

Q4 Pension Perspectives¹

Key Takeaways

- Although aggregate single-employer plan funded status decreased to 102.1% in the fourth quarter, it has now been over 99.5% for nearly two years.²
- The “soft landing” narrative appears to be gaining momentum, but historically tight credit spreads, geopolitical risks, and as-yet-unresolved inflationary risks support maintaining target interest rate hedges, underweighting credit spread hedges, and retaining “dry powder” in case spreads widen.
- On the heels of IBM announcing that it will re-open its (overfunded) cash balance plan effective January 1, 2024 and shift its defined contribution match to the cash balance plan, plan sponsors may wish to assess whether a similar move could be advantageous from balance sheet, retirement income, and human capital perspectives.
- The run-up in interest rates through October and their subsequent decline could make lump sum windows particularly attractive in 2024, while lower interest rates may make pension risk transfer pricing less appealing. The volatility in interest rates could also make it timely to re-visit cash balance plan assumptions and hedges.

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Quarterly Funded Status Drivers

Figure 1. Funded Status Drivers

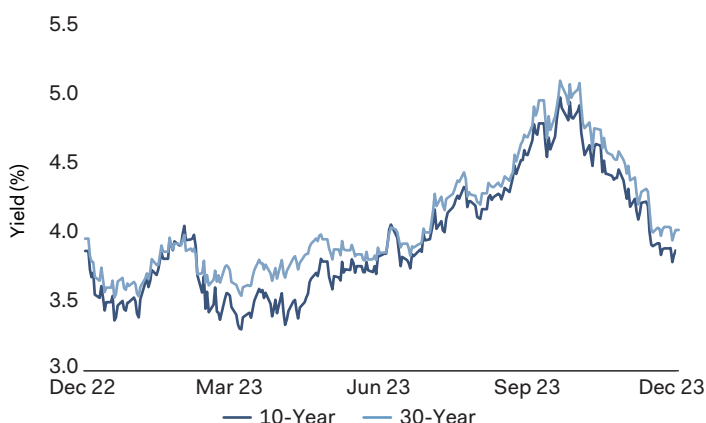
	December 31, 2023	September 30, 2023	December 31, 2022
Milliman 100 Funded Status	102.1%	103.6%	101.9%
Discount Rate (Aa)	5.00%	5.84%	5.22%
U.S. 10-Year Treasury Yield	3.88%	4.57%	3.88%
U.S. 30-Year Treasury Yield	4.03%	4.70%	3.97%
Bloomberg U.S. Long Credit Spread (OAS) ³	117 bp ⁴	133 bp	157 bp
Global Equities (MSCI ACWI Index) Net Total Return	Q4 2023: 11.03% 2023: 22.20%		

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

Decelerating inflation, slowing but still healthy economic growth, and a much more dovish tone from the Federal Reserve in the fourth quarter buoyed the “soft landing” narrative and capital market valuations. Global equities returned 11.0% for the quarter, and U.S. equities outperformed non-U.S. equities. U.S. Treasuries, U.S. investment grade credit, and U.S. high yield bonds all posted solid returns in the 5% to 8% range.

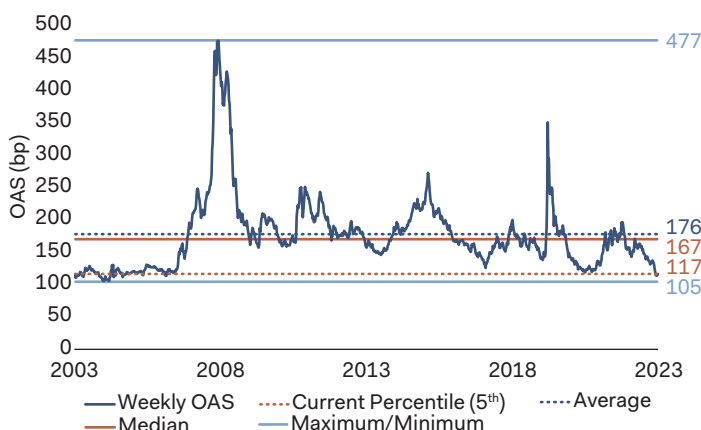
After rising more or less steadily between June and October 2023, long-term Treasury yields fell sharply in November and December and ended the year 0 to 6 bp higher than where they started (see Figure 2). Credit spreads tightened across all maturities, but the supply-demand imbalance at the long end contributed to long credit spreads declining nearly twice as much as intermediate credit spreads (40 bp versus 22 bp, respectively) year over year. The spread on the Bloomberg U.S. Long Credit Bond Index touched 111 bp in December and ended the year at 117 bp, just slightly below its 2021 and 2007 lows (see Figure 3).

Figure 2. U.S. Treasury Yields



Source: Bloomberg Index Services.

Figure 3. Bloomberg U.S. Long Credit Index Spread



Source: Bloomberg Index Services.

Despite typical liability discount rates falling approximately 85 bp (which translates to liability growth of roughly 11% for a mature plan), aggregate funded status of large corporate defined benefit (DB) plans declined by only 1.5 percentage points (pp) during the quarter, from 103.6% to 102.1%. A high degree of hedging and strong global equity market returns contributed to plans maintaining their overfunding. With the exception of April 2023, when it dipped to 99.6%, aggregate funded status has now been over 100% for 22 consecutive months!

The Macro View

First quarter market volatility notwithstanding, our overall macro outlook generally aligns with a “soft landing” narrative, while acknowledging an array of risks, particularly with respect to credit spreads.

We believe plan sponsors are best served by maintaining target interest rate hedge ratios. While it may be tempting to overweight duration⁵ given expectations for slowing economic growth and Fed cuts, we would caution against such a move even after the January up-tick in Treasury yields. First, the substantial decline in long-end yields last quarter eroded much of the potential return from this tactical position. Second, while front-end rates are expected to fall later in 2024, forward curves are pricing minimal declines at the long end. Finally, the probability of a recession (and therefore deeper Fed cuts) has likely decreased, while potential for inflationary spikes remains (e.g., due to the resilient labor market or potential trade disruptions resulting from the unrest in the Middle East).

Although we are largely constructive on corporate credit, historically tight valuations suggest underweighting credit spread hedge ratios and maintaining “dry powder” in the form of U.S. Treasuries and/or other liquid, high-quality credit alternatives. Given a supportive macro backdrop and strong balance sheets, our base case does not envision significant spread widening, but the range of scenarios is skewed more toward widening than tightening. For example, waning recession risk and lower borrowing costs may lead issuers to increase capex and M&A expenditures. This would result in increased borrowing and wider spreads. In addition, if long-end Treasury yields decrease further or stabilize at current levels, long-end issuance may pick up, reversing the downward trend in long-end spreads. Lastly, geopolitical risks (e.g., repercussions from the unrest in the Middle East or the war in Ukraine) may drive spreads wider, if only temporarily, providing better entry points. Given lower spread duration⁶ and better valuations, plan sponsors may wish to overweight Intermediate Credit versus Long Credit, while being mindful not only of the duration differences, but also compositional differences in sectors and issuers, such as a much larger Intermediate Credit Index exposure to Financials and supranationals.

Last quarter, in our full-discretion liability-hedging strategies, we maintained duration-neutral positioning and reduced credit exposure across strategies (and reached the lowest level of credit exposure since inception in our Long Credit strategy). Depending on strategy duration, we also increased allocations to defensive diversifiers, including U.S. Treasuries, U.S. Agency commercial and residential mortgage-backed securities, and high-quality asset-backed securities.

Strategic Considerations: Re-Opening Defined Benefit Plans

In November, IBM made headlines when it announced that starting January 1, 2024, it will re-open its cash balance (CB) plan⁷ and shift its retirement plan contributions from the defined contribution (DC) plan to the CB plan. While subject to DB-specific regulations and risks, this move can achieve multiple objectives, such as:

- Funding retirement benefits via the CB plan surplus and excess asset returns, rather than with cash contributions to the DC plan;
- Offering a retirement income option, since the CB plan lump sum can be converted to an annuity under standard IRS regulations; and
- Offering a differentiated employee benefit to its workforce.

While several other smaller plan sponsors have recently re-opened DB plans, given IBM's prominence, this may be an impetus for other plan sponsors to consider re-opening their plans.

When re-opening the plan, plan sponsors could implement a benefit formula that makes contributions more predictable than in traditional DB plans by significantly reducing plan sponsor investment risk and, potentially, longevity risk. One example is a CB design that defines the benefit as a hypothetical account balance and credits a conservative interest rate (such as the 10-year Treasury yield) or the actual return on plan assets. Another is a variable annuity design, which focuses on retirement income (rather than a lump sum) by defining the benefit as a life annuity and letting it vary based on actual asset returns relative to an assumed hurdle rate. Both designs typically require a differentiated liability hedging approach, compared to traditional frozen DB plans. Coincidentally, in December, the IRS codified regulations required under SECURE 2.0 that make it easier to offer CB plans with variable interest crediting rates.

Revisiting Cash Balance Provisions

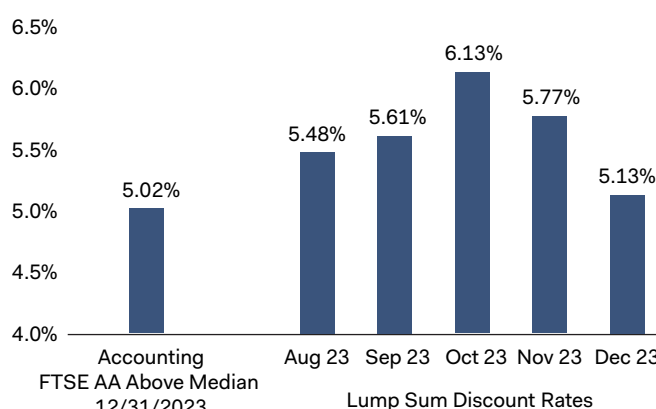
Given the volatility in Treasury yields over the last year, plan sponsors with CB provisions may wish to re-visit their CB crediting rate assumptions and hedging strategies. CB crediting rates based on Treasury yields introduce a number of nuances when computing liability duration, key rate durations, and spread duration. This can be even more complex if crediting rates also involve floors and ceilings near the current yield level (e.g., 4% for a 10-year Treasury yield). In addition, for plans with both traditional annuity and CB components, the CB component is likely to increase relative to the traditional annuity component over time, potentially requiring a bespoke approach at some point.

Reducing Plan Size via Lump Sums

Offering lump sum windows may be particularly advantageous to plan sponsors in 2024. This is the case since for calendar-

year plans, lump sum conversion rates are typically based on September or October corporate yields (i.e., a 3- or 4-month look-back period) and are fixed for the entire calendar year (an annual stability period) and are therefore much higher than the current (and, possibly, projected) accounting discount rate (see Figure 4). For example, a typical vested deferred lump sum with a duration of 11 years could be as much as 6% to 12% lower compared to the associated accounting liability. Actual differences between lump sum settlements and the associated accounting liability will vary based on the stability and lookback periods, participant take-up rates, and market conditions determining the accounting liability.

Figure 4. Lump Sum Conversion Rates vs. Accounting Liability Discount Rates



Source: Dodge & Cox, FTSE Russell, Internal Revenue Service.

Pension Risk Transfer

In contrast to lump sums, pension risk transfer (PRT) pricing typically reflects current yields. Thus, while most competitive PRT pricing may be in line with or slightly above the accounting liability, it is likely to be higher in dollar terms than in 2023, given lower Treasury yields and credit spreads. We estimate 2023 PRT activity⁸ at \$45 billion, compared to \$52 billion in 2022, in part due to fewer and smaller multi-billion dollar deals, like the \$8 billion AT&T PRT in 2023 and the \$16 billion IBM PRT in 2022.

The PRT space remains robust and competitive. The vast majority of the 21 insurers bid on both vested deferred and retiree-only transactions, and nearly half offer buy-ins as well as buy-outs. However, larger plan sponsors may be less inclined to pursue PRT as they re-assess the strategic benefits of maintaining an overfunded plan and gain confidence from successfully preserving strong funded status through market volatility over the last two years. This is especially true if they have already transferred the most attractively priced liabilities, such as retirees with small benefit amounts.

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

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2. All data is as of December 31, 2023 unless otherwise stated.
3. 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.
4. One basis point is equal to 1/100th of 1%.
5. Duration is a measure of a bond's (or a bond portfolio's) price sensitivity to changes in interest rates.
6. Spread duration is a measure of a bond's (or a bond portfolio's) price sensitivity to changes in credit spreads.
7. A cash balance plan is a type of defined benefit plan where each participant has a hypothetical account balance that is credited with an annual pay or service credit (e.g., 5% of pay) and an annual interest credit (e.g., the yield on the 10-year Treasury). Upon retirement, the normal form of benefit is a lump sum. However, under IRS regulations, a participant can elect to convert that lump sum into an annuity.
8. PRT activity includes both buy-outs and buy-ins.