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Dodge & Cox®
Investment Focus

Q2 Pension Perspectives[1]

Key Takeaways

- Aggregate single-employer plan funded status rose to over 106% in the second quarter, but individual plan sponsor results likely varied in the face of elevated market volatility and distinct hedging strategies and asset allocations.
- With the range of macro outcomes widening and the probability of a recession increasing, it may be appropriate to bring asset allocation, interest rate, and credit spread hedge ratios to targets.
- Continued market volatility is likely to present opportunities for rebalancing, and potentially staking out tactical positions. Absent large market swings, individual issuer selection may be critical to performance.
- Plan sponsors may wish to evaluate the impact of the changing economic environment on their pension strategy. In addition, some cash balance plan sponsors may find that crediting rates exceed the floor for the first time in several years, potentially necessitating a review of the liability-hedging approach.

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Quarterly Funded Status Drivers

Figure 1: Funded Status Drivers

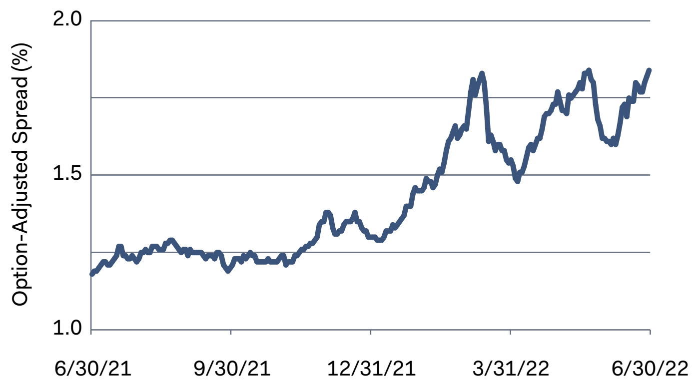
	June 30, 2022	March 31, 2022	December 31, 2021
Milliman 100 Funded Status	106.3%	103.2%	97.9%
Discount Rate (Aa)	4.59%	3.62%	2.80%
U.S. 10-Year Treasury Yield	3.02%	2.34%	1.51%
U.S. 30-Year Treasury Yield	3.19%	2.45%	1.90%
Bloomberg U.S. Long Credit Spread	1.84%	1.55%	1.30%
Global Equities (MSCI ACWI Index) Net Total Return	Q2 2022: -15.66% YTD through 6/30/2022: -20.18%		

Source: Bloomberg Index Services, Milliman, MSCI. The funded status and discount rate are for the Milliman 100 Pension Funding Index.

Capital markets volatility remained elevated in the second quarter, and all major market segments, from U.S. Treasuries to investment-grade credit to global equities posted negative returns. According to Milliman, the aggregate funded status of the 100 largest corporate pension plans ended the quarter at 106.3%, an increase of 3.1% for the quarter and 8.4% year to date. However, individual plan sponsor experience likely varied, depending on the size of return-seeking assets and the degrees of interest rate and credit spread hedging. Plan sponsors with smaller allocations to return-seeking assets and lower interest rate hedge ratios likely fared better, given the double-digit drop in the equity markets and a roughly 100 basis points[2] increase in discount rates.

Treasury yields rose more or less in parallel across the curve, with 2-, 10- and 30-year yields rising 62-74 basis points; the largest increase was on the very front end, where the 3-month rate rose 117 basis points. As of quarter end, long Treasury yields had risen to levels not seen since 2018. As measured by the Bloomberg U.S. Long Credit Index, Long Credit spreads widened 29 basis points to end the quarter at 184 basis points, a level within 1 basis point of the prior highs reached in May and March of this year and slightly above 10-year and 20-year averages (Figure 2). Global equity markets tumbled as many market participants' macro views deteriorated, reflecting stubbornly high inflation, continued supply chain and COVID-related issues, and the war in Ukraine. Emerging markets outperformed developed markets.

Figure 2. Bloomberg U.S. Long Credit Index OAS



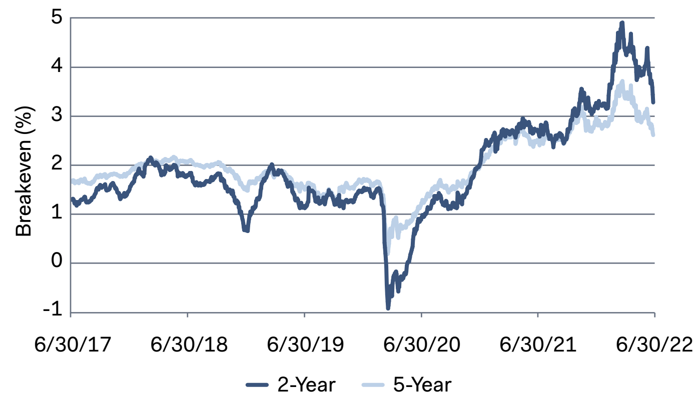
Source: Bloomberg Index Services.

The Macro View and Inflation

Driven partly by persistently high U.S. inflation, the U.S. economy continues to soften. As a consequence, we have evaluated a wider spectrum of near-term scenarios in adjusting our macro outlook. In the base case, we remain modestly optimistic that a recession may be avoided. Even if a recession does occur, we expect it to be relatively shallow and brief as the labor market and balance sheets, both at the corporate and consumer levels, may be strong enough to withstand the macro headwinds. Still, in light of a wide range of potential outcomes, we would encourage plan sponsors to take the long view and remain disciplined in adhering to their asset allocation and target hedge ratios. From a tactical perspective, few corners of the market appear to be particularly undervalued, possibly with the exception of non-U.S. equities versus U.S. equities and value versus growth, with both views expressed in our equity strategies.

As for inflation itself, although U.S. inflation has risen to the highest level since the early 1980s, U.S. breakevens[3] suggest a decline in inflation expectations (Figure 3). We also expect inflation to moderate with the personal consumption expenditures (PCE) inflation[4] falling from its May 2022 level of 6.3% to levels of 2.0% to 3.0% over the next three to five years. That said, as we discussed in our recent Investment Perspectives paper on the topic, we draw wide bands around this projection, given the myriad factors and uncertainties driving inflation currently. In the pension context, inflation has no direct impact on benefit payments for most U.S. corporate plan sponsors (as pension benefits are typically not indexed to inflation). However, for those with open plans and/or large accruing populations, it may be worthwhile to evaluate the impact of 2021 and 2022 wage increases on year-end financials and to ascertain whether a change in the wage inflation assumption going forward is warranted. The latter may have a small, but potentially meaningful impact on the liabilities and may be offset to some degree by higher expected return assumptions.

Figure 3. U.S. Breakevens



Source: Bloomberg Index Services.

Maintaining Target Interest Rate Hedge Ratios

For plan sponsors short their interest rate hedge ratio targets, now may be an opportune time to eliminate or at least significantly reduce their duration underweight. Our view is driven by two factors. First, while fully acknowledging the challenging nature of forecasting interest rates, we believe that there is an increasing risk of long-term interest rates declining over the next 12 to 24 months as both economic growth and inflation moderate, and the market prices in a higher probability of a recession. Further, based on historical experience, should a recession occur, interest rates may fall substantially. Second, from a technical perspective, long Treasury yields have risen materially over the last 12 months, resulting in a relatively flat yield curve and minimal further rate increases priced into the forward curves. Offsetting this view are the risks of an excessively hawkish Fed "overshooting" rates, an inflationary spike, or high inflation persisting longer than expected. After accounting for these possibilities, we have reduced our duration underweight in our full-discretion credit strategies to approximately 0.2 to 0.4 years depending on strategy duration.

Managing through Credit Spread Volatility

As shown in Figure 2, plan sponsors who have been underweight credit spread hedge ratios have had ample opportunities to increase credit exposure in the first half of the year. We believe that being fully or near fully invested in credit may be sensible, now that Long Credit spreads are slightly above 10-year averages (Figure 4), corporate fundamentals remain relatively solid, and a natural demand for long corporate bonds from insurance companies and pension investors persists. Our optimism is tempered by the possibility of spreads widening further if the macro backdrop deteriorates and demand from non-U.S. investors recedes, given their higher hedging costs. However, forecasting large spread moves is challenging, and as in the first two quarters, we expect credit spreads to remain volatile. Consequently, in our full-discretion portfolios, we are selectively adding exposure to individual issuers, while still retaining some dry powder in the form of Treasuries and mortgage-backed securities. For example, year-to-date we have increased credit exposure in our credit-oriented strategies by several percentage points but are still holding short of being (nearly) 100% credit.

Notably, so far this year Intermediate Credit spreads have widened more than Long Credit spreads and are now well above their 10-year averages (Figure 4). This was even after accounting for differences in credit quality, as discussed in our recent paper on Intermediate Credit. This divergence is in part explained by greater liquidity and a smaller set of "buy-and-hold" investors compared to Long Credit. In times of extreme market stress, such as the Global Financial Crisis, Intermediate Credit spreads can approach or even exceed Long Credit spreads. While we still find the relative yield advantage in Long Credit attractive, should this dissonance between Intermediate and Long Credit spreads become even more pronounced, overweighting Intermediate Credit relative to Long Credit may become appealing.

Pension Risk Transfer, Contributions, and Cash Balance Plan Crediting Rates

According to LIMRA, pension risk transfer (PRT) activity remains strong, with first quarter setting a record with $5.3 billion in transactions. Half of this activity reflects four buy-in transactions,[5] compared to only one in the first quarter of 2021 and seven in all of 2021. It remains to be seen whether this trend portends greater interest in buy-in transactions among large plan sponsors. The only large transaction announced so far this year is a $4.3 billion buy-out by Lockheed Martin. Over the past three years, Lockheed has methodically transferred $11.4 billion in pension liabilities, or roughly 20%-25% of its total plan liabilities. While we anticipate PRT activity to remain strong, it very much remains an individual plan sponsor decision, especially in this changing economic environment.

With the September 15 deadline for making pension contributions for the 2021 plan year approaching, plan sponsors with accruing or underfunded plans may wish to make final adjustments to their contribution strategy. This is especially timely in light of last year's pension relief, anticipated increases in PBGC variable-rate premiums (which are indexed to inflation), and each plan sponsor's individual economic circumstances.

Finally, for cash balance plan sponsors, increasing interest rates are likely to result in higher liabilities as both crediting rates and lump sum conversion rates increase. The latter makes annuities more valuable to cash balance plan participants and may lead more participants to elect an annuity form of payment over a lump sum. In addition, with 10- and 30-year Treasury yields now exceeding 3% and long corporate yields approaching 5%, some plan sponsors may find crediting rates above the floor for the first time in several years. This will typically have implications not only for liability present values but also liability duration and the structure of the liability hedge.

As always, we would welcome the opportunity to speak with you about your pension risk management objectives as you proceed on your pension journey.

Figure 4. Intermediate and Long Credit OAS by Quality

	Intermediate Credit					Long Credit				
	IG	AA	A	BBB	BB	IG	AA	A	BBB	BB
June 30, 2022 (bp)	122	49	110	172	402	184	124	155	227	439
YTD Increase (bp)	61	23	57	86	214	55	33	45	71	196
YTD Increase (%)	101%	90%	107%	100%	114%	42%	36%	41%	46%	80%
10-Year Average (bp)	94	52	82	138	288	173	120	144	214	372

Source: Bloomberg Index Services.

1 The information in this paper should not be considered fiduciary investment advice under the Employee Retirement Income Security Act. This paper provides general information not individualized to the particular needs of any plan and should not be relied on as a primary basis for investment decisions. The fiduciaries of a plan should consult with their advisers as needed before making investment decisions.
2 One basis point is equal to 1/100th of 1%.
3 Breakevens estimate the implied inflation rate for the stated term by subtracting the real yield of an inflation-linked bond from a nominal bond of comparable maturity.
4 Personal consumption expenditures (PCE) measure how much consumers spend on durable and non-durable goods and services. PCE is the Federal Reserve's preferred measure for inflation.
5 Unlike buy-outs, buy-ins allow plan sponsors to transfer the risk associated with a portion of their liability to an insurance company without transferring assets and liabilities off the balance sheet and thus avoiding settlement accounting.