulative coverage (5th percentile)	66%	64%	39%



Source: PIMCO as of 31 July 2021. **Hypothetical example for illustrative purposes only.** Returns on the CDI portfolio reflect assumptions in endnote 1. Active fixed income is based on the Bloomberg US Credit Index. The 60/40 portfolio is based on a 60% allocation to the S&P 500 and a 40% allocation to the Bloomberg US Credit Index. The above Figure does not reflect fees and expenses associated with portfolio management and would be lower, if applied. Figure is provided for illustrative purposes and is not indicative of the past or future performance of any PIMCO product.

multiemployer plans? According to our analysis, while a small number of right tail scenarios (about 25%) would produce full coverage (or excess coverage) of the future pension payments, the median coverage of benefits through 2051 would be no better than that offered by Option 2 (71% per Figure 3). Furthermore, it would fail to meet the objective of covering benefit payments over the contemplated horizon 72% of the time (see Figure 3, which shows the probability of full coverage). Option 3 would also run out of money on average after only 19.6 years (compared with the approximate 30-year objective). Even more concerning, according to our analysis, it would lead to a very significant amount of variability in potential outcomes and could leave the plan in a meaningfully worse position than the fixed income-only approaches in a large number of scenarios. For example, among the very large number of scenarios that fail to meet the objective of fully covering benefit payments through 2051 (72% of all scenarios for Option 3), the 25th percentile outcome would cover as little as 49% of future benefit payments. And in more dire market environments (the 5th percentile), that number would fall to 39%.

Therefore, given the initial conditions of the financial markets – specifically, very low yields and levels at or near all-time highs in the U.S. equity markets – none of these three options (rigid cash flow-matching with a 100% CDI allocation, actively managed IG credit, or a traditional 60/40 allocation) would put plan sponsors on a path that is consistent with the assistance program's primary objective of covering all expected benefits through 2051.

ADDRESSING THE ISSUE

To overcome this challenge, plan sponsors would need to construct portfolios with an internal rate of return (IRR) expectation that approaches the 5.5% discount rate used to determine the amount of assistance granted. This, however, needs to be done thoughtfully. Merely increasing risk in the portfolio could put multiemployer plans in an even worse position should those risky assets experience even temporarily challenging performance. This is because losses could be crystalized by benefit payments before the portfolio has a chance to recover.

Fortunately, a properly structured investment strategy can help address this obstacle. The approach entails two different portfolios, each with distinct objectives, but which combine to create a holistic strategy that may have a higher likelihood of meeting all future benefit payments through 2051.

The first portfolio's primary objective would be to cover as much of expected benefit payments as possible with very little variability of outcomes relative to that objective. Think of it as Option 1 in Figure 3, but implemented only for a portion of plan assets and assistance funds. It would be composed primarily of IG credit securities (with potentially a small allocation to high yield securities if these are ultimately allowed by the plan) selected such that their cash flows (coupons and principal) are reasonably well aligned with the pattern of expected future benefit payments. Because of its cash flow-matching nature, this CDI portfolio should take care of approximately half (53% in our example in Figure 4) of the benefit payments coming due between now and 2051. Markets could go up or down in any combination or sequence and this portion of the portfolio would still be expected to cover the same amount or share of pension payments (absent defaults, a historically relatively rare occurrence for investment grade bonds).

With a significant portion of the liability addressed with this CDI allocation, plan sponsors could then turn their attention to the structure of the second portfolio. The objective would be to deliver results that, when combined with those of the cash flow-matching portfolio, would produce an internal rate of return as close as possible to the implied discount rate used to determine the amount of assistance and help cover the entire benefit payment stream expected over the next 30 years. Because a large share of near-term liquidity needs should be met by the CDI portfolio, this return-seeking portfolio could potentially dial up its exposure to different risk premiums and accept higher levels of volatility or illiquidity that would otherwise likely not be appropriate or tolerable. This, in turn, might increase the likelihood of achieving the desired return. Over time, and at opportune moments, the potential income generated by the return-seeking portfolio would hopefully migrate to the CDI portfolio to cover an even larger share of future benefit payments.

Private credit investment strategies could be a fit for some plans within the return-seeking portfolio. With their higher return potential, and associated higher volatility, private credit strategies may help plan sponsors achieve a return in line with the implied discount rate needed to cover future benefit payments – and do so with potentially lower overall portfolio downside risk, as Figure 4 shows (a 25th percentile coverage ratio at 94% for Option 4 versus 55%–68% for Options 1–3). In addition, many private credit strategies offer regular income distribution that could be used to extend the cash

Figure 4: The right investment approach can drastically improve the likelihood of achieving the intended objective of the assistance program

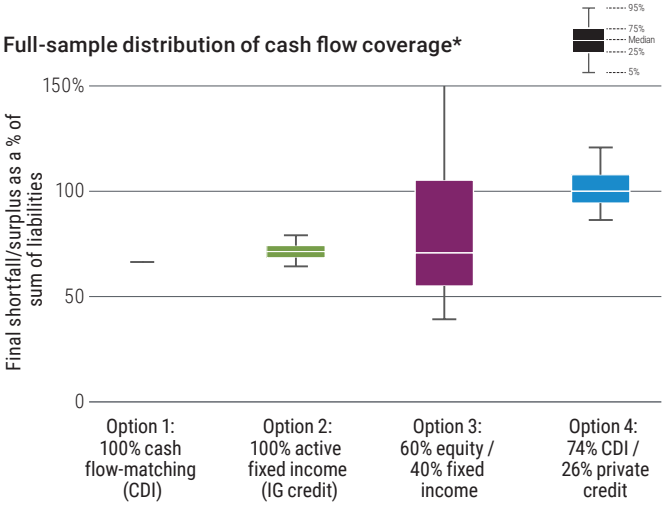
Cash flow coverage statistics
(full sample – across all scenarios)

	Option 1: 100% cash flow-matching (CDI)	Option 2: 100% active fixed income (IG credit)	Option 3: 60% equities / 40% fixed income	Option 4: 74% CDI / 26% private credit[6]
Probability of full coverage through 2051	0%	0%	28%	50%
Average survival time in years	16.0	17.4	19.6	28.3
Cumulative coverage (median)	66%	71%	71%	100%
Cumulative coverage (25th percentile)	66%	68%	55%	94%
Cumulative coverage (5th percentile)	66%	64%	39%	86%

Cash flow coverage statistics
(conditional sample – scenarios failing to meet 100% coverage)

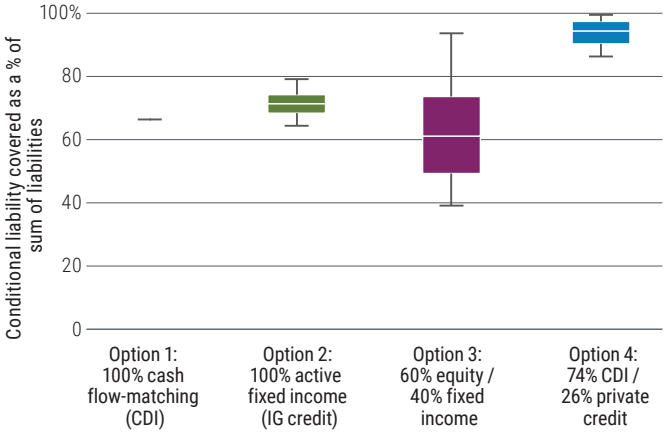
	Option 1: 100% cash flow-matching (CDI)	Option 2: 100% active fixed income (IG credit)	Option 3: 60% equities / 40% fixed income	Option 4: 74% CDI / 26% private credit
Cumulative coverage (median)	66%	71%	61%	94%
Cumulative coverage (25th percentile)	66%	68%	49%	90%
Cumulative coverage (5th percentile)	66%	64%	39%	86%

Full-sample distribution of cash flow coverage*

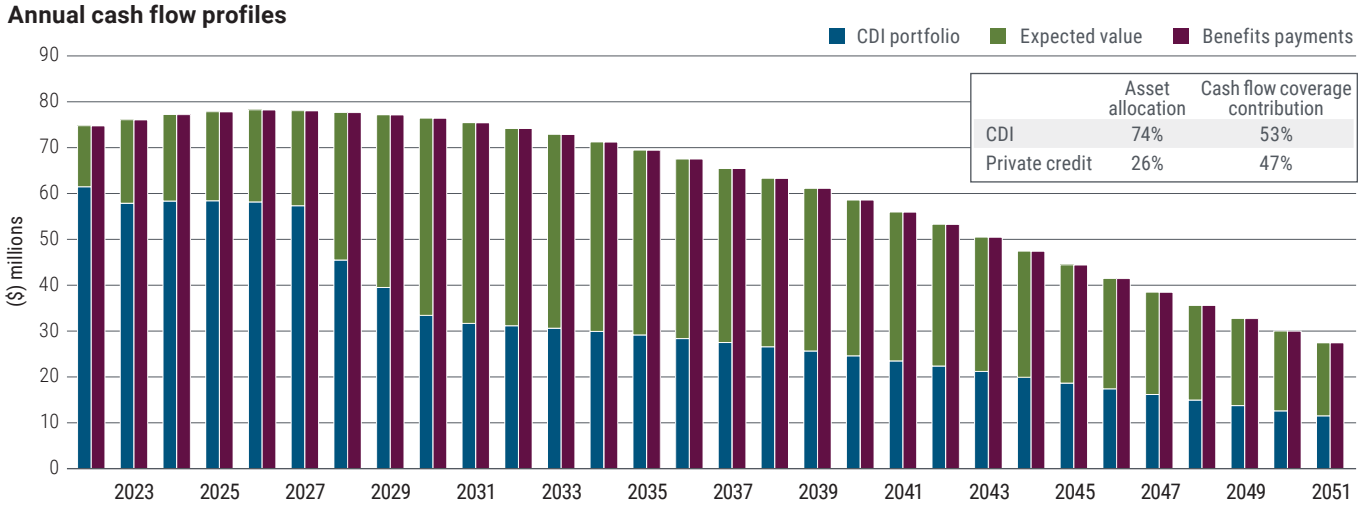


*Not all data points shown. The 95th percentile for Option 3 is at 250%.

Conditional sample distribution of cash flow coverage



Annual cash flow profiles



Source: PIMCO as of date 31 July 2021. **Hypothetical example for illustrative purposes only.** See Figure 3 for detail on Options 1 - 3. See endnote 5 for detail on the private credit model used in Option 4. The above Figure does not reflect fees and expenses associated with portfolio management and would be lower, if applied. Figure is provided for illustrative purposes and is not indicative of the past or future performance of any PIMCO product.

flow-matching portfolio over time. Our analysis found that an allocation of approximately **75% to the CDI portfolio and 25% to a return-seeking portfolio** invested in an evergreen and income-producing private credit strategy[5] could drastically improve the ability of the combination of existing plan assets and assistance funds to cover the next 30 years of expected benefit payments (see Figure 4).

Indeed, as Figure 4 shows,[8] Option 4 is likely to achieve an outcome more consistent with the objectives of the assistance program and those of multiemployer plan sponsors. On average, the option would meet the objective of covering future expected benefit payments through 2051 with a **100% median coverage ratio.** In this approach assets would cover over 28 years of benefit payments on average, a drastic improvement compared to only 16–20 years with Options 1–3. In addition, Option 4 would fare much better in adverse scenarios, with a median conditional coverage ratio of the liabilities of 94% in scenarios where it fails to completely cover the benefit payments over the next 30 years, compared to only 66%–71% with the other three options. In other words, even in situations where it does not fully meet the objective of covering benefit payments through 2051, Option 4 would miss by only a small amount, while Options 1–3 would miss by a significant amount. And in dire market environments (5th percentile), Option 4 would still cover about 85% of the expected liability while the traditional mix of stocks and bonds would achieve less than 40% coverage.

CONCLUSION

The assistance program embedded in the American Rescue Plan Act provides multiemployer defined benefit plan sponsors with an opportunity to secure the retirement benefits of their participants for the next 30 years. However, simple or traditional investment approaches are likely to fail to meet this objective given the gap between the discount rate used to determine the amount of assistance offered and prevailing yields in the investment grade bond market, and lower future return prospects for several asset classes, including public equities and public fixed income.

We believe that many plan sponsors can potentially achieve better outcomes more consistent with the objectives of the program by combining a sizeable allocation to an IG fixed income CDI portfolio with a moderate allocation to a higher-octane private credit strategy designed to boost the overall expected internal rate of return of the portfolio to a level consistent with the discount rate used to determine the amount of assistance funds allocated to each plan. However, we also recognize that the inclusion of private credit might not be appropriate for all plans, and each plan should consult their investment professional prior to making an investment decision.

In order to meet the parameters around the deployment of assistance funds (like the investment grade requirement, for example), those funds would be expected to be invested in the CDI portion of the portfolio while existing plan assets would fund the remainder, if any, of the required CDI allocation as well as the entirety of the private credit allocation.

1 Expected returns are represented by PIMCO 5-year capital markets assumptions (CMAs) as of 4Q 2020, including 95 bps annual net-of-fee alpha for active IG credit portfolios and 25 bps for CDI portfolios. Alpha is modelled with an information ratio is 0.5.

2 Weights are rebalanced annually. The annual cash flow surplus / shortfall is invested into / funded by the portfolio pro-rata.

3 Cumulative coverage of a path is defined as $1 + \frac{NAV_\tau + (\sum PortfolioCashflowsPaid - \sum BenefitPayments)}{\sum BenefitPayments}$ where τ is the year of the survival time of that path.

4 Survival time: This is the last year the portfolio NAV is non-negative.

5 We model the private credit strategy as a duration-hedged high yield exposure and add a level of idiosyncratic risk consistent with achieving the following risk/return characteristics: a total expected return of 10% annually, an income distribution of 6.5% and an annualized volatility of 11%.

6 Option 4: Portfolio weights are not rebalanced. Annual cash flow surplus is re-invested into the portfolio on a 74/26% basis between CDI and private credit. Any annual cash flow shortfall is funded primarily by the CDI portfolio. In the case where the CDI portfolio has been entirely depleted, then any shortfall is funded by borrowing at the prevailing 1-year risk-free rate.

7 The CDI portfolio in Option 4 covers a different cash flow profile compared than Option 1. It has the following characteristics: 9.1 years of duration and 2.5% expected yield inclusive of 25 bps alpha annually.

8 Redemptions from the private evergreen credit strategy are designed to contribute no more than 60% of any annual liability cash flow.

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