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Insight INVESTMENT

JUNE 2021

THE BUTCH LEWIS ACT: A SOLUTIONS-BASED PERSPECTIVE

AS WE AWAIT IMPLEMENTATION GUIDANCE ON THE BUTCH LEWIS ACT, WE BELIEVE ELIGIBLE PLANS SHOULD LAY THE GROUNDWORK FOR HIGH-CERTAINTY FIXED INCOME AND LIABILITY MANAGEMENT SOLUTIONS.

THE BUTCH LEWIS ACT EXPLAINED

The Butch Lewis Act (the Act), was passed as part of the 'American Rescue Plan' in March 2021. It includes an estimated $86bn of special financial assistance to certain multi-employer pension plans facing severe economic challenges.

The Act is expected to provide single lump sum grants to cover 185 eligible plans' pension obligations for the next 30 years (up to 2051), with no obligation for plans to repay the government. The US Treasury will pay the lump sums directly to plans and the Pension Benefit Guaranty Corporation (PBGC) will administer the grants.

Plans must invest the lump sums into segregated portfolios (i.e. outside the plan's existing assets). The Act lists "investment grade bonds and other approved investments" as defined by the PBGC as eligible assets. The PBGC is expected to release final regulations to implement the Act in early July 2021, providing more details on this and other issues.

The Bank of New York Mellon (BNYM), Insight's parent company, was an early supporter of legislative efforts to assist multi-employer plans. When those efforts culminated in the Act, BNYM was one of the leading financial institutions endorsing its passage.

THE KEY CHALLENGE IN MAKING THE ACT WORK

The Act currently states that lump sum values will be determined based on a liability discount rate we estimate to be ~5.7% for most plans[1].

This implies that plans' investments must consistently return ~5.7% every year to keep pace with their liabilities. However, investment grade corporate bonds currently offer average yields of ~3.5%. Therefore, the assistance provided under the Act is likely to be insufficient for many plans to retain benefit levels through 2051. We project that, for many plans, under the calculation approach described in the Act, the assistance would be sufficient to maintain benefits only until ~2040, an 11-year funding 'shortfall'[1].

Figure 1: There is a risk that plans will only receive lump sums to meet obligations to 2040[1]

Plans would therefore be incentivized to 're-risk', by investing in higher risk and more volatile instruments such as equities to cover the potential shortfall. Although equities are not currently permitted investments for these segregated asset pools, plans may choose to re-risk their existing non-segregated plan assets to rebalance their overall asset allocation mix accordingly. This re-risking also creates a

[1] Public data, Insight calculations. Under the legislation, the discount rate is based on assumptions used in a plan's most recent status determination filing from before January 1, 2021 subject to a cap based on the Treasury "third segment rate" for the applicable month plus 200bp. The discount rate cap is expected to apply in almost all cases. Source BAML curve data at March 31, 2021.Before investment and other expenses are deducted. For illustrative purposes only. Does not represent any strategy, composite, or client account managed by Insight. Information contained herein is derived from sources believed to be reliable. Insight does not guarantee or warrant the accuracy, timeliness, or completeness of the information either collected, sourced or otherwise provided, and is not responsible for any errors or omissions

potential inequality between segregated and non-segregated asset pools and an intergenerational risk transfer from current retirees to active participants.

Therefore, we believe the current discount rate is not in keeping with the spirit and objective of the Act. Insight and BNYM have had discussions with the PBGC, the Department of Labor, the Department of the Treasury and the Department of Commerce. We have suggested the government use flexibility provided in the Act to adopt a discount rate consistent with current investment grade corporate bond yields. We believe this will help ensure the Act achieves its primary goal of providing for long-term plan solvency, and allow plans to achieve the required investment returns with high-quality fixed income portfolios that offer a high degree of cashflow certainty. We estimate this would increase the proposed total funding relief under the Act from ~$86bn to ~$100bn, which is permitted by the legislation.

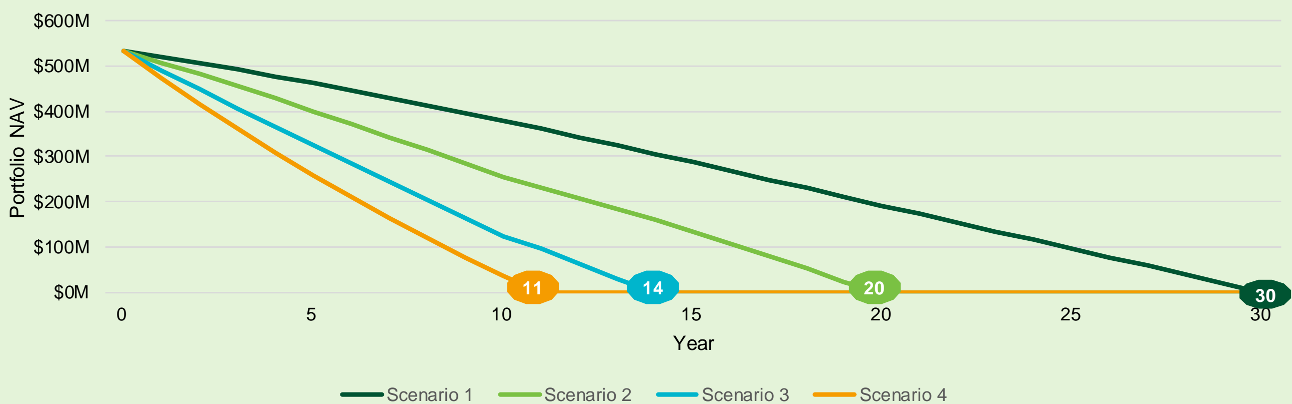
'DECUMULATION' ADDS FURTHER CHALLENGES

Multi-employer plans are increasingly moving from the 'accumulation' stage to the 'decumulation' stage of the investment cycle. Their membership is shifting, on balance, from working participants (i.e., still contributing to plan assets) to retirees (to whom regular obligations are paid from the plan). As such, plans increasingly need to spend assets down to meet pension 'promises'.

Decumulation can make meeting a return target far more challenging. Outflows can dramatically diminish the compound return effect (see the Appendix for an illustration using S&P 500 returns). Further, if positive returns on volatile assets are not delivered in earlier investment years, the plans' lump sums from the Act can even run out due to outflows.

For example, consider an illustrative plan seeking to meet $1bn of cashflows over 30-years, growing from a base of $533m, therefore needing to grow at 5.7% pa (or $467m cumulatively). Low returns in earlier years can cause the assets to be depleted well before the 30-year target (Figure 2).

Figure 2: Timing of returns is crucial in decumulation – returns need to be delivered early[2]



Return scenario		Cumulative $ Returns	Year assets are depleted	Residual Nominal $ shortfall
(dark green line)	5.7% pa	467M	30	0
(light green line)	3.3% pa in years 1 to 10, 6.92% thereafter	215M	20	252M
(blue line)	0% pa in years 1 to 10, 8.67% thereafter	21M	14	446M
(orange line)	-3.3% pa in years 1 to 10, 10.51% thereafter	(88M)	11	555M

The decumulation stage leaves Trustees particularly vulnerable to market uncertainty. We believe this increases the need for the Act to ensure that plans can invest entirely in investment grade assets due to the high quality nature of the investments and the relative cashflow certainty they can provide, while reducing the burden of timing risk associated with meeting cash obligations.

[2] Source: Insight calculations. For illustrative purposes only. Information shown herein is hypothetical and not meant to depict the performance of any client account or strategy managed by Insight Investment or its affiliates. Illustrative plan assumed to pay out $1B in cashflows over next 30 years. NPV of cashflow @ 5.7% = $533M.

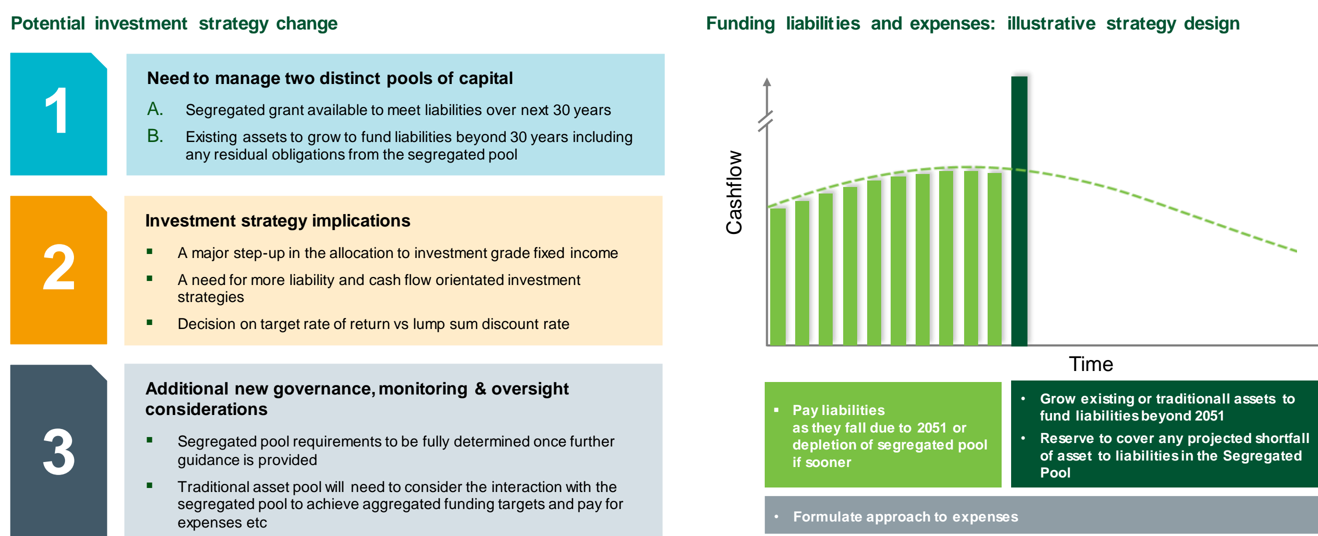
GOVERNANCE AND INVESTMENT STRATEGY IMPLICATIONS

It may be too soon for multi-employer plans and their consultants to take concrete actions. However, it is a good time to consider the important governance and investment strategy implications of the Act.

Plans will need to manage two pools of assets. We believe plans should structure their segregated assets from the Act with the aim of creating a 'high certainty' approach that maximizes the probability of fully meeting plan obligations until 2051. An emphasis on hedging liability risk and meeting cashflows is important to increase the likelihood that the assets provided under the Act will continue until 2051. Similarly, corporate bonds across different maturity profiles, non-US developed and emerging market bonds, global structured credit and / or interest rate overlays can also play a role.

We also believe that investors should consider solutions that allow them to grow their existing, non-segregated assets to meet their liabilities beyond 2051. While plans may wish to place a greater emphasis on return-seeking assets for this pool, we believe the allocations should also consider some component of fixed income and liability matching (Figure 3).

Figure 3: Funding liabilities and expenses: illustrative strategy design[3]



CONSIDERING A LIABILITY 'QUARTERBACK'

Many plans already have fixed income managers. However, Trustees of plans adhering to a multi-manager investment framework may wish to work with a liability solution 'quarterback' – i.e. a manager with a specific mandate and responsibility to 'complete' the plan's overall fixed income exposure to ensure liability risks and cashflows are well-matched to the underlying liabilities up to 2051. The quarterback would be responsible for co-ordinating across multiple managers and managing across both physical assets and simple derivative overlays to 'fill in the gaps' where appropriate, including appropriate reporting and oversight communication.

READY, SET, WAIT

The PBGC is scheduled to release additional guidance in July 2021 which will hopefully clarify key parameters for the recipients of special financial assistance under the Act, including:

- What investment objective should Trustees follow for allocating assets in the segregated pool?
- What discount rate will be used to calculate the grant amount?
- What investments will qualify as eligible?
- What investment tools are Trustees allowed to deploy to manage interest rate (or discount rate) risk (i.e., will interest rate derivatives be permitted)?

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[3] Public Information, American Rescue Plan Act of 2021. Information contained herein is derived from sources believed to be reliable. Insight does not guarantee or warrant the accuracy, timeliness, or completeness of the information either collected, sourced or otherwise provided, and is not responsible for any errors or omissions. Opinions expressed herein are as of the date of this presentation, and are subject to change without notice. Insight assumes no responsibility to update such information or to notify a client of any changes. Insight does not provide tax or legal advice to its clients and all investors are strongly urged to consult their tax and legal advisors regarding any potential strategy or investment

- Under what circumstances is it appropriate to pursue a riskier strategy than implied by a ‘least-risk’ approach?
- What happens if a ‘shortfall’ emerges?
- How should Trustees set investment strategy for the existing pool of assets covering liability obligations beyond 2051?
- What is the process to assess ‘investment grade’ credit risk? And what actions are necessary if an investment is subsequently downgraded to non-investment grade?

Insight and BNYM will review the updated PBGC guidance when released and will subsequently publish a follow-up paper.

ABOUT INSIGHT

Insight specialises in fixed income, LDI and cashflow-driven investment solutions for large institutional clients such as pension plans. Insight works with clients around the world and has total global assets under management of $970bn[4].

Within our global fixed income group, we invest across Core, Core Plus, Corporate, global, emerging market and global structured credit, including both public and private investment grade lending opportunities. We have total dedicated fixed income assets under management of ~$206bn[4].

We incorporate many of these opportunities into long, intermediate or short duration liability-aware fixed income strategies as well as CDI strategies. Within our LDI strategies we are also highly experienced in implementing overlay and liability completion strategies. Within our risk management solutions group, we have total global assets under management of $702bn[4].

ABOUT BANK OF NEW YORK MELLON

BNYM is Insight’s parent and one of the largest service providers and asset managers in the multi-employer pension plan industry.

BNYM is a long-time advocate of efforts to address the challenges facing multi-employer pension plans and an early supporter of the Butch Lewis Act specifically. We welcome the Act and believe it to be timely and necessary.

[4] As of March 31, 2021. Assets under management (AUM) are represented by the value of the client’s assets or liabilities Insight is asked to manage. These will primarily be the mark-to-market value of securities managed on behalf of clients, including collateral if applicable. Where a client mandate requires Insight to manage some or all of a client’s liabilities (e.g. LDI strategies), AUM will be equal to the value of the client specific liability benchmark and/or the notional value of other risk exposure through the use of derivatives. Figures shown in USD. FX rates as per WM Reuters 4pm spot rates.

APPENDIX: THE BURDEN OF DECUMULATION ON COMPOUND RETURNS

Consider a $1bn investment in the S&P 500, which earned 6.1% pa on average from 2000-2019. Assuming no outflows, this is a cumulative return of $2.2bn regardless of the timing of returns (Figure 4)

Figure 4: S&P 500 investment with no outflows demonstrated strong 20-year returns[5]

However, if we now assume a $50m outflow every year, a 6.1% pa average return would earn a $1.4bn cumulative return. But given actual timing of returns on the S&P 500 over this period, the return would only be $384m, less than a third of the 'steady returns' scenario (Figure 5). This is due to the strongest S&P 500 returns occurring toward the end of the period, when the bulk of outflows had already occurred.

Figure 5: Outflows can diminish the compound return effect[2]

If positive returns on volatile assets are not delivered in earlier investment years, the plans' lump sums can potentially run out due to outflows. This impact would significantly increase the burden on the Trustees to achieve significantly higher investment returns to meet any expected funding 'shortfall', thereby decreasing the 'certainty' of meeting the necessary benefit payments.

[5] Source: Bloomberg. Past performance is not indicative of future results. *S&P 500 total returns for period 12/31/1999 12/31/2019. 2. 28% = $384 / $1,391. For illustrative purposes only. 2000 2019 S&P500 performance returns and the impact to a sample plan. Information shown herein is hypothetical and not meant to depict the performance of any client account or strategy managed by Insight Investment or its affiliates. The information does not reflect trading or market conditions.

FIND OUT MORE

Insight Investment
200 Park Avenue, 7th Floor
New York, NY 10166
212-527-1800

Client Relationship Management
institutionalna@insightinvestment.com

Consultant Relationship Management
consultantsna@insightinvestment.com

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