October 25, 2022

Dodge & Cox®
Investment Focus

Q3 Pension Perspectives[1]

Key Takeaways

- Despite negative returns across all major asset classes, aggregate single-employer plan funded status rose to 109.2% in the third quarter, as the decline in liabilities outpaced the decline in assets.
- With market volatility likely to continue, plan sponsors may be well served by taking the long view and ensuring that they have efficient processes to rebalance and/or take advantage of market dislocations.
- As the probability of an economic slowdown, or even a recession, increases and credit spreads remain only modestly above their long-term averages, maintaining interest rate hedge ratios near targets and retaining some dry powder within credit may be prudent.
- The year-to-date increases in inflation and interest rates are likely to have a larger-than-usual impact on year-end actuarial assumptions, lump sum elections, and cash balance crediting rates. The resulting changes to the liabilities may necessitate a review of the liability-hedging approach.

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Quarterly Funded Status Drivers

Figure 1: Funded Status Drivers

	September 30, 2022	June 30, 2022	December 31, 2021
Milliman 100 Funded Status	109.2%	105.9%	97.9%
Discount Rate (Aa)	5.36%	4.59%	2.80%
U.S. 10-Year Treasury Yield	3.83%	3.02%	1.51%
U.S. 30-Year Treasury Yield	3.78%	3.19%	1.90%
Bloomberg U.S. Long Credit Spread	1.96%	1.84%	1.30%
Global Equities (MSCI ACWI Index) Net Total Return	Q3 2022: -6.82% YTD through 9/30/2022: -25.62%		

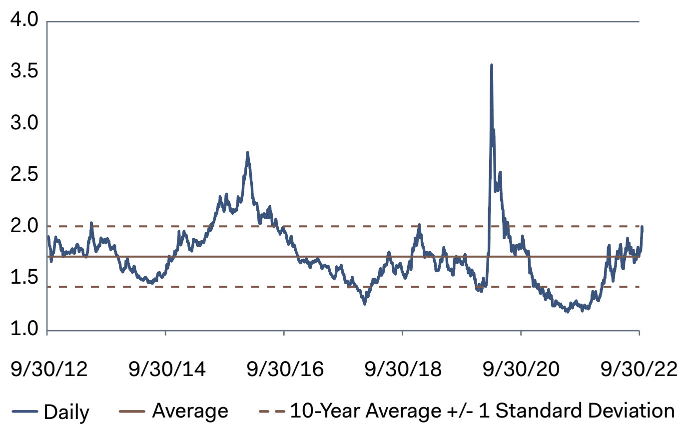
Source: Bloomberg Index Services, Milliman, MSCI. The funded status and discount rate are for the Milliman 100 Pension Funding Index.

In both the second and third quarters of 2022, Treasury yields rose, credit spreads widened, and global equity markets fell. Much of the markets' selloff accelerated after the Federal Reserve's hawkish statements emphasized the central bank's willingness to impose a hard landing if necessary to accomplish its goal of reining in inflation. The September selloff turned into an early October rally, underscoring the markets' volatility and uncertainty. For corporate plan sponsors, falling asset prices were offset by declining liabilities. According to Milliman, the aggregate funded status of the 100 largest corporate pension plans ended September 30, 2022 at 109.2%, an increase of 3.3% during the third quarter and 11.3% year to date. Still, individual plan sponsor experiences likely varied depending on asset allocation,

the degree of interest rate hedging, and the geographical exposure within global equities.

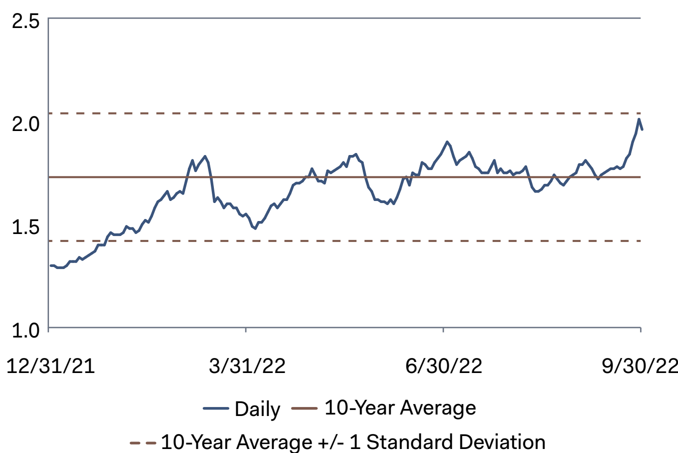
Treasury yields continued their march upward and the curve flattened further, with 2-year yields rising 132 basis points[2] (bps) and 30-year yields rising 59 bps. This led to a short-lived 10-30 inversion and put 10-year and 30-year yields at their highest levels since 2008 and 2014, respectively. Despite equity market volatility, long credit spreads remained range-bound around their long-term average for much of the quarter, but ultimately ended the quarter 12 bps higher (see Figures 2 and 3). Within global equities, U.S. stocks outperformed developed markets, which in turn outperformed emerging markets.

Figure 2. Bloomberg U.S. Long Credit Index OAS, Past 10 Years



Source: Bloomberg Index Services.

Figure 3. Bloomberg U.S. Long Credit Index OAS, Year to Date



Source: Bloomberg Index Services.

More Volatility Ahead

Driven by a variety of considerations, including a hawkish Fed, U.S.-dollar strength, and the continuing war in Ukraine, the macro outlook continues to deteriorate. Corporate balance sheets are still in relatively good shape, leaving corporations better placed to weather the coming macro headwinds compared to previous cyclical downturns. In the prevailing environment of heightened volatility, maintaining some dry powder to take advantage of further risk asset weakness could be a tactical approach worth considering.

From a liability-hedging perspective, we believe that over the next 12 to 24 months, the Fed's actions are likely to cool the labor market, slow economic growth, and lower inflation, putting pressure on the level of long-term Treasury yields. Consequently, while we acknowledge inflationary pressures in some parts of the economy, particularly energy, and market expectations of another 150 bps of Fed tightening in the next six months,[3] we believe it is prudent to remain close to interest rate hedge ratio targets given the downside risks. In late September, we therefore eliminated our remaining duration underweight in our liability-hedging portfolios in favor of a duration-neutral stance.

Much of this quarter's, or even year's, "pain" in equities has not translated to credit: although long credit spreads ended the quarter 66 bps (51%) wider than at the beginning of the year, they are still largely within one standard deviation of their long-term averages (see Figure 3). Further, while the trend has been upward, the path has been volatile: we have seen four peaks and troughs through early October. Consequently, some plan sponsors may wish to underweight credit spread hedge ratios by moving up in quality across corporate issuers, adding lower-volatility "corporate-adjacent" sectors (such as taxable municipals or high quality securitized assets), or simply overweighting Treasuries. This defensive positioning needs to be balanced against the associated decline in the portfolio's yield, especially relative to the liability hurdle rate.

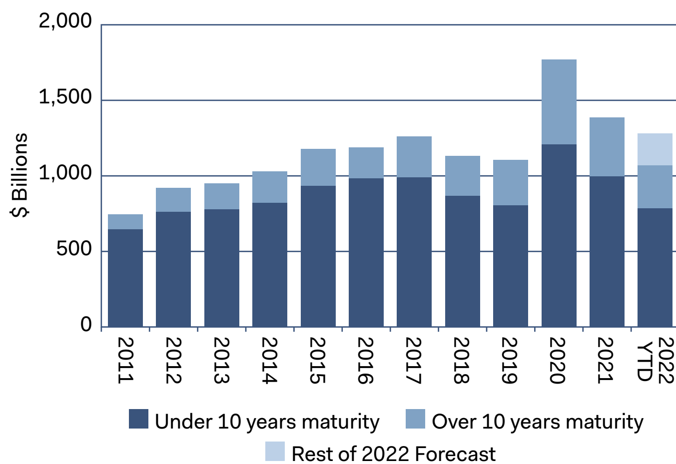
For example, in our full-discretion Intermediate Credit strategy, we recently added AAA-rated credit card debt. Along with Agency[4] mortgage-backed securities (MBS), this position is attractive relative to AAA- and AA-rated corporates and also serves as a source of liquidity and ballast, especially relative to some of the higher-beta credits in the portfolio. Across our full-discretion, liability-hedging portfolios, we are reserving some dry powder and remain measured in how quickly we add to credit.

Credit Liquidity and New Issuance

As plan sponsors consider rebalancing, we would highlight two recent trends supportive of credit trading: (1) growth in ETF and portfolio trades which allow for efficient trading of large quantities of bonds, including some less liquid ones, and (2) algorithmic trading, which has also led to more efficient trading of smaller lots and less liquid credits. In addition, healthy new issuance, as we have seen for most of the year, is also supportive as it leads to more turnover and, by extension, secondary trading. That said, any bout of market volatility is likely to increase trading costs (at least temporarily), and it may be prudent to assess trading costs and execution timing with investment managers before engaging in a transaction. Maintaining a cushion of liquid assets—such as cash or Treasuries—to pay benefit payments, meet capital calls, and settle margin requirements remains sensible in our view.

Despite higher coupons and yield volatility (which can delay new issues from coming to market, as it did in the month of September), year-to-date investment-grade corporate issuance remains strong and is on track to end the year slightly below 2021 levels (Figure 4). The same is not true for the below-investment-grade space, where year-to-date issuance has been substantially lower than in the past three years.

Figure 4. Investment-grade Corporate Issuance (Gross)



Source: J.P. Morgan

Completion Portfolio and Leverage

September's news of UK liability-driven investing (LDI) strategies wreaking havoc amidst rapidly rising gilt rates may have given pause to U.S. plan sponsors who employ similar strategies, typically in Treasury-only and completion portfolios. While we continue to believe that capital-efficient completion portfolios remain prudent, it may be worthwhile to re-assess the size of the completion portfolio relative to total assets; its duration, leverage, and collateral requirements; the choice of investment vehicle; and, the governance process to raise cash to meet margin requirements. In particular, while operationally somewhat more complex than a collective vehicle (or a blend thereof), a separately managed completion portfolio may help plan sponsors insulate themselves from the actions of other investors and enable them to set specific risk parameters (such as duration targets, leverage limits, and collateral requirements) in the guidelines.

A Few (Other) Implications of Rising Interest Rates

For most plan sponsors, the primary impact of rising corporate bond yields is an increase in the liability discount rate and a corresponding decline in the present value of liabilities. However, there may be offsetting effects, and plan sponsors may wish to review their actuarial assumptions and investment strategy in light of the following considerations:

Cash Balance Considerations

Assuming interest rates remain at or above current levels through year-end, bond-based cash balance interest-crediting rates (ICRs) may exceed their floors and/or prior actuarial assumptions for the first time in many years. Not only is this likely to increase liabilities (due to higher interest credits), it may also lower liability duration as future changes in discount rates would be (at least) partly offset by corresponding changes in ICRs. Given this year's increase in ICRs and, likely, funded status, cash balance plan sponsors may wish to revisit the alignment between the investment strategy and the actuarial approach for estimating future ICRs.

Lump Sums

Higher corporate bond yields also translate into lower lump sum values, which could make lump sums appear less attractive than annuities to many plan participants, especially those who have seen higher lump sum estimates in the past, when interest rates were lower. With fewer participants electing lump sums, future lump sum windows may be less effective, and, for plans offering ongoing lump sums, liquidity needs may be lower and total fixed-rate PBGC premiums may be higher.

Inflation and Wage Growth

Plan sponsors with accruing plans are likely to see an increase in their year-end liability due to higher-than-projected wage growth in 2022, off-setting some of the decline in the liability due to rising discount rates. The impact may be even greater if the *long-term* wage growth assumption is increased to reflect higher long-term inflation expectations. Such an increase in the liabilities (typically unhedged) would likely reduce funded status and could lead plan sponsors to consider re-risking or including inflation-sensitive assets.

Expected Return on Assets (EROA)

Finally, to conclude with what may be a silver lining, after years of declining EROAs, resulting from low inflation, low interest rates, and high equity valuations, 2023 EROAs may increase as these trends reverse. Although EROA is meant to be a long-term assumption and although many plans de-risked in the first half of 2022, barring a significant recovery in the equity markets the spread between EROAs and discount rates may increase compared to year-end 2021. This could lead to lower pension expense (or higher pension income).

Pension Risk Transfer and the Post-PRT Strategy

We would be remiss if we did not acknowledge the blockbuster pension risk transfer (PRT) transaction of the year, the $16 billion retiree lift-out by IBM announced in early September. The second-largest U.S. PRT transaction ever, it covers 100,000 participants who retired prior to 2016 and represents over 40% of the plan liabilities. With the fourth quarter typically being the busiest for PRTs, 2022 is on track to set a record at as much as $50 billion in PRTs.

According to Aon, the vast majority of PRT premiums continue to be retiree lift-outs, rather than full plan terminations.[5] After a large retiree lift-out, the remaining liability is likely to exhibit a longer duration, lower near-term cash flows, a larger cash balance component (if offered), and less certain mortality experience and participant behavior. Combined with the reduction in plan size relative to the corporate balance sheet, these factors may justify a review of the overall pension strategy, including reassessing ultimate objectives as either termination or hibernation, and the investment strategy in particular, including risk tolerance, glide path structure, liquidity requirements, and alpha targets.

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

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2 One basis point is equal to 1/100th of 1%.

3 As of September 30, 2022.

4 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.

5 AON. "U.S. Pension Risk Transfer 2022 Mid-Year Update," 2022. https://insights-north-america.aon.com/pension-risk-management/aon-u-s-pension-risk-transfer-2022-mid-year-update-article.