WHITE PAPER

DiMeo Schneider & ASSOCIATES, L.L.C.

LDI Debate

May 2018

Factors to Consider Managing Pension Liabilities in a Transforming Environment

Brian Samuels, CFA
Institutional Consultant
Ryan M. Schultz, CFA
Research Analyst – Global Public Markets

- The combined expectations of the Tax Cuts and Jobs Act's (tax reform) and shifting capital markets have created new and timely reasons for plan sponsors to evaluate their pension liabilities.
- The tax reform's impact on pension contributions and projected increases in the Pension Benefit Guaranty Corporation (PBGC) Premiums, have produced incentives for plan sponsors to consider accelerating contributions to the plan.
- Complicating the decision are the prevailing conditions of capital markets and the current interest rate environment.

Tax reform & new incentives to accelerate contributions

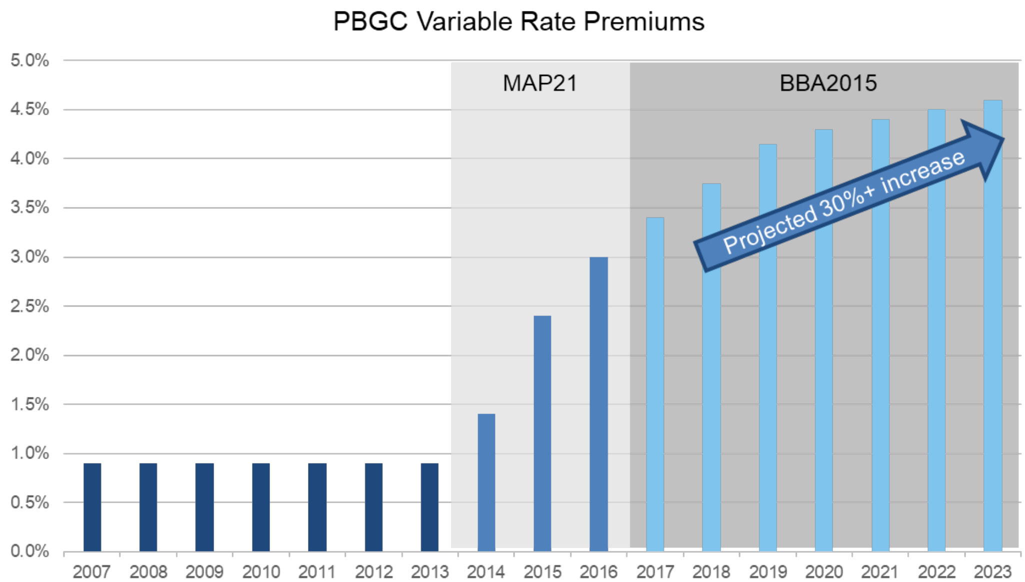
With the passage of tax reform, management teams across industries are evaluating how the new legislation will impact their various business strategies. Among the common funding strategies for pension contributions are: 1) contributions from the firm's balance sheet 2) asset allocation and 3) liability driven investment (LDI) strategies. However, this equation, has changed with tax reform revealing new opportunities and risks for plan sponsors.

A key provision of tax reform changes the tax treatment for employer contributions. The new legislation has reduced the corporate income tax rate to 21 percent from 35 percent; as well as the benefit of contributions made at the current tax rate by a 14 percent differential. Previously, pension contributions were tax-deductible at 35 percent; in-line with corporate income tax rate. There is, however, a caveat. Tax reform was enacted with a provision that extends making tax-deductible contributions at the previous rate of 35 percent. The extension schedule is as follows:

Tax Year Ending	Original Due Date	Extended Due Date	Timeline of Marginal Tax Rate
12/31/2017	4/15/2018	9/15/2018 **(+ 5 months)**	• Until 9/15/2018: **35%** • 9/16/2018 forward: **21%**
Any date other than 12/31/2017 (example: 9/30/2017)	15th day of the fourth month after the end of the taxable year	**Six month extension**	• Until 7/15/2018: **35%** • 7/16/2018 – 4/15/2019: **24.5%** • 7/16/2019 forward: **21%**

Source: Internal Revenue Service

Tax reform also modifies how management and plan sponsors make contributions. The new legislation allows for a favorable treatment of repatriated capital previously held overseas; providing companies with additional cash for their contributions. The 14-percent decrease in corporate tax rates has made appropriating debt capital for pension contributions less attractive with the reduction of the tax-shield. However, with PBGC Premiums and penalties imposed on plan sponsors for maintaining lesser funded statuses, debt financing may still be a viable option for making pension contributions. PBGC Premiums have increased and for the foreseeable future are expected to continue.



Source: Wells Fargo Asset Management

Although PBGC Premiums are rising, borrowing costs are still below Premiums, plans that aren't well funded have more incentive to increase their funding statuses through contributions from either balance sheet capital or external debt markets.

LDI in a rising rate environment

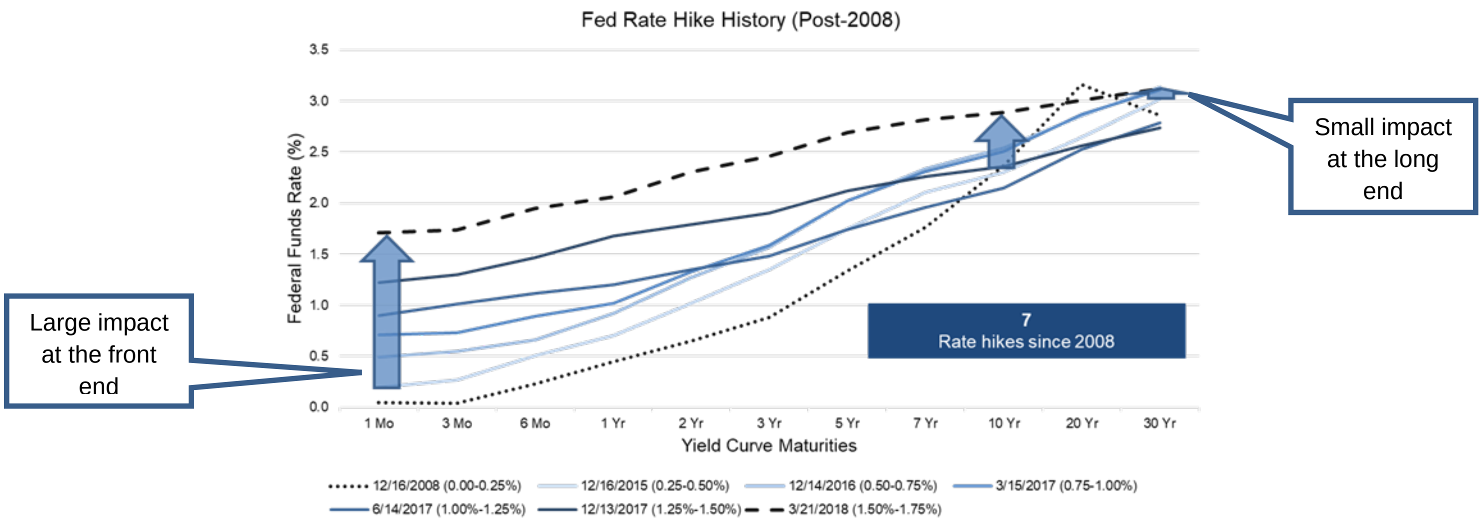
As interest rates rise, with the Federal Reserve System (Fed) having announced a tightening cycle to begin in June 2018, plan sponsors are asking: "Does an LDI portfolio still make sense?"

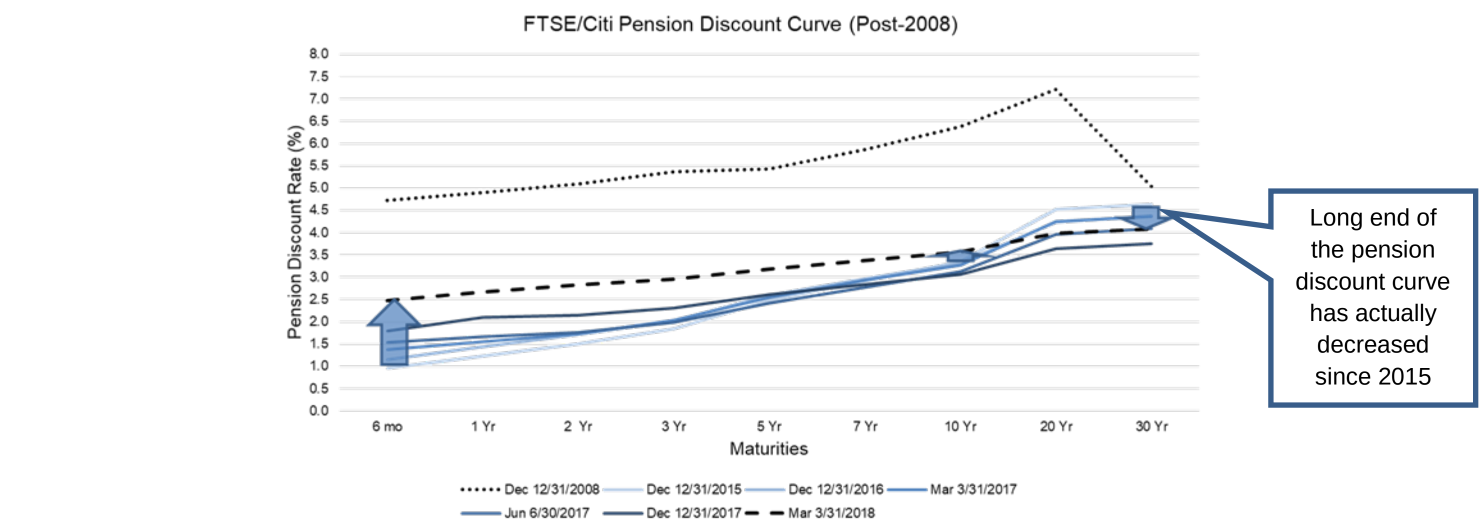
It is a valid question; with pension assets at a disadvantage, relative to pension liabilities.

Pension liabilities are discounted at the AA corporate credit rate. The long-duration, high-investment grade, corporate credit market maintains a high-level of demand from the number of participants far outweighing supply. This is from corporate pensions and insurance companies being prominent buyers of long-dated corporate bonds. For the past 30 years, this has led to liabilities consistently outperforming assets as interest rates trended downwards. Plan sponsors question: "Would under-hedging lead to outperformance of pension assets, relative to liabilities, if interest rates rise?" Unlikely!

The impact of Fed policy on interest rates is shown to be confined to the front-end of the yield curve, while the policy impact on longer-dated rates is muted by inflation and supply/demand. The effect is even more pronounced on pension discount rates since the Fed began raising rates.

However, it's unknown if the rates will continue to increase, and at what pace, across the curve.





Sources: United States Department of the Treasury, Society of Actuaries

Transformations to the pension landscape as a result of the Tax Cuts and Jobs Act can potentially impact fund statuses. With the timeliness of the issues outlined and how they can affect your Plan, reach out to DiMeo Schneider & Associates, L.L.C. to start the conversation.

Note: This report is intended for the exclusive use of clients or prospective clients of DiMeo Schneider & Associates, L.L.C. Content is privileged and confidential. Any dissemination or distribution is strictly prohibited. Information has been obtained from a variety of sources believed to be reliable though not independently verified. Any forecast represent median expectations and actual returns, volatilities and correlations will differ from forecasts. Past performance does not indicate future performance.

About the Authors:

Brian Samuels, CFA
Institutional Consultant

Brian services institutional clients by providing counsel and guidance on portfolio design, asset allocation, manager selection, investment policy statements and performance monitoring. Prior to joining the firm in 2017, Brian was an Investment Consultant at Willis Towers Watson. Brian earned a BA in Management and a BA in Communication & Media Studies from Goucher College. He received his Master of Business Administration (MBA) with concentrations in Investment and Corporate Finance from Duke University's Fuqua School of Business. Brian is a CFA® charterholder and member of the CFA Society of Chicago. In his free time, Brian enjoys travel, skiing and cooking.

Ryan Schultz, CFA
Research Analyst –
Global Public Markets

Ryan researches and performs operational due diligence on core investment managers. He is a member of our Global Public Markets Team. Prior to joining the firm in 2014, Ryan served as a Research Assistant in U.S. Public Finance for S&P Ratings Services. He received a BS in Management from Indiana University's School of Public and Environmental Affairs. He is a CFA® charterholder and member of the CFA Society of Chicago and CFA Institute. Ryan is a member of the Children's Research Fund Junior Board and enjoys competing in triathlons.