4Q22

TOPICS OF INTEREST

A brief guide to the SFA program

An investment perspective

October 2022

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Executive summary

The rules of the Special Financial Assistance (SFA) program have been published, and Plan actuaries have been discussing this with affected institutional clients over the past few months. In this paper we will not be doing a deep dive into the rules and inner workings of the program, though investors can access this information at ***https://www.pbgc.gov/arp-sfa****. Instead, we plan to approach this from an investment perspective.*

First, we describe the interest rate rules which determine how much funding a Plan may be eligible for, and the types of investments which are permissible. Next, we offer some ways in which investors may think about their legacy assets (non-SFA assets) relative to their new SFA funds, and how this funding might affect enterprise risk tolerance. Here we offer examples of investment approaches based on various funding situations. This section concludes by outlining a strategy in which SFA funds are used to ***cash flow match*** *expected future liability payments, which can help reduce funding volatility and mitigate a Plan sponsor's need to touch portfolio assets for meeting liability payments. Overall, the health of a Plan will determine how much SFA funding is available, and the total amount of SFA funding awarded will likely determine the degree to which this program should reasonably impact an investor's total portfolio strategy.*

What is Special Financial Assistance?

The SFA Program was created as a component of the American Rescue Plan Act of 2021 to assist underfunded multiemployer pension plans. Below is the official statement from the Department of Labor[1]:

> *"On March 11, 2021, Congress passed and President Biden signed the American Rescue Plan (ARP) Act of 2021, which authorized special financial assistance (SFA) through the Pension Benefit Guaranty Corporation (PBGC) to help save severely underfunded multiemployer plans and enabled over three million participants and beneficiaries to receive the pension benefits they earned through many years of hard work. Importantly, the multiemployer plans that cut their retirees' pension benefits under the Multiemployer Pension Reform Act (MPRA) must reinstate those benefits if the plans are approved for SFA."*

The PBGC estimates a total of $94 billion of available funding to support eligible pensions applying for SFA. Eligibility is determined by assessing Plan health by discounting assets at a given interest rate.

Interest rate rule (separate rate for non-SFA & SFA assets)

The amount of SFA available is based on the health of a pension. This is determined by projecting a Plan's existing cash flows from the measurement date (the last day of the third calendar month following the initial application) out into the future through year 2051, taking into account the forecasted liability payments during that time. This exercise, of course, requires an interest rate assumption with which to calculate future investment returns. The SFA program determines the interest rate to be the lesser of the interest rate used for minimum funding (actuarial assumed rate of return/hurdle rate) for its 2020 PPA certification[2] or:

- **SFA Assets:** lowest average of the unadjusted segment rates (described below) published by the Internal Revenue Service (IRS) for the month of the SFA application or any of the three preceding months +0.67%.
- **Non-SFA Assets:** lowest unadjusted 3rd segment rate published by the IRS for the month of the SFA application or any of the three preceding months +2.0%.

The segment rates are three interest rates calculated from corporate bond yields. They are published monthly by the IRS. Segment rates are used to discount the present value of the annuity payment that would have been made during a specific time period of an individual's retirement. A plan actuary will then use the rates provided by the IRS to determine its own segment rates applicable to its pension plan.

As of this writing the average segment rate (if using a June 2022 measurement date) for SFA assets is 2.4% and for non-SFA assets the rate is 3.38%. For example, if a Plan had an actuarial assumed rate of return of 6.75% as of its 2020 PPA certification, after receiving SFA funds the hurdle rate would change to approximately 3-4% for SFA monies (segment rate +0.67%) and 5-6% for legacy assets (segment rate +2.0%). Any additional return above the two hurdle rates would prolong the longevity of the Plan (i.e., an achieved return that is above portfolio *assumed rate of return* effectively improves the funded status of a Plan as assets are growing faster than what is needed to cover liability payments).

Permissible investments

An investor's legacy assets and the new monies received via the SFA program must be segregated. There are no rules or encumbrances on the legacy Plan assets but there are rules surrounding how the SFA money received is to be invested. The final rule allows up to 33% of funds to be invested in return seeking assets. These return seeking assets may include common stock, mutual funds, commingled funds, and ETFs denominated in U.S. dollars and registered with the Securities Exchange Commission. The other 67% of the funds must be allocated to investment grade bonds that pay a fixed rate of interest and are denominated in U.S. dollars. High yield bonds are only permitted if these bonds were rated investment grade upon purchase. Investment vehicles are limited to individual securities, mutual funds, ETFs, and commingled/pooled vehicles.

How do we invest the pools of money?

In this section we assume that regardless of whether the Plan holds legacy assets or not, the SFA funds will be drawn on first to pay benefits and plan expenses[3]. We believe this is prudent given that the SFA money comes with restrictions.

We also assume that the following examples are not meant to be a one-size-fits-all. Instead, every Board must consider their specific situation and how much risk they want to take within each pool of money.

Once funds are received, all Plans that received money will be in better financial shape in terms of funded status, as funding aims to prolong solvency through 2051. But differences will exist regarding funded status, the size of the separate pools, their proportion to one another, and the cashflow needs of each individual Plan which translates into how long the SFA portion will last. For example, a large portion of the funds received may go towards paying back retirees who saw their benefits cut years ago. These variables can affect how the SFA funds are invested.

In this section we provide a few ideas on how to invest SFA and Non-SFA monies. If a Plan has a very small proportion, or zero, in legacy assets, a cash-matching strategy (described below) may be the best option given that the Plan participants were not accruing future benefits before the legislation passed and trustees would want surety that benefits promised can be paid. Plans that are not frozen and still have an active population will need to weigh the risks relative to the possible returns needed to keep the Plan solvent past 2051.

Non-SFA funds (legacy Plan)

Unlike SFA funds, the legacy assets are likely associated with a higher expected return—generally between 5-6%—with no SFA-related investment restrictions. However, the goal is the same; to avoid large losses and keep the Plan solvent for as long as possible. Upon receipt of SFA funding, Plans may choose to shift their strategy in a variety of ways. The first approach may involve lowering the risk of the legacy assets since the return hurdle is now lower than most Plans' assumed rates. Second, the Board could decide to raise the risk of the legacy assets since the safer pool of SFA funds could reasonably be expected to protect against downturns, perhaps in efforts to maintain *total* portfolio risk at the previous level. As we stated earlier, most Plans will opt to let SFA funds be drawn upon first to pay liabilities. Investors should be aware that as they draw down SFA funds, overall Plan risk may naturally rise (drawing down the low risk SFA assets first means higher risk assets will remain). This may require a careful balancing act to keep the risk-and-return profile stable. Lastly, the Plan could remain diversified—simply maintaining existing allocations. Many diversified Plans are expected to return between 5-6% according to Verus 10-year capital market assumptions[4], which may support the case for staying the course. Leaving the portfolio 'as is' would help avoid manager turnover, which is time consuming, expensive, and can lead to a drag on performance.

SFA funds

These funds have restrictions, will be used to pay benefits and expenses, and will likely have a hurdle rate of around 3-4%. A 3-4% hurdle should not be too high of a bar given the possible 33% allocation to risk-seeking assets. The structure of this pool may be similar to a Health & Welfare Plan since these pools of money share many of the same characteristics. A lower return target means that the Plan can take less risk and likely avoid large losses, remaining liquid to pay obligations and expenses. Below are a few example allocations that conform to the rules, along with ten-year return-and-risk assumptions.

FIGURE 1: EXAMPLE SFA MIXES

	100% Core fixed income	75% Core fixed income 25% U.S. Equity	67% Core fixed income 33% U.S. Equity
Expected Return	3.2%	4.2%	4.5%
Expected Risk	4.1%	5.0%	5.9%

Source: Verus 10-year capital market forecasts as of 7/31/22

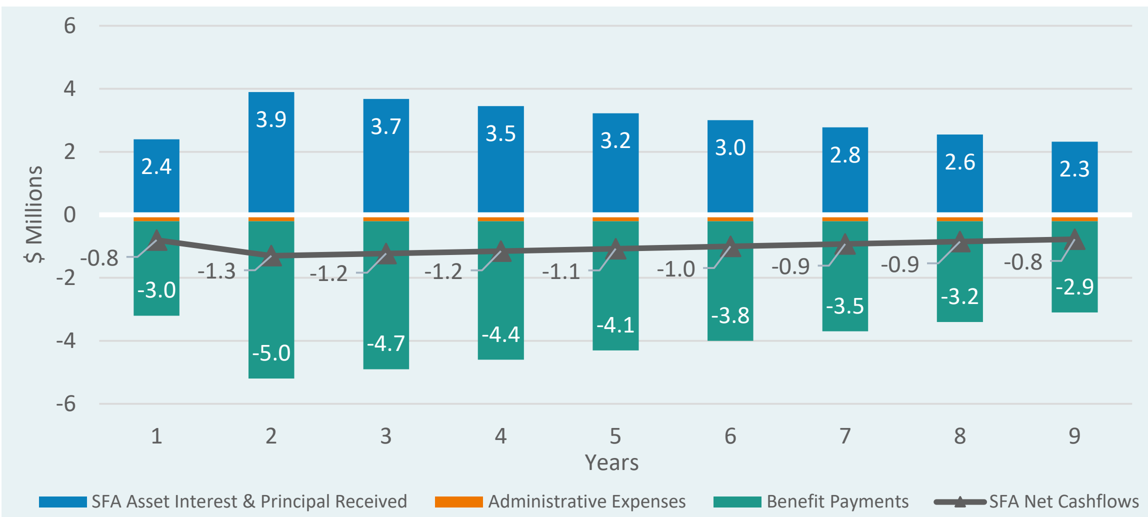
Cash-flow matching

In addition to deciding how SFA funding might impact the overall risk stance of the portfolio, investors should discuss whether *cash-flow matching* could be beneficial to Plan management. Cash-flow matching involves identifying expected benefit and operational expense payments that will be required in the near future (typically 1-3 years) and investing

SFA funds in a way which generates cash flows to match these future payments. For example, a bond portfolio might be purchased to provide steady coupon and principal cashflows to *match* ongoing liability payments. If implemented effectively, cash-flow matching helps reduce funding volatility and helps mitigate the Plan sponsor's need to sell portfolio assets in order to meet those liability payments.

The chart below provides an illustration of the concept of cash-flow matching. Expected future benefit and administrative expenses (cash outflows noted as negative payments in teal and orange) are partially *matched* by incoming cash flows from a bond portfolio (cash inflows noted in blue as positive inflows) which was purchased with SFA funds. In this example, the volatility of future liability payments was reduced while the size of needed cash outflows was also reduced.

FIGURE 2: CASH-FLOW MATCHING PROJECTION



Source: Verus, for illustrative purposes only

Broadly, when designing an investment strategy around SFA funding, a simple and cost-effective program may best serve investors. An investment program does not need to be complicated or expensive to be impactful, and this is especially applicable when Plans must be cost conscious and make every dollar count. A Plan with lower fees will perform better than a Plan with higher fees; all else being equal.

Summary

The SFA Program was created as a component of the American Rescue Plan Act of 2021 to assist underfunded multiemployer pension plans. The PBGC estimates a total of $94 billion in available funding to support eligible pensions applying for SFA. In this Topic of Interest white paper we addressed the subject from an investment perspective. First, we described the interest-rate rules which determine how much funding a Plan may be eligible for, and the types of investments which are permissible. Next, we offered ways in which investors might think about their legacy assets relative to their new SFA funds, and how this funding might affect enterprise risk tolerance. This included examples of investment approaches based on various funding situations and concluded by outlining a strategy for SFA fund *cash flow matching*, which can help reduce funding volatility and mitigate the Plan sponsor's need to touch portfolio assets for meeting liability payments. Overall, the health of a Plan will determine how much SFA funding is available, and the total amount of SFA funding awarded will likely determine the degree to which this program should reasonably impact an investor's total portfolio strategy.

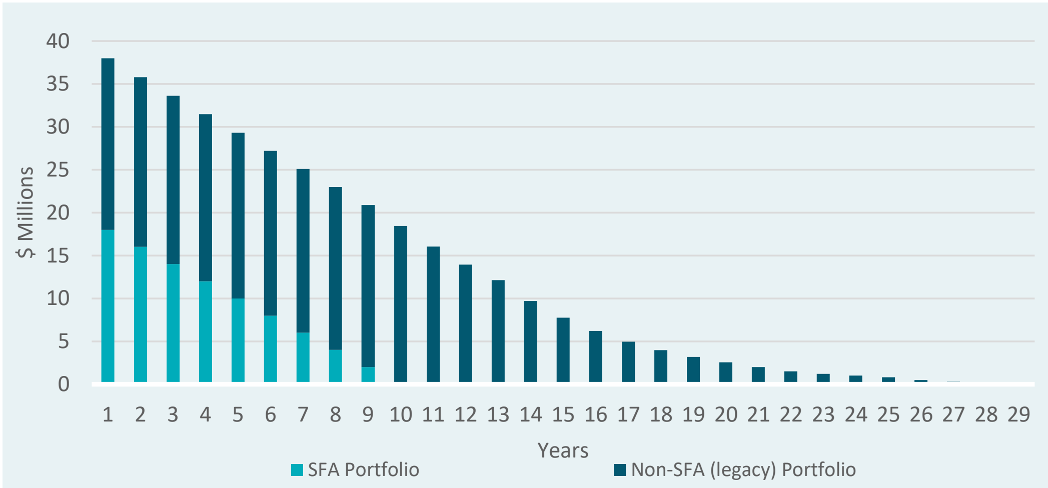
The SFA program has given many pensions a second chance and more importantly has given the hardworking people who earned those benefits peace of mind. To keep promises and pay benefits that have been promised, an investment portfolio must hit certain targets. The structures proposed above can be implemented in a cost-effective manner using simple best-in-class manager allocations combining both active and passive strategies. For more information regarding our views on the SFA program, please reach out to your Verus consultant.

Notes & Disclosures

1 *Department of Labor. U.S. Department of Labor Statement on PBGC "Special Financial Assistance" Interim Final Rule for Eligible Multiemployer Plans. https://www.dol.gov/agencies/ebsa/laws-and-regulations/laws/arp/dol-statement-on-pbgc-special-financial-assistance-interim-final-rule#:~:text=On%20March%2011%2C%202021%2C%20Congress,over%20three%20million%20participants%20and. Accessed 19 August 2022.*

2 *Multi-Employer Pension Plans are required to certify their zone/funded status once a year to the IRS. The zones are divided between healthy, endangered, seriously endangered, critical and critical and declining. Each Plan is placed in a zone based on how well funded the pension is at year-end. The purpose of this process is to put Plans into certain zones based on their projected ability to meet future pension obligations.*

3 *EXAMPLE: SFA & LEGACY PORTFOLIO ASSET VALUE PROJECTIONS*



Source: Verus, for illustrative purposes only

4 *TYPICAL INSTITUTIONAL PORTFOLIO ALLOCATIONS*

	Mix 1	Mix 2	Mix 3	Mix 4
US Large	21.4	24.4	23.1	29.0
US Small	2.4	2.7	2.6	3.2
Total Domestic Equity	***24***	***27***	***26***	***32***
International Developed	7.3	17.2	13.4	10.7
Emerging Markets	4.6	5.2	3.8	4.3
Total Int'l Equity	***12***	***22***	***17***	***15***
Total Equity	***36***	***50***	***43***	***47***
Core Fixed Income	35.2	18.2	11.6	16.7
Global Sovereign ex-US	2.6	3.8	2.5	3.3
Emerging Market Debt (Hard)	1.7	1.9	1.7	1.7
Emerging Market Debt (Local)	1.7	1.9	1.7	1.7
Total Fixed Income	***41***	***26***	***18***	***23***
Commodities	2.4	3.2	4.8	2.0
Core Real Estate	7.8	9.1	4.8	14.3
Total Real Assets	***10***	***12***	***10***	***16***
Hedge Fund	7.4	5.4	15.8	7.4
Private Equity	5.6	7.0	14.2	5.7
Total Non-Public Investments	***13***	***12***	***30***	***13***
Total Allocation	**100**	**100**	**100**	**100**

	Mix 1	Mix 2	Mix 3	Mix 4
Mean Variance Analysis				
Forecast 10 Year Return	***4.8***	***5.5***	***5.8***	***5.5***
Standard Deviation	8.8	11.4	12.1	11.0
Return/Std. Deviation	*0.5*	*0.5*	*0.5*	*0.5*
1st percentile ret. 1 year	*-13.7*	*-17.7*	*-18.8*	*-17.2*
Sharpe Ratio	0.54	0.50	0.50	0.51

Source: Verus, 2022 Capital Market Assumptions – each mix represents the median average of an institutional portfolio type (Corporate DB, Public DB, Endowment & Foundation, Taft Hartley)

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