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Dodge & Cox®
Investment Focus

# Q4 Pension Perspectives[1]

## Key Takeaways

- Aggregate single-employer plan funded status rose to 110.0% in the fourth quarter, an increase of 1.2% for the quarter and 12.1% for the year.
- While certain large tactical bets paid off this year, the markets' volatility also reinforced the importance of maintaining both a long-term view and the flexibility to respond quickly to changes in the market backdrop.
- Plan sponsors may wish to consider maintaining (or possibly overweighting) target interest rate hedge ratios and underweighting plan-level credit and equity beta based on expectations of heightened market volatility, a potential recession, and a Fed pause or pivot some time in 2023.
- Given improvements in funded status and the evolving interest rate environment, offering lump sums and re-visiting the choice of the discount mechanism used for funding valuations may be appropriate.

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## Quarterly Funded Status Drivers

**Figure 1: Funded Status Drivers**

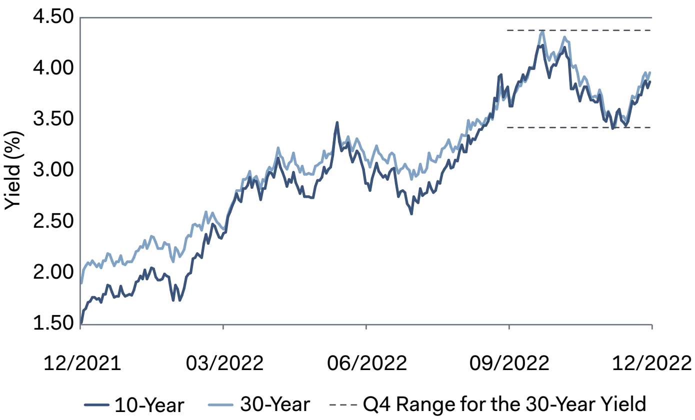
| | December 31, 2022 | September 30, 2022 | December 31, 2021 |
|---|---|---|---|
| Milliman 100 Funded Status | 110.0% | 108.8% | 97.9% |
| Discount Rate (Aa) | 5.22% | 5.36% | 2.80% |
| U.S. 10-Year Treasury Yield | 3.88% | 3.83% | 1.51% |
| U.S. 30-Year Treasury Yield | 3.97% | 3.78% | 1.90% |
| Bloomberg U.S. Long Credit Spread | 1.57% | 1.96% | 1.30% |
| Global Equities (MSCI ACWI Index) Net Total Return | | Q4 2022: 9.76%<br>2022: -18.36% | |

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

Against a background of hawkish Federal Reserve policy, increasing recession expectations, and mixed signals from the labor market, the fourth quarter saw moderating inflation and relatively healthy corporate earnings. Consequently, equities rallied and credit spreads tightened, while long-term Treasury yields rose only slightly. For corporate plan sponsors as a whole, this dynamic amounted to a further 1.2% increase in funded status, bringing year-over-year improvement to 12.1%.

Consistent with the two Fed hikes last quarter, the three-month Treasury yield rose 110 basis points[2] (bps) while 2-, 10-, and 30-year yields rose less than 20 bps. The quarter-over-quarter increase in long-end Treasury yields masked significant volatility; for example, 30-year Treasury yields traded in a nearly 100-bps range, reflecting market participants' varying and evolving views on the trajectory of inflation and timing of a potential Fed pivot (see Figure 2). Credit spreads, on the other hand, displayed a relatively consistent downward trend, with the Bloomberg U.S. Long Credit Index option-adjusted spread declining 39 bps, to 157 bps, its lowest level since April (see Figure 3). Global equities returned 9.76%, with developed ex-U.S. equities substantially outperforming both domestic and emerging markets equities.

**Figure 2. 10-Year and 30-Year Treasury Yields**




Source: Bloomberg Index Services.

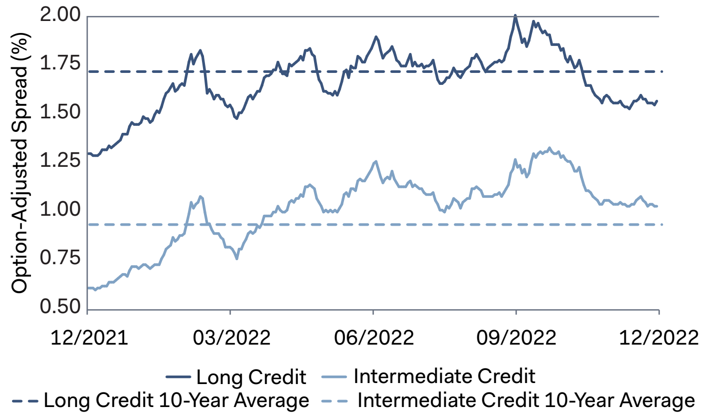
## A Dramatic Year of Funded Status Improvement and Volatility

For total return investors, 2022 was a deep disappointment, but for most single-employer plan sponsors, it was a boon: funded status rose and deficits fell, as the decline in liabilities (driven by rising discount rates) outpaced the decline in assets (as global equities generally outperformed liabilities and long duration fixed income). Plans with larger allocations to return-seeking assets and lower hedge ratios likely saw the biggest improvements, and well-funded, well-hedged plans likely benefited less.

Some large tactical bets paid off on a calendar-year basis (e.g., underweighting interest rate and credit spread hedge ratios, overweighting value over growth, hoarding cash), but plan sponsors who stayed closer to their asset allocations targets and rebalanced amidst market volatility likely also added value. For example, the roller-coaster ride in credit spreads (Figure 3) presented multiple opportunities to shift between Treasuries and credit, and, for credit managers, to dial up and down the credit beta of their portfolios. Similarly, rebalancing between domestic, developed ex-U.S., and emerging markets equities throughout the year could have been additive given the divergence of equity markets returns by region.

In our full-discretion liability-hedging portfolios, we eliminated our modest duration underweight and moved to a duration-neutral stance by September, reflecting our outlook for long-term Treasury yields to decline over a 12 to 24 month horizon. As the year progressed, we opportunistically increased credit exposure, taking advantage of the four spread sell-off episodes. When spreads narrowed sharply in the fourth quarter, we slightly reduced credit exposure in several strategies based on specific issuer valuations.

**Figure 3. Bloomberg U.S. Long Credit and Intermediate Credit Indices OAS, Year to Date**




Source: Bloomberg Index Services.

## Looking Ahead to 2023

In 2022, many plan sponsors have been adjusting their portfolios to protect hard-earned funded status improvements by increasing hedge ratios and hedging interest rate and credit spread risk more granularly; diversifying their sources of credit beta (e.g., by employing private placements or dedicated securitized strategies); and, improving operational efficiencies by simplifying equity portfolios and establishing derivative overlays. We expect these strategic shifts to continue.

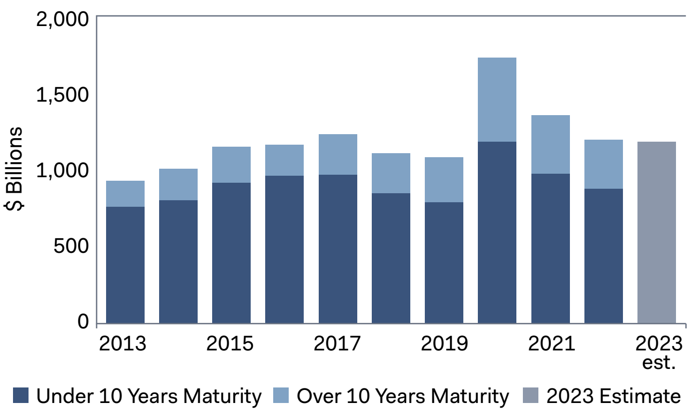
Heading into 2023, plan sponsors may wish to consider defensive portfolio positioning, given the uncertain path of the economy, inflation, and interest rates; the continuing Russia-Ukraine war; and, the implications of China's abrupt change in its zero-COVID policy. In particular, it may make sense to maintain (or possibly overweight) interest rate hedge ratios and to consider underweighting plan-level credit spread and equity betas relative to targets.

Our base-case macro outlook calls for the economy to continue to soften, and potentially fall into a mild recession in 2023, and for long-term Treasury yields to decline over the next 12 to 24 months. However, the timing and magnitude of these events is uncertain. We remain largely constructive on corporate credit and, while some widening seems likely, we do not expect credit spreads to widen out to traditional recessionary levels. Fundamentals are very strong, though admittedly likely to deteriorate somewhat, and technicals, especially in the long end, are supportive. As in 2022, spread volatility may weigh on short-term performance, but it may also provide opportunities to add to individual issuers at attractive yields. In our full-discretion, liability-hedging portfolios, we are maintaining a duration-neutral posture and exposure to corporate issuers we believe are well positioned to operate through a recessionary environment. Allocations to certain non-corporate spread sectors (such as taxable municipal bonds) provide portfolio-level diversification, while Treasuries and/or Agency mortgage-backed securities (MBS) provide us with dry powder and liquidity.

Market expectations for investment-grade corporate issuance for 2023 are similar to 2022, which is down from 2021 and

2020 levels but above 2019 and 2018 (see Figure 4). Issuance of long bonds (i.e., those with at least 10 years to maturity) has declined from 32% of total issuance in 2020 to 27% in 2022, partly reflecting some issuers' reluctance to lock in relatively high yields for 20 or 30 year maturities. If this trend continues, it could be supportive of longer maturity bond spreads. Although foreign demand for U.S. corporates may decline (given rising yield levels globally and elevated hedging costs due to dollar strength), domestic demand from plan sponsors and insurers (including those in the pension risk transfer space) is likely to remain strong.

**Figure 4. Investment-Grade Corporate Issuance**




Source: J.P. Morgan.

## Operational Considerations: Raising Cash for Benefit Payments

Due to improved funded status, more lenient funding rules, and/or other corporate priorities, many plan sponsors may not be making contributions in 2023. It may, therefore, be worth re-evaluating options for sourcing cash for benefit payments. These include:

- Maintaining a cash position to pay three to six months' worth of benefits, replenishing it several times a year, and using a derivatives overlay to maintain market exposure;
- Raising cash from different asset classes and managers as part of monthly rebalancing; and/or
- Harvesting (i.e. not re-investing) coupons and possibly dividends on a monthly basis.

While we have observed plan sponsors employ all three of these approaches, the optimal solution depends on the amount of benefit payments relative to total assets; the liquidity, weight, and style of the different investment strategies; and, the internal resources available to the plan sponsor.

## Strategic Considerations

We conclude with thoughts on pension risk transfer, lump sums, contributions for 2023, and two regulatory updates.

### Pension Risk Transfer

We estimate that U.S. pension risk transfer (PRT) activity, including buy-outs and buy-ins, totaled approximately $57 billion in 2022, smashing last year's record of $38 billion, partly due to the $16 billion IBM transaction, which covered 100,000 employees and over 40% of the plan's liabilities. According to Milliman, PRT pricing deteriorated in the second half of the year as insurers filled (or came close to filling) their PRT capacity and could afford to be more selective. In particular, "competitive" pricing for a sample retiree lift-out rose from 96.9% of PBO as of August 31, 2022 to 100.3% of PBO at year end.[3]

We anticipate robust PRT activity in 2023, supported by strong funded status, an increasing number of insurers in the market, ever-increasing PBGC[4] fixed-rate premiums (now more than double a decade ago!) and a growing interest in buy-ins.[5] However, an economic slow-down and a decline in bond yields could potentially counter the trend, as PRT premiums relative to the accounting liability would likely rise, and plan sponsors may prefer to preserve cash.

### Lump Sums

With 2023 lump sums typically determined using interest rates as of late 2022, plan sponsors may find it advantageous to offer lump sum windows in 2023, especially if they expect interest rates to decline. The cost of the lump sums may be *lower* than the associated annuity purchase cost and balance sheet liability, both of which are determined on a mark-to-market (rather than lagged) basis. On the other hand, lump sum take-up rates may be lower than in years past, when interest rates were lower and lump sum values were higher.

### Contributions and Funding Discount Mechanism

Plan sponsor contributions are likely to decline in 2023, just as they did in 2022, due to improvements in funded status and more lenient funding rules. Plan sponsors may wish to evaluate their choice of discount mechanism used to determine their funding target liability (FTL) and minimum required contribution (MRC). Due to higher interest rates, some plan sponsors may find that for January 1, 2023 funding valuations, their long-standing choice of using the funding segment rates (which reflect a 25-year average of corporate bond yields subject to certain corridors) results in higher FTL and MRC, compared to using the PPA spot curve (which reflects current yields on corporate bonds rated A or higher).

In general, compared to the spot curve, the segment rates are likely to produce lower liabilities in falling interest rate environments and higher liabilities otherwise. Thus, despite the potential benefits for 2023 (and possibly 2024), a switch to the spot curve should be evaluated carefully, particularly by plan sponsors that are underfunded, maintain lower hedge ratios, and/or have large return-seeking allocations. For well-funded and well-hedged plan sponsors, the choice of funding discount mechanism may not be as material, and indeed switching to the spot curve would align accounting and funding methodologies more closely. Other technical considerations, such as the process to switch back to the segment rates and the implications for PBGC variable rate premiums (VRP), may also influence this decision.

## PBGC Variable Rate Premiums

SECURE Act 2.0, enacted in December, ends the indexation of the PBGC VRP and sets it permanently at the 2023 level of 5.2% of underfunding (computed on a PBGC basis). Since this change fixes the penalty associated with asset underperformance relative to liabilities, some plan sponsors may be willing to adopt a marginally more aggressive investment approach.

## Final Department of Labor ESG Rule

In November, the Department of Labor released final regulations concerning the consideration of environmental, social, and governance (ESG) factors in ERISA plans. The rule updates 2020 regulations and, while emphasizing core fiduciary responsibilities under ERISA, expressly states that ESG factors may be viewed as relevant risk and return factors by ERISA fiduciaries. As part of our investment process, we evaluate financially material ESG factors to better understand a company or bond issuer's potential risks and opportunities.

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



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. Milliman. "Milliman Pension Buyout Index." https://www.milliman.com/en/insight/milliman-pension-buyout-index-january-2023.
4. PBGC is the Pension Benefit Guaranty Corporation.
5. A buy-in allows a plan sponsor to transfer much of the risk associated with a set of liabilities or the entire plan without moving the assets and liabilities off the balance sheet; it often serves as a precursor to a full termination while the plan sponsor is working through the regulatory termination process.