

# Tax Reform: Implications for Pension Contributions and the Yield Curve

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**Tuesday, February 13 at 3:00 ET**

**Dial in: (888) 549-3557 | Conference ID: 5777009**

FOR PROFESSIONAL INVESTORS ONLY

Wells Fargo Asset Management is a trade name used by the asset management businesses of Wells Fargo & Company.



# Presenters

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**Fredrik Axsater, CFA**

*Executive Vice President, Head of Strategic Business Segments, Wells Fargo Asset Management*

Fredrik is Head of Strategic Business Segments at Wells Fargo Asset Management (WFAM). In this role, he is responsible for growing key WFAM businesses, including Defined Contribution (DC) and Environmental, Social and Governance (ESG) investing. He co-led a strategic partnership between State Street and the CFA Institute, and for many years he has also worked closely with the CFA Institute to evolve the CFA curriculum. Fredrik is a member of the WFAM Executive Committee.



**Andy Hunt, FIA, CFA**

*Co-Head of WFAM Global Fixed Income / Head of LDI and Global Credit*

Andy Hunt serves as the co-head of Global Fixed Income and head of liability-driven investing and global credit at Wells Fargo Asset Management (WFAM). In this capacity, he focuses on building out the firm's LDI solutions, creating a cohesive global credit platform. He has earned the right to use the CFA designation, as well as the United Kingdom's Fellow of the Institute of Actuaries (FIA) designation.



**Jonathan Hobbs, CFA, FSA**

*Head of US Portfolio Solutions, Multi-Asset Solutions*

Jonathan Hobbs is the head of U.S. portfolio solutions for the Multi-Asset Solutions team at Wells Fargo Asset Management (WFAM). In this capacity, he designs and implements outcome-oriented investment portfolios. He holds a bachelor's degree in actuarial science / finance from Drake University, is a Fellow of the Society of Actuaries, and has earned the right to use the CFA designation.



**Janet Rilling, CFA**

*Team Leader and Senior Portfolio Manager, Customized Fixed Income*

Janet Rilling is leader of the Wells Fargo Asset Management (WFAM) Customized Fixed Income team and senior portfolio manager. Janet is a Certified Public Accountant and has earned the right to use the CFA designation.

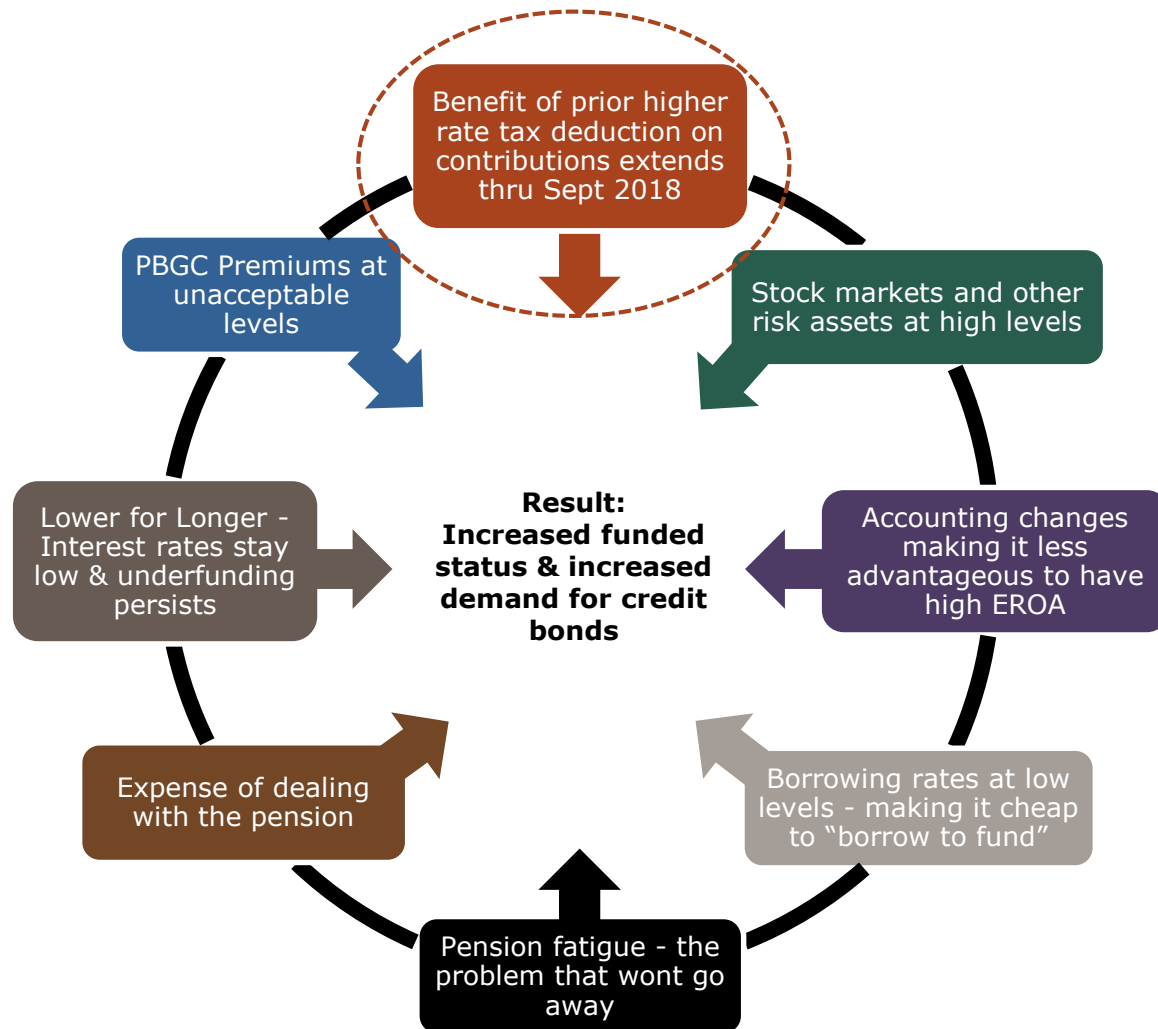
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# Agenda

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- 1 2018 – A year of de-risking activity for DB plans
- 2 Implications for US Treasury curve and credit spreads
- 3 What to do with your pension plan investments?
- 4 Introduction to Small Issuer Long Credit (SILC)

# 1 2018 – A year of de-risking activity for DB plans?



# 1 35% Window for Pension Contributions Closing

- The Tax Cuts and Job Acts has happened – but pension plan contributions can be made in 2018 that count as 2017 contributions and hence are able to gain deductibility at the old levels – i.e. up to 35%
- This provides a clear opportunity to pull forward expected future contributions and gain a tax benefit

Tax Year Ending	Unextended Due Date	Extended Due Date	Timeline of Marginal Tax Rate
12/31/2017	April 15	Five-month extension: September 15	<ul style="list-style-type: none"> <li>• Until 9/15/2018: 35%</li> <li>• 9/16/2018 forward: 21%</li> </ul>
6/30/2017	September 15	Seven-month extension: April 15	<ul style="list-style-type: none"> <li>• Until 4/15/2018: 35%</li> <li>• 4/16/2018-4/15/2019: 28%</li> <li>• 4/16/2019 forward: 21%</li> </ul>
Any date other than 12/31/2017 or 6/30/2017 (9/30/2017 as an example)	15 <sup>th</sup> day of the fourth month after the end of the taxable year	Six-month extension	<ul style="list-style-type: none"> <li>• Until 7/15/2018: 35%</li> <li>• 7/16/2018-7/15/2019: 24.5%</li> <li>• 7/16/2019 forward: 21%</li> </ul>



# 1 Wave of voluntary pension contributions

- This is not just talk... we have seen a wave of voluntary pension contributions
- Below is a list of announcements from just one week of earnings calls:

Company	Date	Industry	Contribution Size (US\$MM)
FedEx	1/26/2018	Air Freight and Logistics	\$1,500
FirstEnergy	1/22/2018	Electric Utilities	\$1,250
Raytheon	1/25/2018	Aerospace and Defense	\$1,000
Caterpillar	1/25/2018	Machinery	\$1,000
UBS	1/22/2018	Finance	\$770
AbbVie	1/26/2018	Biotechnology	\$750
3M	1/25/2018	Industrial Conglomerates	\$600
Northrop Grumman	1/25/2018	Aerospace and Defense	\$500
Celanese	1/25/2018	Chemicals	\$316
Rockwell Automation	1/24/2018	Electrical Equipment	\$200
Moog	1/26/2018	Aerospace and Defense	\$180
Allegheny Technologies	1/23/2018	Metals and Mining	\$135
Brown-Forman	1/23/2018	Beverages	\$120
Illinois Tool Works	1/24/2018	Machinery	\$115
<b>Total</b>			<b>\$8,436</b>

Source: Wells Fargo Securities

## 2 U.S. Tax reform – impact on corporate bonds

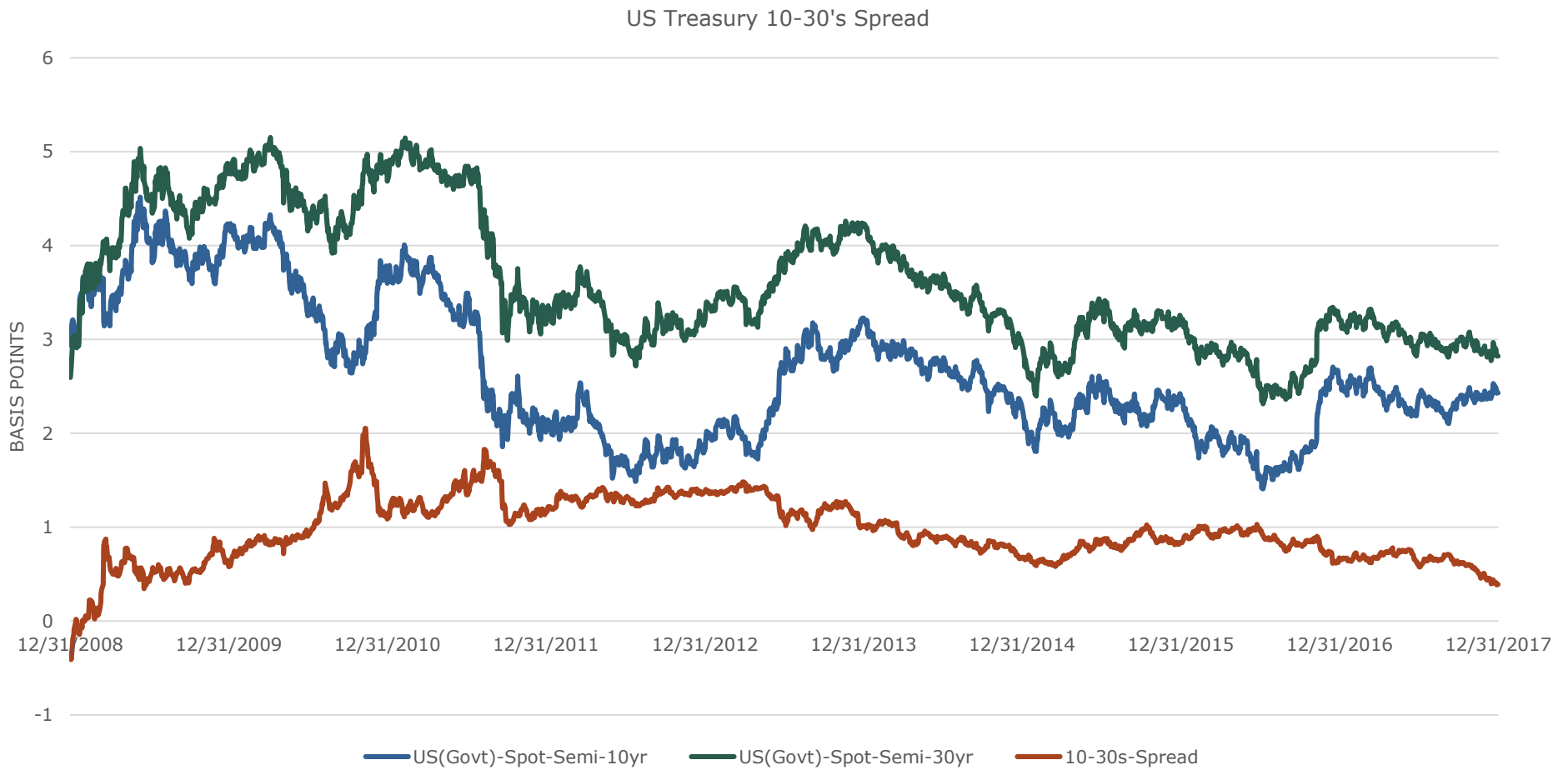
- US Tax Reform has had, and will continue to have, quite an impact on the corporate bond market
- These effects will have an impact on defined benefit plans that are seeking to hedge their liabilities





## 2 Curve flattening-driven by pension plan buying?

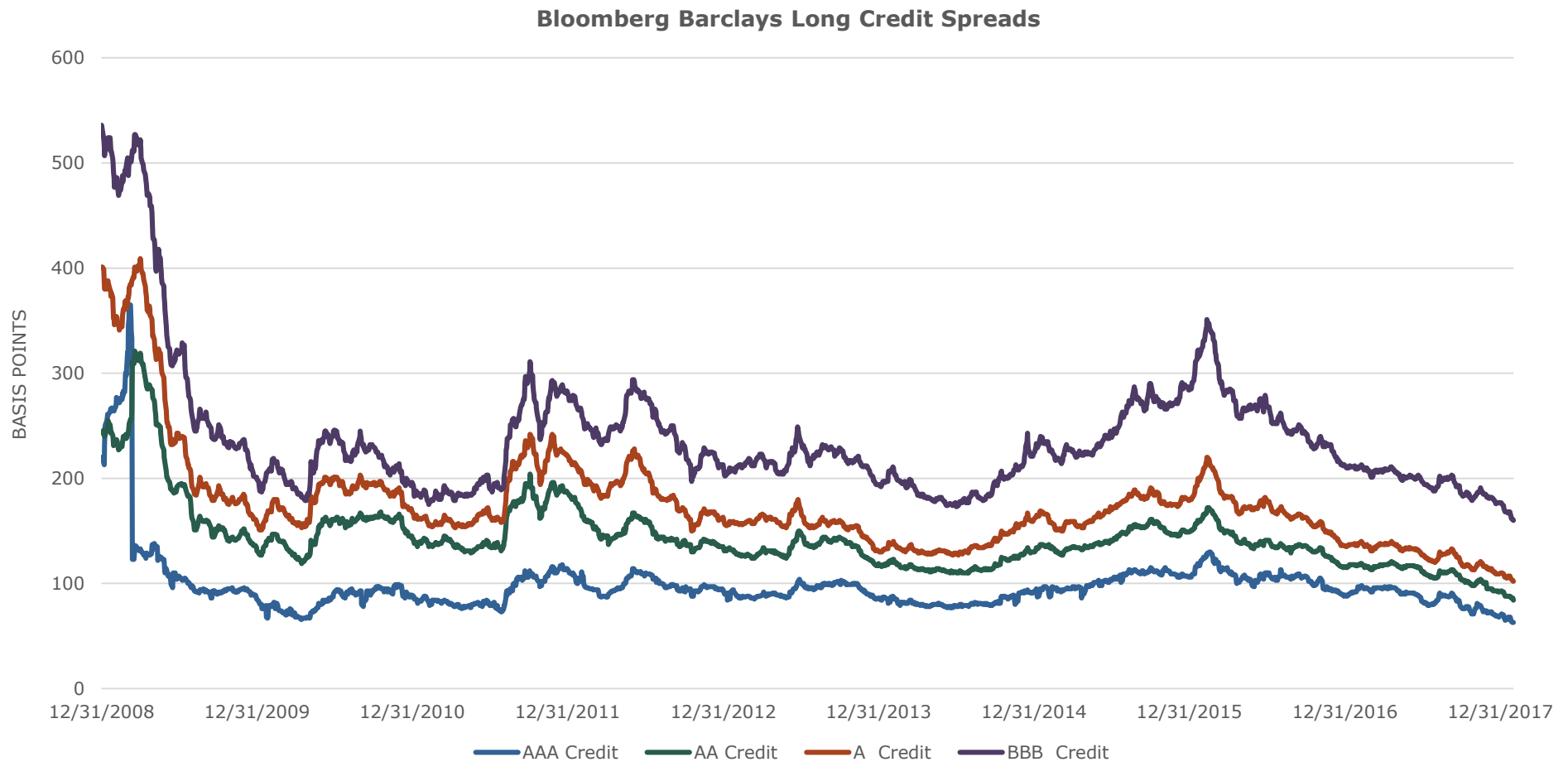
- The LDI bid continues to drive curve flattening - recent curve flattening with improved funded status.
- The tax benefit of advanced funding is creating greater demand for long liability hedging assets – STRIPS creation has been at high levels.



Source: ML Indices, as of December 31, 2017

## 2 Credit spreads – driven by pension plan buying?

- The LDI bid continues to drive spreads tighter- recent spread tightening coincides with improved funded status.
- The tax benefit of advanced funding is creating greater demand – long credit issuance is small in relation to the size of potential pension buying
- Pension plans are likely to be buy and hold only.

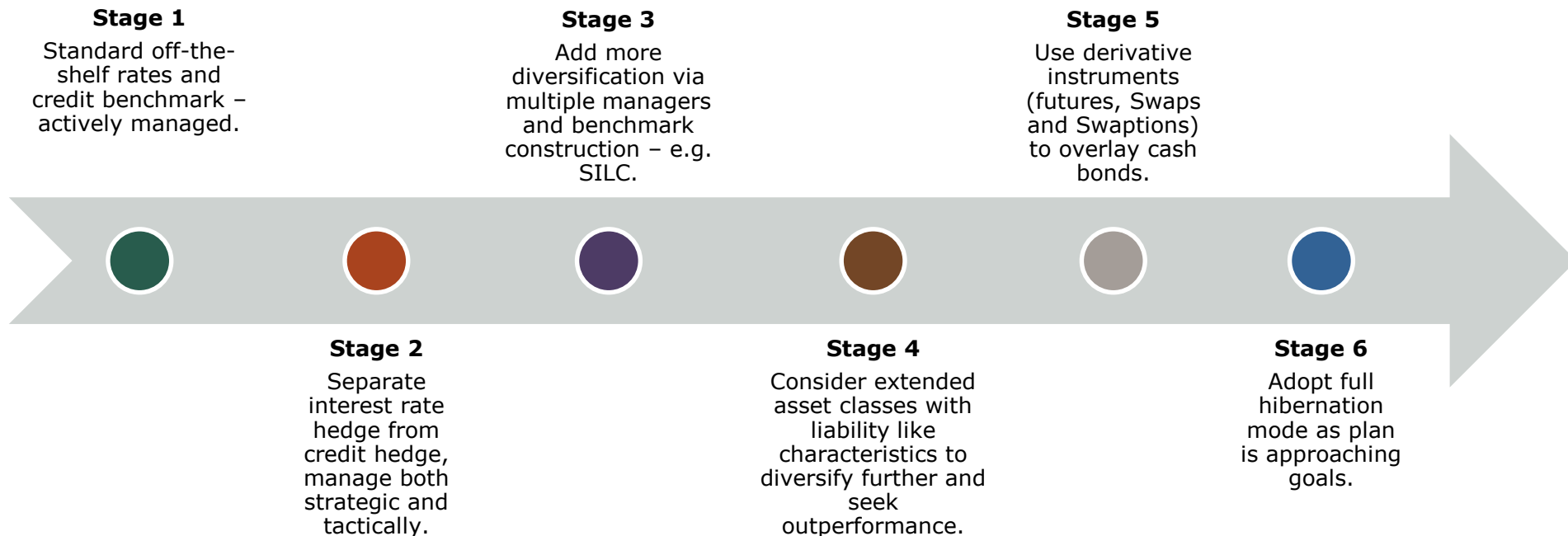


Source: Bloomberg Barclays, as of December 31, 2017

# ③ What to do with your pension plan investments?

Strategy	Rationale	Investment Ideas ... and how we can help
<b>1. Liability hedging bonds</b>	De-risk in step with increasing funded status and lock in tax arbitrage	<ul style="list-style-type: none"><li>• Active long credit and long govt mandates – with excellent risk-adjusted performance</li><li>• Novel diversifying strategies – in particular SILC and ACMBS</li><li>• Custom liability benchmarks</li></ul>
<b>2. Risk-managed equities</b>	Investors who like the upside of equities but wary of long bull market	<ul style="list-style-type: none"><li>• Liability plus equity</li><li>• Low vol equities</li><li>• Equities with volatility control</li><li>• Explicit downside risk management</li></ul>
<b>3. Low beta strategies</b>	Investors who dislike the valuations of equities and bonds	<ul style="list-style-type: none"><li>• Alternative risk premium</li><li>• Liquid absolute return strategies</li><li>• Risk parity</li></ul>

# 3 The journey to better LDI bonds



<b>Benefit</b>	Simple first step, easy move from Aggregate bond benchmark to Long Government Credit.	Value added opportunities as spreads change. More tunable risk management.	Seek value added opportunities from asset diversification.	Seek value added opportunities from other relevant fixed income sectors.	Offers portfolio efficiencies plus downside protection.	Manages Key rates, DV01, DTS01, and sector exposure in line with liabilities.
<b>Comment</b>	Easy and effective at low funded status levels.	DV01 and DTS01 (plus key rates) as management tool.	Concentration problem... largest issuers make up majority of benchmark, but offer no added yield.	Moves away from just US IG corporate bonds. E.g. Agency multi-family CMBS; US HY, non-US IG.	Requires lots of client hand holding – especially Swaptions.	lowers tracking error to minimal levels.

## 4 WFAM's LDI bond offerings

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### Investment teams

- Work alongside clients and their advisors as their specific needs change over time.
- Strategic partnership provides a future-proof relationship.
- Provide a wide array of LDI solutions from simple “off the shelf” benchmarks to bespoke liability matching.

#### Customized Fixed Income team

##### Suitability

- Larger clients may utilize separate accounts with standard or custom liability benchmarks (>\$100M).
- Smaller clients may utilize pooled funds (>\$25M).
- Single LDI manager or one of a stable of managers.

##### Offering

- Separate accounts and pooled vehicles to achieve tailored liability hedge.
- Variety of customizable strategies and benchmarks across rates and credit.

##### Features

- Well-resourced credit research team.
- Security selection alpha and flexibility are hallmarks of active process.
- Increased profile with institutional consultants.

#### Montgomery Fixed Income team

##### Suitability

- Component of large plan liability hedging solution.
- Customization by client and plan's other LDI managers.
- Large plans utilize Montgomery in conjunction with LDI completion or LDI quarterback manager.

##### Offering

- Separate accounts (>\$100M) managed to Bloomberg Barclays U.S. Long Credit Index.

##### Features

- High information ratio and low tracking error to benchmark are hallmarks of alpha generation.
- Standardized offering.
- High profile with institutional clients.

## 4 Small Issuer Long Credit = SILC

### Liability driven investors encounter three obstacles in executing a long credit portfolio implementation:

- 1) Credit indexes have natural issuer concentration in their construction, producing outsized exposures to “mega issuers”
- 2) Large issuer liquidity can provide a false sense of security... size DOES NOT equal safety
- 3) Large asset managers are forced into the largest issuers, compounding concentration and limiting alpha diversification

### These obstacles can be overcome by making a dedicated small issuer allocation

#### ➤ The Customized Fixed Income team overcomes flawed index construction with introduction of the Small Issuer Long Credit Custom Index (SILC Custom Index)

- Targets the smallest 90% of issuers in benchmark construction
- Provides access to alpha diversification and risk diversification
- Has a risk exposure similar to the full Bloomberg Barclays U.S. Long Credit Index across all key dimensions of risk

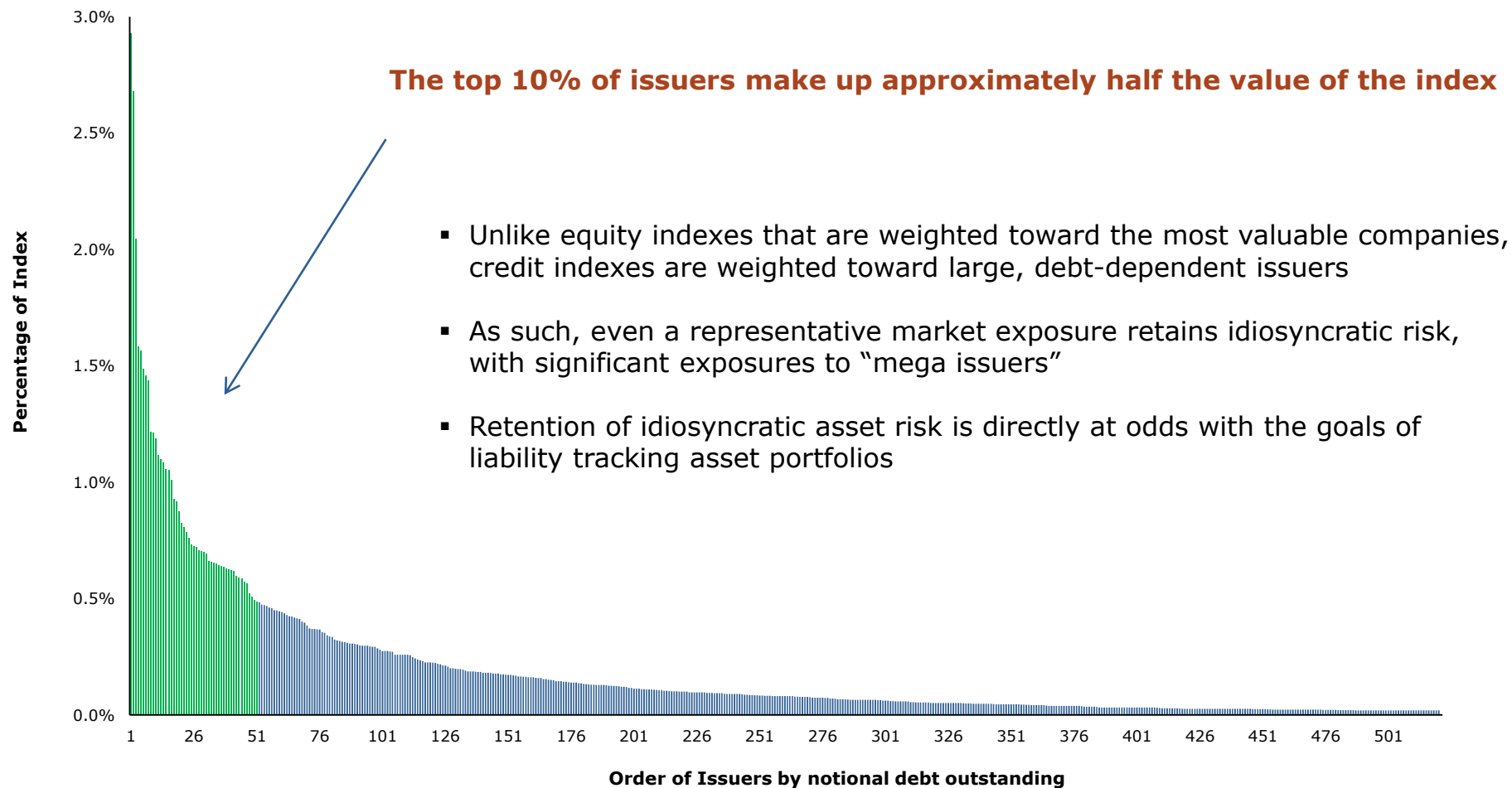
#### ➤ SILC is the active interpretation of the SILC Custom Index

- SILC provides both risk diversification and alpha diversification
- Complements existing Long Credit portfolios without changing the investor’s overall risk profile
- SILC is executed by the Customized Fixed Income team

SILC = The ideal complementary strategy alongside existing managers as pension plans push further into LDI

# 4 Issuer concentration is natural in credit indexes

The Bloomberg Barclays U.S. Long Credit Index is dominated by large issuers



Source: Wells Capital Management, Bloomberg Barclays indices, all data as of 4/28/2017.

# Why WFAM for LDI?

## Experience

Deep experience in advising US and UK pension plans on solutions that spans many decades

## Full service

Full pension solutions service that includes: analytics, LDI design, broad investment platform and ongoing solutions management

## Partnership

Working in partnership with our clients and their advisors, changing as their needs change

## Resources

Deep resourced firm with expertise in multiple asset classes

## Track Record

Excellent performance in liability-driven fixed income portfolios coupled with a “goldilocks” size

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# Disclosure

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