The impact of market volatility on funded status

January 2019

MARKET PARTICIPANTS REMAIN FOCUSED ON DOWNSIDE RISKS, LEADING PESSIMISM, RATHER THAN OPTIMISM, TO PERMEATE THE INVESTMENT LANDSCAPE. But perhaps this downbeat view is warranted—last week saw the largest decline in the ISM Manufacturing index since October 2008, December light vehicle sales were disappointing, the outlook for global growth remains lackluster, consumer and business confidence are under pressure, and political uncertainty continues to hang heavy in the air. While the December employment report was solid, this broader backdrop suggests that markets will remain choppy in the coming weeks, and that it may take time for this haze of negativity to clear.

If you do not believe the economy is headed into recession this year, the deterioration we have seen in asset prices, fundamentals, and sentiment has simultaneously created opportunity. The forward P/E ratio of the S&P 500 currently sits below its 25-year average, with stocks now looking cheap relative to their own history, as well as relative to bonds. Last year was a bit unique in the sense that the stock market fell despite a backdrop of robust earnings growth; since 1989, there have been five years when this occurred, and returns the following year have averaged 15.2%. If we think more broadly about years where equity multiples have contracted, there have been 15 years since 1989 when the forward P/E of the S&P 500 declined. During these years, the forward P/E fell by an average of -10.6%, and six of the 15 observations saw P/E's contract more than 10%. The market saw average returns of 7.4% in the year following a P/E contraction, and average returns of 22% when multiples fell by more than 10%. So, the set up for this year is undoubtedly more favorable than had it ended on September 30.

Pension plan funded status has deteriorated during the past few weeks, with total return-oriented plans getting hit the hardest. While the re-rating in equity valuations has left these markets looking more attractive, the prospect of elevated volatility may warrant a more defensive, income-oriented approach. As such, we continue to focus on those assets which provide a healthy stream of income alongside the potential for capital appreciation. By trying to split the difference between a defensive and risk-on posture, we believe that investors can position themselves to capture any upside that might materialize between now and the end of the cycle, with income providing a buffer against elevated levels of volatility.

We remain cautiously optimistic that economic growth will stabilize, profit growth will remain positive, and some progress will be made on trade. However, cheap markets can always get cheaper. Fundamentals will matter as liquidity is withdrawn from the system, and knowing what you own will be of the utmost importance.

AUTHORS

David Lebovitz
Global Market Strategist, Global Market Insights

Michael Buchenholz
Head of U.S. Pension Strategy, Institutional Strategy and Analytics

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EXHIBIT 1: IMPACT ON SAMPLE CORPORATE PENSION PLAN*

	11/30/2018	Period impact	1/4/2019
Assets ($mm)	880.0	-1.8%	864.2
Liabilities ($mm)	1,000.0	3.1%	1,030.6
Funded status (%)	88.0	-4.1%	83.9

*Sample Plan: Liability Duration of 12.5 yrs and the following asset allocation: 36% S&P 500, 15% EAFE, 3% EM Equity, 40% US Long Gov/Credit, 3% US High Yield, 3% EMD; Interest Rate Hedge Ratio = 45%. Calculation is simulated and no guarantee can be given that a strategy/product will perform accordingly (as based also on other factors that may not be part of the simulation).

- The sample corporate plan funded status **fell 4.1%** from 11/30/2018 to 1/4/2019.
- Lower treasury rates and wider spreads in the led to a ~25bps decrease in discount rates over the period, but the increase since year-end 2017 is still +63bps.
- Negative public equity returns were partially offset by high quality fixed income, leading to a -1.8% portfolio return over the period.
- More de-risked plans with less public equity exposure and higher hedge ratios would see more moderate funded status decreases over the same period.

EXHIBIT 2: PENSION DISCOUNT CURVE CHANGE

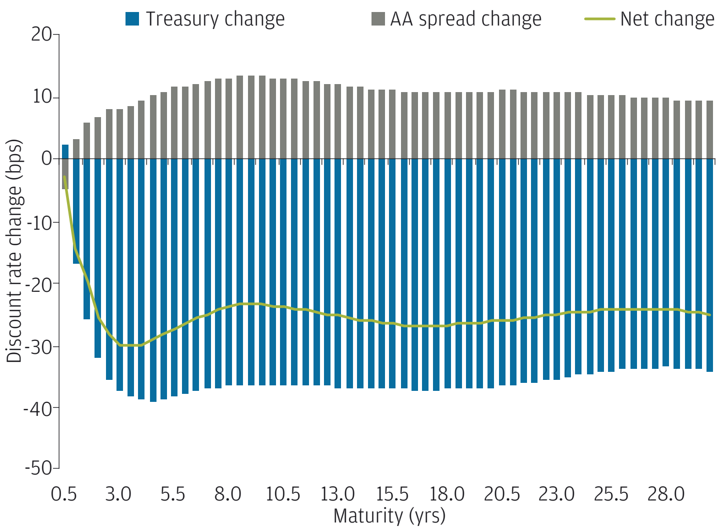
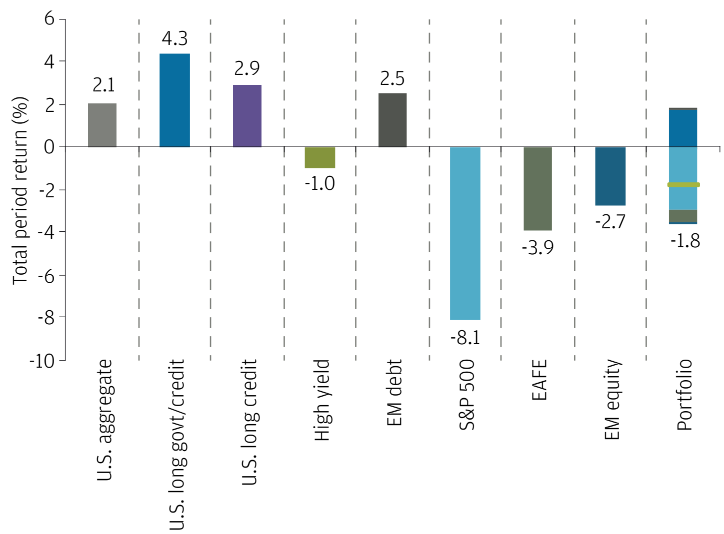


EXHIBIT 3: ASSET CLASS RETURNS



Source for Exhibits 1-6: J.P. Morgan Asset Management Inc., Bloomberg, Barclays Live, Morgan Markets as of market close 1/4/2019. The information in the graphs and charts is for illustrative purposes only. Readers should not rely on them when making investment decisions.

EXHIBIT 4: ARCHETYPAL SAMPLE PLANS

Portfolio	Hedge ratio (%)	Period funded status change (%)
Baseline	45	-4.10
TOTAL RETURN	18	-5.30
DE-RISKED	75	-1.50

In contrast to our baseline portfolio example:

- A more **DE-RISKED** portfolio would have fared better from lower public equity exposure and protection from falling interest rates
- A more **TOTAL RETURN-ORIENTED** portfolio would have fared worse, with similar public equity levels but less duration exposure in the fixed income to act as a ballast in volatile markets

EXHIBIT 5: DAILY FUNDED STATUS TRACKING

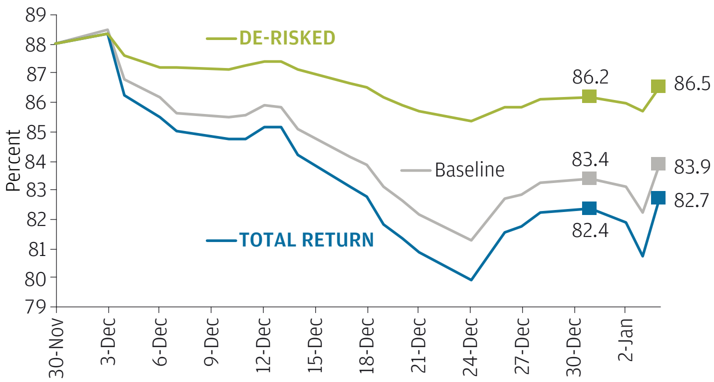
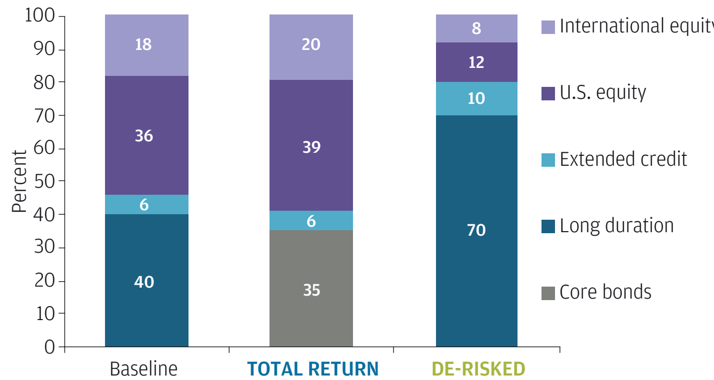


EXHIBIT 6: ARCHETYPAL SAMPLE PORTFOLIOS



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