BEYOND TRADITIONAL DE-RISKING

Structured Equity to Increase Hedge Ratios While Maintaining Exposure to Growth Opportunities

Gallagher



Many well-funded pension plans are now tempted to sell equities and increase liability-matching bond allocations, but de-risking in this traditional sense has drawbacks. Can de-risking be implemented more efficiently, without forgoing future funding improvements to the same extent? This piece examines how derivative-based solutions may allow sponsors to manage funded status while still experiencing the benefits of equity market participation on a risk-controlled basis.

The well-funded plan dilemma

Following years of sponsor contributions and favorable investment performance, many defined benefit pension plans now find themselves at or near full funding. As funded status improves, the investment objective often shifts from closing a funding deficit to protecting funded status and managing surplus risk.

This evolution reflects the inherently asymmetric risk profile of a mature pension plan. While a plan can benefit from modest improvements in funded status, excess surplus often has limited economic value due to restrictions on sponsor access and potentially punitive tax consequences. In contrast, a significant decline in funded status can materially increase balance sheet volatility, increase pension expense and potentially trigger future contribution requirements. As a result, many plan sponsors prudently reduce risk as they approach or exceed full funding.

Historically, de-risking has involved reducing allocations to return-seeking assets and increasing exposure to liability-hedging fixed income strategies. However, achieving full funding does not necessarily eliminate the need for growth-oriented investments. Even well-funded plans will need to continue to generate returns sufficient to keep pace with liability growth, administrative expenses and the accrual of future benefits to maintain full funded status without additional contributions. Additionally, maintaining an allocation to growth assets can support favorable pension economics, including the pension income generated by higher expected asset returns. Consequently, many sponsors retain some exposure to equities and other return-seeking assets to support these ongoing objectives while balancing the need to protect funded status.



A fundamental constraint of traditional de-risking is that growth and liability hedging compete for the same pool of capital. Every dollar allocated to liability-hedging fixed income is a dollar that cannot be invested in growth assets. Conversely, every dollar allocated to equities reduces the assets available for liability hedging and may limit the plan's hedge ratio.

Breaking the growth vs hedging compromise

Derivative-based strategies can help alleviate this trade-off by allowing pension plans to make decisions regarding equity exposure and interest rate hedging independently. Rather than maintaining a traditional mix of physical equities and bonds, a pension plan can allocate most or all of its assets to liability-hedging fixed income while obtaining equity exposure synthetically through derivatives.

By investing physical assets in liability-matching bonds and obtaining equity exposure synthetically, a plan can maintain equity market participation while preserving a high hedge ratio. While physical equities can be combined with interest rate derivatives as an alternative method to increase hedge ratios, obtaining equity exposure synthetically offers certain distinct advantages:

- Using physical equities with interest rate derivatives introduces collateral management requirements that can detract from portfolio efficiency. Since equities cannot be used to satisfy margin requirements, plans must reserve cash or Treasuries to support derivative positions. In periods of market volatility, collateral calls force equity sales to raise additional margin, potentially at unfavorable valuations.
- On the other hand, by holding physical liability-hedging bonds and obtaining equity exposure synthetically, Treasury securities can often serve dual purposes as both liability-hedging assets and collateral, which may potentially improve capital efficiency and reduce operational complexity.
- Committing more capital to the hedging portfolio can enable a more precise alignment of duration, yield curve exposure, credit characteristics and cash flow profiles with the plan's liabilities. A larger physical credit allocation can also enhance expected returns and mitigate credit spread risk with liabilities.
- A synthetic equity strategy combines the return generated by the physical liability-hedging portfolio with the equity risk premium obtained through derivatives. The income earned on the underlying bonds helps offset the modest financing costs associated with the derivatives, allowing sponsors to maintain attractive return expectations while increasing hedge ratios. This higher expected return on assets can also alleviate pension accounting implications, sometimes a hurdle for sponsors considering de-risking.

Expected return assumptions may be higher due to additional equity exposure and physical credit allocation, although results are not guaranteed.

Examples of portfolio structures: Synthetic equity may enhance hedge efficiency while preserving growth exposure

Sample portfolio structure	Equity exposure	Liability - hedging allocation	Interest rate hedge ratio	Credit spread hedge ratio	Expected return
Traditional portfolio	30% Physical equity	70%	70%	70%	Baseline
Improved hedge with interest rate derivatives	30% Physical equity	70%	100%	70%	Similar and may introduce collateral drag
Synthetic equity structure	40% Synthetic equity	100%	100%	100%	Higher, supported by additional equity exposure and physical credit allocation

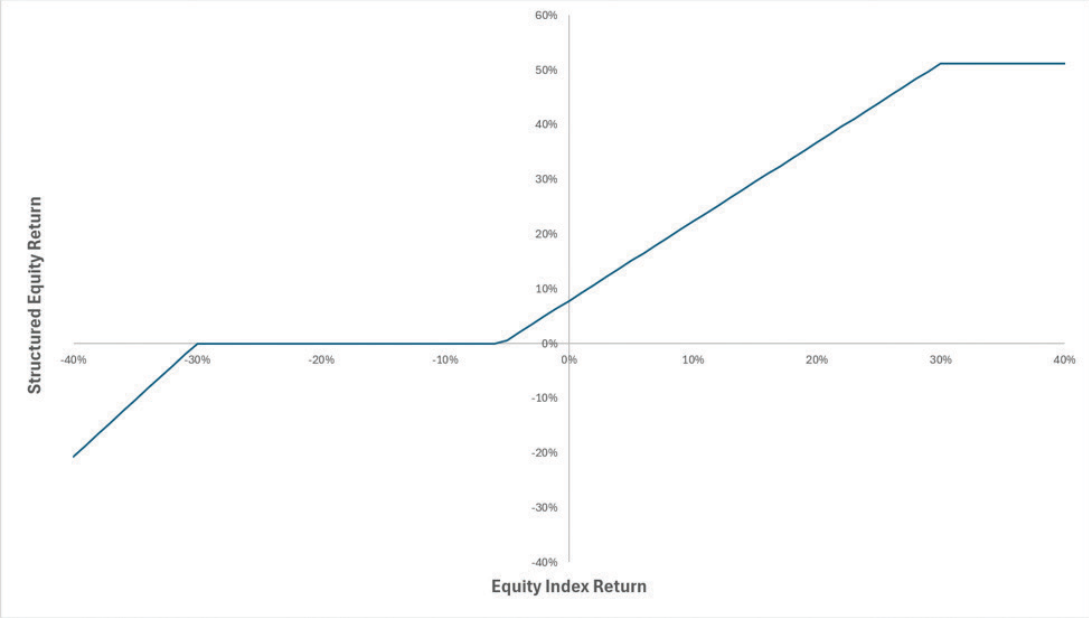
Portfolio examples are illustrative only. Actual outcomes will vary based on market conditions, implementation costs, portfolio construction and other factors.

Shaping equity returns

For plans that have already achieved most of their funding objectives, preserving funded status usually supersedes capturing every dollar of future market appreciation. This creates an opportunity to reshape the equity return profile by exchanging a portion of potential upside to mitigate against material market declines. Such structures are often referred to as collars or, more broadly, structured equity strategies. Via put and call options, a plan can sell a portion of future upside beyond a predetermined level and use the proceeds to purchase downside protection.

Importantly, the strategy is highly customizable. A sponsor can determine how much downside protection is desired, how much upside can be surrendered and over what time horizon protection should apply. The objective is not necessarily to eliminate market risk but rather to remove the portion of risk that is least useful to the pension plan. The strategy participates fully in equity market gains up to a predetermined cap while limiting losses beyond a specified protection level.

Structured equity payoff example: In this example, the investor exchanges upside returns beyond 40% for protection against losses greater than 0% over a three-year period.



Sample payoff illustration as of 8/10/2026.

This illustration is hypothetical and provided for educational purposes only. It does not represent actual portfolio performance, is based on assumptions that may not occur and is not indicative of future results.

From concept to execution

While structured equity strategies offer several potential benefits, they also introduce additional complexity. Establishing a derivative program may require upfront legal and operational work, including negotiating trading agreements, onboarding counterparties and implementing collateral management procedures. Sponsors must also be comfortable with derivative-related risks, including counterparty exposure, financing costs and the potential for collateral calls during periods of market stress. In particular, environments characterized by falling equity markets and rising interest rates can increase liquidity demands, underscoring the importance of thoughtful portfolio construction and ongoing risk management.

When supported by an experienced investment consultant, these considerations can often be effectively managed within a broader pension risk management framework. An investment consultant can play a central role in evaluating implementation alternatives, coordinating service providers, and establishing a governance structure that supports ongoing oversight and decision-making. The consultant can assist in selecting an asset manager with deep experience transacting and managing derivative portfolios, as well as a custodian capable of supporting derivative instruments and collateral arrangements.

Equally important is helping committee members and investment staff understand both the strategy and its role within the broader pension framework. The investment consultant can help educate plan fiduciaries on implementation, performance measurement, risk monitoring and provider oversight. With these governance processes in place, the strategy can be formally incorporated into the investment policy statement, creating a clear and durable framework for ongoing review and decision-making.

Connect with us

Theresa Roy, CFA®, FSA, EA
Senior Vice President
Gallagher Fiduciary Advisors, LLC

30 Speen Street, 5th Floor
Framingham, MA 01701
E: theresa_roy@ajg.com

James Walton, FSA
Senior Vice President
Gallagher Fiduciary Advisors, LLC

30 Speen Street, 5th Floor
Framingham, MA 01701
E: james_walton@ajg.com

The next evolution of pension risk management is not necessarily holding less equity but holding equity differently. Equity derivatives allow well-funded pension plans to separate two decisions that historically were intertwined: liability hedging and equity exposure.

By investing physical assets in liability-matching bonds, obtaining equity exposure synthetically and shaping returns through options, plan sponsors can potentially maintain participation in equity markets while seeking to reduce funded status volatility. For plans that are already well funded, where preserving gains may be more valuable than capturing every dollar of future upside, structured equity provides a customizable framework for balancing growth and protection.

Effective risk management is not about eliminating risk altogether, but about being intentional in the risks that are taken. By working with their investment consultants, plan sponsors can tailor structured equity solutions to their specific objectives, retaining exposure to risks that support long-term outcomes while mitigating those that could undermine funded-status stability. For well-funded plans, this may provide a more efficient path to balancing growth, protection, and funded status preservation.

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