January 31, 2025

Dodge & Cox®
Investment Focus

Q4 Pension Perspectives[1]

Key Takeaways

- Aggregate single-employer plan funded status rose by 2.5 percentage points to 105.0%, its highest level in over two years, as discount rates rose in the fourth quarter and year over year.[2]
- Staying close to strategic asset allocation targets may be most prudent given policy and macro uncertainty associated with the Trump Administration; however, modest tactical underweights may be justified in investment-grade credit and U.S. equities given their historically rich valuations.
- Active management within credit may deliver lower alpha in the near term compared to previous years if tight spreads, low issuer dispersion, and supportive fundamentals and technicals persist. However, spread volatility could provide attractive opportunities to add value via issuer selection.
- Plan sponsors may wish to continue refining and aligning funding liabilities, accounting liabilities, and investment strategies, while also focusing on hibernation, aggressive pension risk transfer (PRT), plan re-opening, and plan termination—or some combination of the four.
- The recent wave of lawsuits in the PRT space is likely to elevate plan sponsor scrutiny of PRT providers and may put a damper on large-plan PRT activity in an otherwise healthy market.

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Quarterly Funded Status Drivers

Figure 1. Funded Status Drivers

	December 31, 2024	September 30, 2024	December 31, 2023
Milliman 100 Funded Status	105.0%	102.5%	99.5%
Discount Rate (Aa)	5.59%	4.96%	5.00%
U.S. 10-Year Treasury Yield	4.57%	3.78%	3.88%
U.S. 30-Year Treasury Yield	4.78%	4.12%	4.03%
Bloomberg U.S. Long Credit Spread (OAS)	100 bps	108 bps	117 bps
Global Equities (MSCI ACWI Index) Net Total Return		Q4 2024: -0.99% 2024: 17.49%	

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

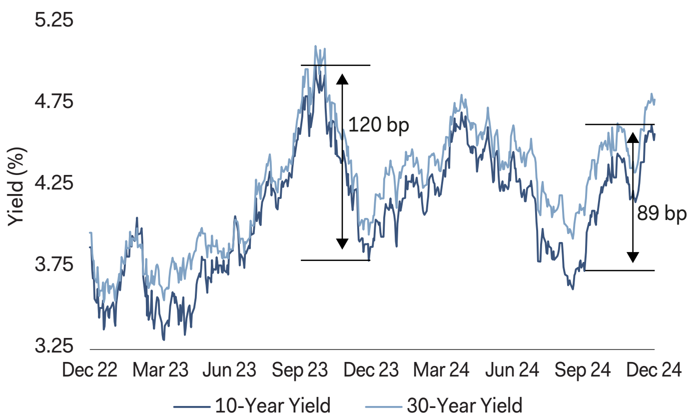
In the fourth quarter, long-term Treasury yields rose sharply as the economy proved to be more resilient than expected, the Federal Reserve (Fed) communicated a less accommodative path for future rate cuts, and Donald Trump was re-elected President, sparking concerns around fiscal deficits and heightened inflation. Investment-grade

(IG) credit spreads tightened slightly; U.S. equity markets posted a modest positive return, while non-U.S. equity markets tumbled. In this environment, the rise in liability discount rates—and the associated decrease in liabilities—outweighed the decline in assets. According to Milliman, the aggregate funded status of the 100 largest corporate pension plans rose 2.5 percentage points to 105.0%, the highest level in over two years.

Thinking Probabilistically, Minding Valuations

For many plan sponsors, the top investment priority continues to be protecting funded status in a supportive but uncertain macro environment. While interest rate volatility persists (see Figure 2), it is often hedged well, such as via completion strategies. However, policy uncertainty associated with the new Administration and rich valuations in IG credit spreads and U.S. large-cap equities present more of a challenge. With that in mind, we encourage plan sponsors to take a probabilistic view of the markets to help ensure that (1) their strategic asset allocation aligns with their target funded status volatility and (2) tactical deviations reflect strong conviction and are sized appropriately.

Figure 2. U.S. Treasury Yields



Source: Bloomberg Index Services.

At a high level, potential Trump Administration policies—tariffs, immigration, and tax cuts—appear likely to result in higher inflation and higher Treasury term premiums. Similarly, the Administration's pro-business initiatives (e.g., deregulation, lower corporate taxes) are likely to support U.S. economic growth. However, the *magnitude, timing, and duration* of these impacts depend on actual policy details. The small Republican majority in the House, the potentially lengthy rule-making process, and competing Administration priorities further complicate any forecasting. Consequently, we currently caution against taking any large tactical positions based on anticipated Trump Administration policies.

That said, in our base case, we expect economic growth to average around potential, inflation to continue to moderate, and 10- and 30-year yields to decline modestly over the next two years. However, the path is likely to be bumpy, and the cone of outcomes around the base case is quite wide. For example, aggressive tariffs could lead to resurgent inflation, forcing the Fed to change course and re-start hikes and push long-term yields higher. On the other hand, overly restrictive trade policy or geopolitical disruptions could lead to economic deceleration or even a recession, with the Fed shifting to a more accommodative stance.

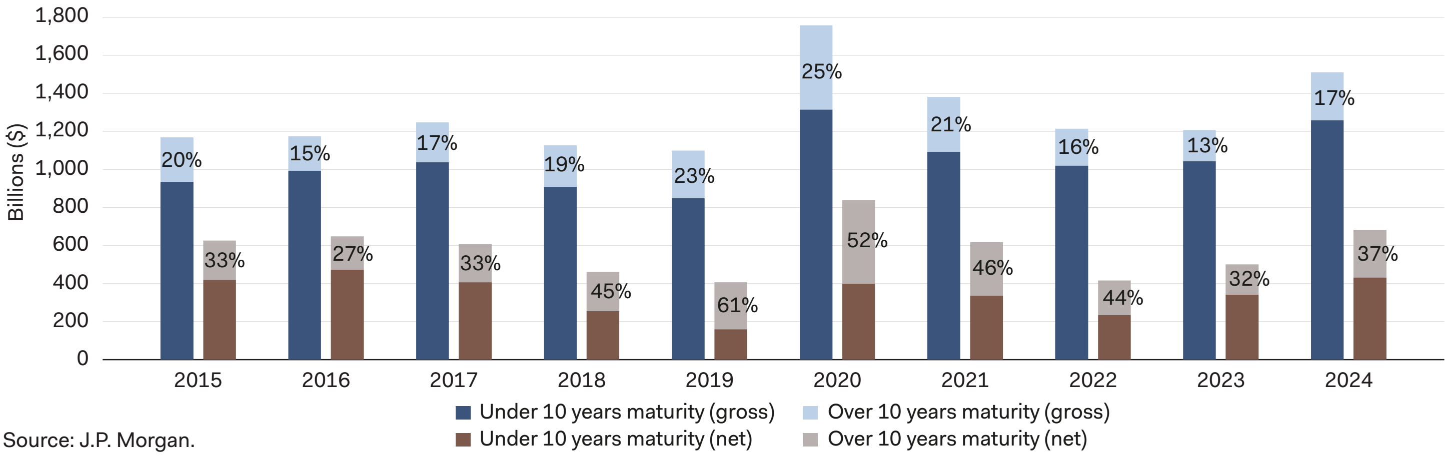
As for valuations, IG credit spreads and U.S. equity valuations, as measured by the Shiller price-to-earnings (P/E) ratio for example, ended the year slightly off their highs reached in December. Aside from a short-lived spike in August, Long Credit spreads tightened in 2024, reaching a low of 96 bps in November (and then again in December), the lowest level since the late 1990s. The S&P 500 Shiller P/E ratio reached a three-year high of 36.6 times in December, well above pre-2021 levels. While valuations can remain high for some time, valuation discipline suggests that over a long-term horizon, an underweight may be justified.

Tempering IG Credit Alpha Expectations

IG credit is often the largest asset allocation component for well-funded plans and a meaningful contributor to relative performance versus both market benchmarks and liabilities. Given tight starting spreads and low issuer spread dispersion, investors should temper near-term alpha expectations. Other notable market dynamics include:

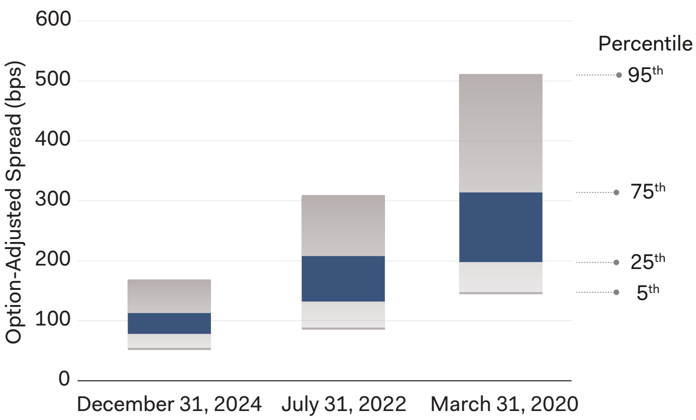
- **Strong demand continues to put pressure on spreads, limiting potential alpha from a credit underweight.** Although 2024 corporate bond supply was the second highest on record (see Figure 3), it was well-absorbed by broad, yield-driven demand for fixed income. Notably, issuance of long-term corporate bonds, as a percentage of total issuance, was highest in the third quarter when overall yields fell due to the sharp decline in the Treasury component. Supply/demand dynamics are an added source of uncertainty as greater expected maturities (e.g., from five-year bonds issued in 2020) may be balanced by elevated M&A issuance.
- **Issuer dispersion is very low, limiting sector and issuer selection opportunities.** As of December 31, the middle half of the Bloomberg U.S. Long Corporate Index traded within a 35-bps spread range, compared to a more typical 76-bps range or a more attractive 116-bps range observed near pandemic highs (see Figure 4). According to Barclays, Credit sector dispersion in early December was near its lowest level since 2006. Low dispersion reduces active managers' ability to harvest incremental spread advantage or add value via issuer selection, *unless* spreads widen.
- **Rating agency upgrades continue to outpace downgrades, reducing effectiveness of upgrade anticipations.** 2024 was the fourth straight year that upgrades exceeded downgrades, with no slowdown from 2023. Consequently, many portfolios, including our own, reflect higher quality and limited upside for further upgrades

Figure 3. U.S. Investment-Grade Issuance



Source: J.P. Morgan.

Figure 4. Bloomberg U.S. Long Corporate Index OAS Dispersion



Source: Bloomberg Index Services, Dodge & Cox.

and associated spread compression.

Continuing Asset-Liability Refinements

For plans that have not yet switched from the IRS Segment Rates to the IRS Full Yield Curve for funding requirements, now may be an opportune time to do so. As of December 31, the Full Yield Curve reflects higher yields at longer maturities (and, therefore, lower liabilities for many plans). By virtue of being a spot-like curve rather than a long-term average, it aligns more closely with accounting discount curves. Given interest rate volatility, the growth of liability-hedging assets, and the low likelihood of interest rates falling to pandemic-era lows, this alignment can help ensure that contribution requirements and Pension Benefit Guaranty Corporation (PBGC) variable-rate premiums more closely reflect balance sheet treatment of assets and liabilities.

As in prior years, continuing to improve liability calculations by implementing plan-specific mortality and linking cash balance plan assumptions to actual market conditions—rather than long-term averages—can reduce unexpected funded-status volatility. This may be particularly important for plan sponsors with cash balance interest crediting rates linked to Treasury bond yields, considering recent interest rate volatility.

Strategic Developments

With stable or growing pension plan surpluses over the last two years, plan sponsors have had some time to make progress on a range of long-term plans, including hibernation, pension risk transfer (PRT), plan termination, and possibly plan re-opening! Indeed, as illustrated by IBM, which both re-opened its plan *and* transferred a large portion of its legacy liabilities in 2024, a multi-pronged approach may be sensible. Potential developments in 2025 include:

- **Greater scrutiny of PRT providers:** As we discuss below, a recent wave of lawsuits may lead plan sponsors to more closely evaluate PRT providers' investment, re-insurance, regulation, and governance policies, potentially dampening certain types of PRT activity.
- **Growth in deferred-life PRTs:** With many retiree liabilities already transferred, plan sponsors are likely seeking to transfer liabilities associated with deferred lives, which are typically more expensive. Consequently, insurance companies may be focusing on better pricing for these liabilities.
- **Re-opening the plan:** Besides IBM, no large plan sponsor has announced a plan re-opening. However, that may change due to growing surpluses, balance sheet considerations, and interest from employees, as we saw during the Boeing strike. Funding retirement benefits from a pension plan surplus rather than from cash in a defined contribution plan may be particularly attractive to some plan sponsors.
- **Terminations:** Although small plan terminations are increasing, large plan terminations remain rare due to plan complexity, accounting considerations, and reversion-related taxes. Nevertheless, some plan sponsors may follow Kodak, which signaled that it may terminate its overfunded plan.

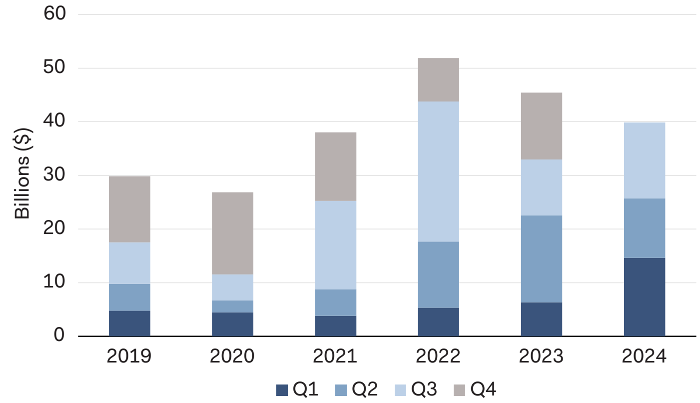
Pension Risk Transfer

PRT activity continues to be robust, totaling almost $40 billion in the first nine months of 2024 (see Figure 5); however, 15% of this was due to the $6 billion IBM PRT announced in September and 36% was split among four other transactions. We estimate calendar-year PRT activity to total around $50 billion, in line with the prior two years. Interestingly, buy-ins[3] may be gaining popularity. There were nine buy-ins year to date through September 30, compared to eight in 2023 and seven in 2022; yet, volumes remain low at only $3 billion to $4 billion per year.

Overall, the PRT market appears to be strong, buoyed by strong funded status, high interest rates, ongoing insurer competition, and benign regulation. But this year's wave of eight lawsuits may put a damper on large-scale PRT activity. In 2024, former plan participants filed class-action lawsuits, alleging that seven plan sponsors acted imprudently when they selected Athene, a private equity-backed insurer, for their PRTs. In December, Verizon was also sued, as plaintiffs claimed that Prudential's and RGA's convoluted re-insurance arrangements made the selection of those providers imprudent. While the lawsuits are pending, elevated headline risk and greater plan sponsor selectivity may lead to reduced competition and higher pricing in the large-plan space.

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

Figure 5. Pension Risk Transfer



Source: LIMRA.

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2. Unless otherwise specified, all weightings and characteristics are as of December 31, 2024.
3. In a buy-in transaction, the plan sponsors transfer the assets and liabilities associated with a group of participants to an insurance company, but both the buy-in contract (as an asset) and the liabilities remain part of the plan and the corporate balance sheet. In a buy-out transaction, the assets and liabilities are transferred outside the plan and the corporate balance sheet.