April 27, 2023

Dodge & Cox®
Investment Focus

Q1 Pension Perspectives[1]

Key Takeaways

- Aggregate single-employer plan funded status fell by 1.8% in the first quarter to 100.0% as strong fixed income and equity market returns were offset by falling discount rates.
- Recent market volatility, conflicting macroeconomic data, and a broad range of potential macro outcomes over the next one to two years suggest that plan sponsors may be best served by maintaining their asset allocation and hedge ratio targets and rebalancing as needed.
- As demonstrated by the recent turmoil in the Banking sector, sector and issuer dispersion in credit may provide opportunities for active managers to generate alpha.
- As plan sponsors de-risk further into corporate bonds, allowing liability hedging investment managers to include modest, tactical allocations to securitized assets could increase liquidity, diversification, and alpha potential, without necessarily diminishing the effectiveness of the hedge.

Contributors

Alex Pekker, Ph.D., CFA, ASA
Liability Hedging Solutions Strategist

Tony Brekke, CFA
Investment Committee Member and Credit Analyst

Mike Kiedel, CFA
Investment Committee Member and Credit Analyst

Quarterly Funded Status Drivers

Figure 1: Funded Status Drivers

	March 31, 2023	December 31, 2022
Milliman 100 Funded Status	100.0%	101.8%
Discount Rate (Aa)	5.00%	5.25%
U.S. 10-Year Treasury Yield	3.47%	3.88%
U.S. 30-Year Treasury Yield	3.65%	3.97%
Bloomberg U.S. Long Credit Spread (OAS)[2]	159 bps[3]	157 bps
Global Equities (MSCI ACWI Index) Net Total Return	Q1 2023: 7.31%	

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

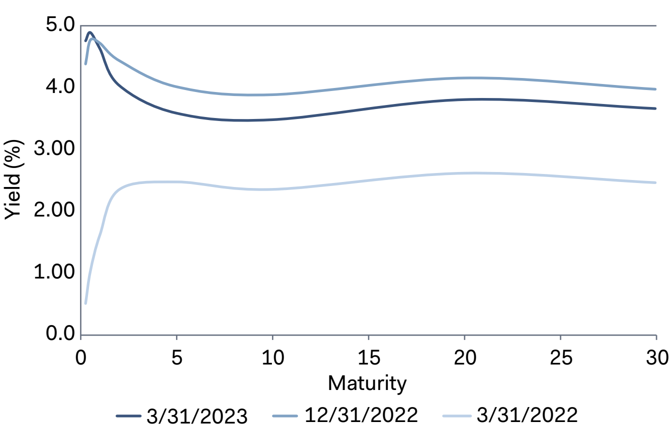
Despite volatility in the capital markets, the aggregate funded status of U.S. corporate defined benefit plans remained strong in the first quarter. Liabilities increased as discount rates fell, and asset values were driven higher due to both declining bond yields and strong global equity returns. With domestic and global equities slightly outperforming high-quality bonds, both well-hedged plans and those with high allocations to return-seeking assets likely fared well.

The recent bank failures and resultant depositor flight away from small and regional banks seem to have increased the risk of an economic slowdown in the United States and the likelihood of a more dovish Federal Reserve policy. As a result, the yield curve inverted further and shifted lower by roughly 30-40 bps in maturities over two years (see Figure 2). While investment-grade (IG) credit spreads spiked in the immediate aftermath of Silicon Valley Bank's failure, spreads retraced much of the widening and ended the quarter only a few basis points higher.

The modest quarter-over-quarter increase in credit spreads masked significant dispersion across sectors and maturities (see Figure 3). Specifically, while the spread on the Bloomberg U.S. Long Credit Index rose only two bps during the quarter, the spread on the Bloomberg U.S. Intermediate Credit Index rose 10 bps. The disparity in spread moves largely reflects Intermediate Credit's much larger exposure to the Financial sector broadly (36% versus 15% as of March 31, 2023) and banks in particular (26% versus 7%), as well as its larger exposure to non-systemically important banks.[4] A broader investor base, better liquidity, and faster price discovery in the intermediate-duration[5] space may have also played a role.

Developed market equities outperformed emerging markets equities, while growth stocks outperformed value. In particular, the Information Technology sector posted very strong positive returns, reversing the trend from 2022.

Figure 2. U.S. Treasury Yield Curves



Source: Bloomberg Index Services.

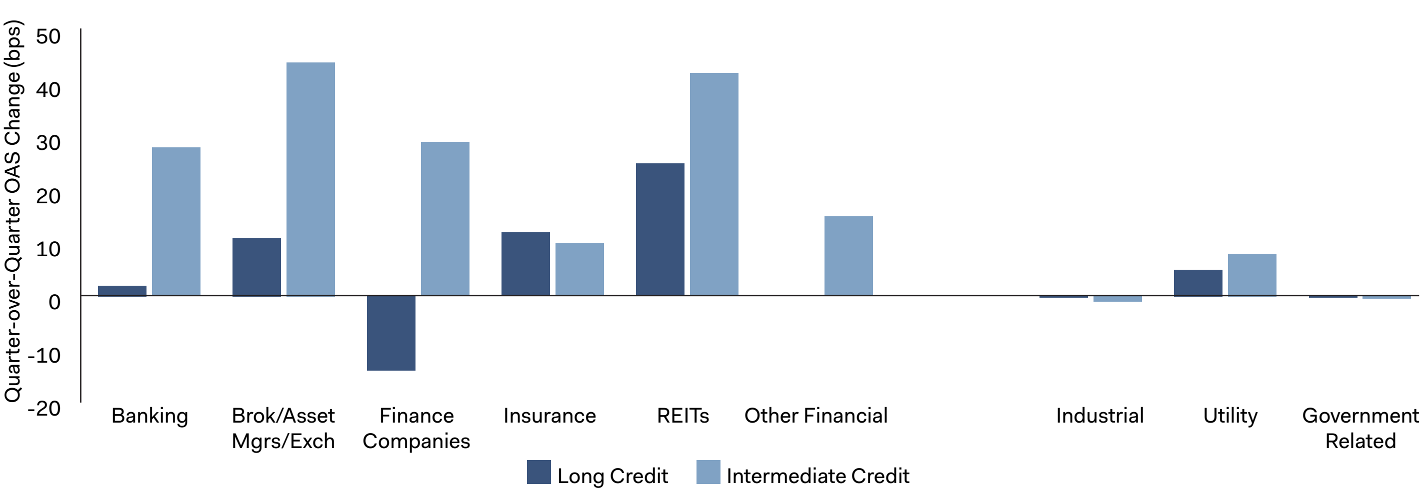
Staying the Course

Whether or not the factors responsible for the March turmoil in the Banking sector are truly in the rear-view mirror, fundamental macro indicators continue to paint an uncertain picture, leaving the range of potential outcomes over the next 12-24 months wide. For example, inflation is running well above the Fed's target; unemployment remains low at 3.5% (as of March), despite softness in the Information Technology sector; and the Fed continues to articulate a hawkish policy. On the other hand, inflation is moderating—the March 5.0% Consumer Price Index[6] print is well below the June 2022 high of 9.1%; job openings have been declining for two months; and long-term inflation expectations remain anchored. In addition, judging by the forward curves, market expectations for Fed tightening appear to be far removed from the Fed's own projections (as reflected in its dot plot[7]). Consequently, even putting aside idiosyncratic events—such as the Banking sector turmoil this quarter and looming debt ceiling negotiations—we believe that plan sponsors may be well-served by staying the course and taking advantage of market moves to rebalance to asset allocation and hedge ratio targets.

This quarter's long-end Treasury volatility was a good reminder of the challenging nature of forecasting interest rates and implementing tactical positions based on those forecasts (see Figure 4). For plan sponsors with interest-rate-based glide path triggers, these moves created opportunities to de-risk (and re-risk), but the short-lived nature of the peak rate, as well as heightened daily volatility in March, almost certainly made timely and effective implementation challenging.

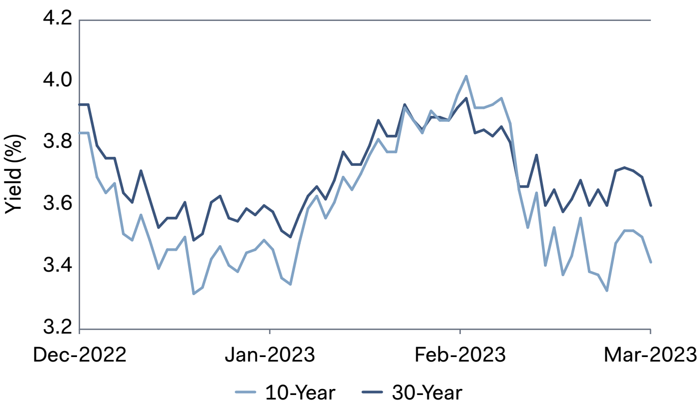
Not to be outdone, credit spreads experienced their own roller-coaster ride, ultimately settling within roughly 20 bps of their 10-year averages, with Intermediate Credit spreads slightly above and Long Credit spreads slightly below. Plan sponsors (and credit managers) had the opportunity to reduce credit beta early in the quarter when spreads were steadily declining to levels not seen since the spring of 2022. The sharp increase in March presented an opportunity to re-risk, particularly for investment managers, given the dispersion of spread moves and a quick retrenchment.

Figure 3. Q1 2023 Option-Adjusted Spread Change by Sector



Source: Bloomberg Index Services.

Figure 4. 10- and 30-Year Treasury Yields



Source: Bloomberg Index Services.

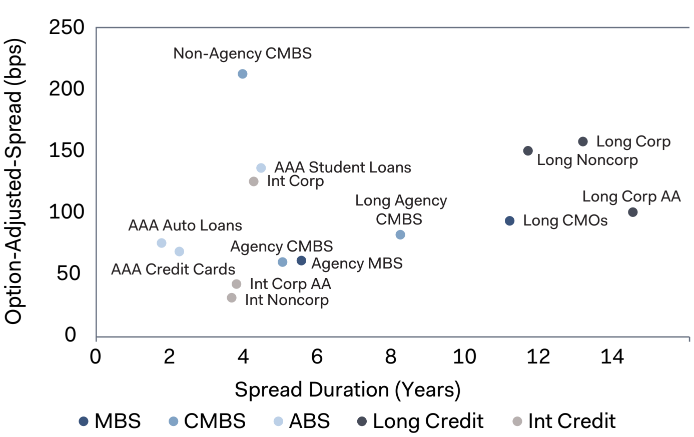
Should rate and spread volatility continue, plan sponsors will likely have more opportunities to rebalance across Treasuries and Credit, between different credit sleeves (i.e., long, intermediate, and, if applicable, high yield), and between managers within a given sleeve. As the Banking sector turmoil illustrated, dispersion across sectors and issuers underscores the importance of deep credit research and active management, both as a way to potentially avoid problematic issuers and take advantage of attractive ones.

In our full-discretion liability-hedging strategies, we remain duration-neutral and largely constructive on corporate credit. Still, with heightened spread volatility and the possibility of a recession, we are retaining some dry powder in the form of Treasuries and, in our Intermediate Credit strategy, high-quality, liquid asset-backed securities (ABS) and Agency[8] mortgage-backed securities (MBS).

Diversifying the Credit Spread Hedge

With credit spreads hovering near historical averages, plan sponsors with large corporate bond allocations, as well as those considering intermediate-duration strategies, may wish to diversify their credit spread hedge via "corporate-adjacent" sectors—such as government-related credit (i.e., dollar-denominated sovereigns, foreign Agencies, and taxable municipals) and securitized assets—so long as the overall credit spread hedge remains effective. Government-related credit has become a well-accepted component within liability-hedging strategies, in part due to the sector's high correlation to corporate bond returns as well as its inclusion in Bloomberg credit indices. However, securitized assets are not necessarily an obvious fit.

Figure 5. Option-Adjusted Spread versus Duration for Various Indices (as of March 31, 2023)[9]



Source: Bloomberg Index Services, ICE BofA. For Long CMOs, duration shown is duration which is substantially similar to spread duration.

Indeed, generally speaking, securitized assets exhibit duration, convexity, and spread changes that do not align well with those of typical pension liabilities. However, when viewed within a broader portfolio context, modest, variable allocations to select securitized segments and issuers may provide valuable diversification, liquidity, and/or relative value benefits, especially in Intermediate Credit portfolios. For example, currently AAA-rated ABS (e.g., auto loans, credit card receivables) offer spreads comparable to AA corporates (see Figure 5), and although subject to many of the same risks as corporates, their fundamental credit risks (i.e., consumer behavior) are somewhat differentiated. In longer-duration portfolios, Agency commercial mortgage-backed securities and long-duration collateralized mortgage obligations may underyield comparable high-quality corporates, but also offer a degree of safety and a counterbalance to higher-beta corporate issuers.

Expanding the investment toolkit to allow for limited securitized assets exposure within credit portfolios could help enhance the portfolio return opportunity set and risk management without detracting from the primary objective of hedging credit spread risk. The liquid nature of many securitized sectors, and the ability to shift exposure to Treasuries and/or credit easily, may not even be an obstacle for plan sponsors focused on plan termination and transferring assets in-kind, which typically focuses on corporate bonds.

Re-Evaluating the Pension Strategy

As we have noted in our previous Pension Perspectives, given the industry-wide improvement in funded status and our conversations with clients over the last two years, we believe many plan sponsors may be re-evaluating their asset allocations and refining their liability-hedging strategies. Some changes we have observed include:

- Increasing interest hedge ratios by moving to longer-duration mandates;
- Hedging interest rate and credit spread risk more granularly by implementing a completion portfolio, incepting Intermediate Credit mandates, and/or adjusting benchmarks to align more closely with liabilities;
- Becoming more comfortable with derivatives, exchange-traded funds, and portfolio trading to help effect rebalancing, transitions, and/or tactical views;
- For frozen plans, moving toward simpler, more liquid, and lower-cost return-seeking portfolios; and,
- For accruing plans, revisiting the overall asset allocation to help generate sufficient returns to offset benefit accruals.

An even broader reassessment of plan objectives may also be in order. For example, in 2022, several plan sponsors re-opened their frozen plans to attract talent and/or reduce overall retirement costs by adjusting their defined benefit/defined contribution mix. Extremely overfunded plans (e.g., those with funded ratios of at least 120%) may also wish to evaluate whether it is appropriate to shift their focus from de-risking, termination, and/or hibernation to a more balanced optimization between hedging and return generation. A large surplus could support future benefit accruals, retiree medical payments (if applicable), or pension income under U.S. accounting standards.

Pension Risk Transfer

According to LIMRA, U.S. pension risk transfer activity surged by 36% to $52 billion in 2022, though nearly 40% of that record-setting premium was split between just two transactions. That momentum is likely to carry over into 2023, given strong funded status and continuing insurance company interest in this space. However, lower interest rates (and therefore less attractive pricing), deteriorating economic conditions, and potential regulatory changes could present headwinds. In particular, the Department of Labor is expected to release updated fiduciary guidance on selecting annuity providers sometime this year, as mandated by SECURE 2.0.

As always, we welcome the opportunity to speak with you or your advisor about pension risk management solutions as you progress along your pension journey.

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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. Option-adjusted spread (OAS) is the option-adjusted yield differential between stated index and comparable U.S. Treasuries. OAS does not translate into a return.
3. One basis point is equal to 1/100th of 1%.
4. All data is as of March 31, 2023 unless otherwise stated.
5. Duration is a measure of a bond's (or a bond portfolio's) price sensitivity to changes in interest rates.
6. The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.
7. The Fed's dot plot is a chart that shows the interest rate predictions of each Fed official for the next three years and the long term.
8. The U.S. Government does not guarantee the Fund's shares, yield, or net asset value. The agency guarantee (by, for example, Ginnie Mae, Fannie Mae, or Freddie Mac) does not eliminate market risk.
9. Indices used in the analysis: **Long CMO**: ICE BoA 10+ Year US Agency CMO Z-Tranche Index (CM9Z); **Long Agency CMBS**: Bloomberg U.S. Agency CMBS 8.5+ Year Index; **Agency MBS**: Bloomberg U.S. MBS Agency Fixed Rate MBS Index; **Agency CMBS**: Bloomberg U.S. Agency CMBS Agg Eligible Index; **Non-Agency CMBS**: Bloomberg Non-Agency CMBS Agg Eligible Index; **AAA Auto Loans**: Bloomberg ABS Auto AAA Index; **AAA Credit Cards**: Bloomberg ABS Credit Card AAA Index; **AAA Student Loans**: Bloomberg U.S. ABS Floating Rate Student Loan Aaa-rated Index; **Long Corporate, Long Corporate, Long Non-corporate, and Long Corporate AA**: Bloomberg U.S. Long Corporate, Non-Corporate, Corporate Long Aa Index; **Long High Yield**: Bloomberg Long U.S. High Yield Index; **Intermediate Corporate, Intermediate Non-corporate, and Intermediate Corporate AA**: Bloomberg U.S. Intermediate Corporate, Intermediate Non-Corporate, Intermediate Corporate AA Index, respectively.