

Pension Insights

Out of Benchmark, but Not Out of Scope

Key Takeaways

- Investors in investment-grade (IG) credit strategies typically allocate to out-of-benchmark (OOB) securities to enhance potential returns but limit those exposures to manage tracking error (TE) to market benchmarks.
- OOB market segments may serve offensive, defensive, opportunistic, or diversification goals but may also arise from restrictive index construction criteria.
- OOB exposures can complement each other, provide flexibility to the IG credit portion of the portfolio, and even *reduce* benchmark-relative risks.
- We encourage investors to embrace a wide investment universe and tailor their OOB opportunity set to specific manager expertise and risk management objectives.

Out-Of-Benchmark Exposures: Seeking Alpha and Managing Risk

Asset owners and investment managers typically incorporate OOB securities in U.S. IG credit portfolios to boost the portfolio's excess return potential. By virtue of being *out of benchmark*, these exposures are typically assumed to raise TE as well. These considerations, as well as the investor's comfort with and a manager's expertise in different types of OOB exposures, are reflected in investment guidelines.

However, overly strict investment guidelines may unduly limit the investment opportunity set, dampen return potential, and even impede risk management. For example, OOB exposures may actually reduce risk if they are negatively correlated with each other or with in-benchmark securities in the portfolio.

In the next three sections, we briefly address each of the primary categories of OOB exposures:

- OOB sectors and quality buckets;
- IG credit securities not meeting index structure and maturity criteria; and
- Derivatives and exchange-traded funds (ETFs).

We also illustrate how OOB investments can help generate alpha, manage risk, and lead to more efficient portfolio management. Lastly, we suggest a few specific implementation considerations and highlight [applications for liability-hedging investors](#).

Unless otherwise noted, this paper focuses on IG **credit** benchmarks, which include both corporate and U.S. dollar-denominated, non-U.S. government-related bonds. Please see [Appendix A](#) for more information.

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The Big Categories: OOB Sector and Quality

Tactical allocations to OOB segments can be offensive, defensive, diversifying, and/or opportunistic (see Figure 1). When managed together, they can enhance performance while mitigating TE.

Playing Offense

Managers may seek to overweight credit spread risk in anticipation of tightening credit spreads by, for example, taking outsized allocations to BBB-rated credit or extending credit maturities. We believe that investing in select below-IG issuers, especially fallen angels (i.e., IG issuers that were downgraded to below-IG), can also be highly effective, due to both elevated spread income and potential price appreciation if fundamentals and ratings improve. However, this approach can increase default and liquidity risks.¹

Indeed, we do not advocate broad-based allocations to below-IG credit, BB-rated credit, or fallen angels; rather, we believe that deep expertise in issuer selection is critical when making these types of investments, both to generate return and control risk. At Dodge & Cox, we incorporate thorough fundamental analysis and extensive stress-testing

of each issuer to evaluate spread compensation vs. default and spread-widening risk, inform issuer sizing, and assess portfolio fit. At the portfolio level, the increase in a portfolio's systematic and issuer-specific credit risk can be (partly) offset with an allocation to higher-quality credit, such as taxable municipal bonds, or to high-quality OOB sectors, such as U.S. Treasuries. This demonstrates how OOB exposures can offset each other.

For more on incorporating below-IG credit, please see our paper, [Go BIG, but Carefully: Enhancing Liability-Hedging Portfolio Returns with Below Investment-Grade Bonds](#).

Playing Defense

Conversely, when credit valuations are demanding and/or the economic outlook is weak, a credit manager may find it prudent to underweight credit spread risk, often by moving up in quality or reducing contribution to duration (CTD) from credit. Investing in Treasuries may also be sensible in these circumstances, as their zero correlation and beta to IG credit spreads and greater liquidity may outweigh the spread give-up, especially in periods of extremely tight credit spreads such as the summer of 2025.

Figure 1. Primary OOB Market Segments

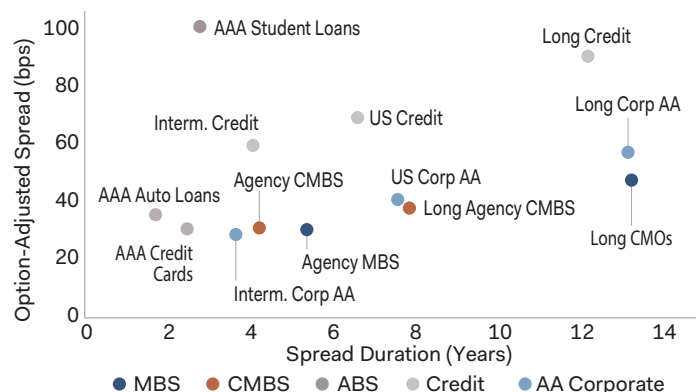
	Type	Role	Mandate Fit	Correlation to IG Credit Spreads
U.S. Treasuries	Nominal	Liquidity, defense, diversification, duration curve risk management	Any	Low
	Inflation-linked	Diversification, opportunistic exposure based on inflation view	Any	Low
High-Quality Securitized Assets	Agency Residential Mortgage-Backed Securities (MBS)	Defense, diversification, liquidity, alternative to high-quality credit; subject to prepayment and convexity risk	Any	Low
	Agency Commercial Mortgage-Backed Securities (CMBS)	Defense, diversification, opportunistic alternative to high-quality credit; minimal prepayment and convexity risk	Long, U.S.	Medium
	AAA-rated consumer Asset-Backed Securities (ABS)	Defense, diversification, liquidity, opportunistic alternative to high-quality credit	Intermediate, U.S.	Low
Other Securitized Assets	Non-Agency CMBS, Non-Consumer ABS	Opportunistic, yield enhancement, issuer- or sector-specific views	Intermediate, U.S.	Medium
Below Investment Grade	BB-rated, Fallen Angels	Offense, yield enhancement, issuer-specific views, opportunistic alternative to BBB-rated credit	Any	High
	Original Issue High Yield	Offense, opportunistic, yield enhancement, issuer- or sector-specific views	Any	High
Non-Dollar	Corporate and Government	Opportunistic, diversification, issuer or country-specific allocation based on relative value and currency view (if unhedged)	Any	Varies

Source: Dodge & Cox. Intermediate: 1-10 Year Maturity; Long: 10+ Year Maturity; U.S.: 1+ Year Maturity. This is not meant to be a complete list of OOB market segments or their characteristics.

High-quality securitized assets are often another attractive alternative to both high-quality corporates and Treasuries as they offer some spread compensation, which helps maintain portfolio yield relative to the benchmark, while also exhibiting lower credit beta than comparable-duration corporates. The relative value of securitized assets (see Figure 2) needs to be considered in the context of unique risks of this asset class, such as convexity (for Agency MBS) and macro and consumer health (for ABS backed by consumer debt).

For more on employing securitized assets, please see our paper, [Investing Outside the Credit Box: Hedging and Diversifying via Securitized Assets](#).

Figure 2. Relative Value: Option-Adjusted Spread vs. Spread Duration²



Source: Bloomberg Index Services, ICE, Dodge & Cox. Data is as of September 30, 2025.

Diversification and Risk Reduction

In addition to tactical positioning, Treasuries and high-quality securitized assets serve an important offsetting, or diversifying, role to higher-beta credit, allowing for more flexibility within the credit portion of the portfolio. A stylized example of this diversification benefit is shown in Figure 3: a duration-neutral portfolio that is 80% Long Credit, 10% Long Corporate BB, and 10% Long Treasuries (Portfolio A) has similar yield and spread as a portfolio that is 95% Long Credit/5% Long Corporate BB (Portfolio B) but lower spread risk, as measured by duration-times-spread (DTS).

Figure 3. Sample Portfolios³

	Portfolio		Bloomberg U.S. Long Credit Index
	A	B	
Long Credit	80%	95%	100%
Long Corp BB	10%	5%	-
Long Treasuries	10%	-	-
Ultra-Long Futures (Notional)	1%	1%	-
Duration (Years)	12.66	12.66	12.66
Yield to Worst (%)	5.61	5.64	5.53
OAS (bps)	95	98	91
DTS	10.8	11.5	11.0

Source: Bloomberg Index Services, Dodge & Cox. Data is as of September 30, 2025.

Opportunistic Allocations

Certain OOB allocations can be opportunistic, reflecting unique market opportunities and relative value dynamics not necessarily related to credit spread risk. Examples include non-dollar securities (vs. dollar-denominated securities of the same issuer), non-Agency CMBS, lower-quality and non-consumer ABS, and Treasury Inflation-Protected Securities (TIPS). Typically, these exposures are relatively small and may be short-lived owing to their truly unique characteristics.

IG Credit Beyond the Index

Index construction criteria typically exclude many attractive IG securities, such as securities issued pursuant to Rule 144A⁴ (which comprise over 20% of the IG credit market), many hybrid securities, and securities not meeting index maturity criteria. At Dodge & Cox, we analyze opportunities across the entire capital structure of a given issuer to determine the best relative value and portfolio fit. For example, historically, we have found value in 144A securities issued by large non-U.S. companies and certain industrial hybrids where we view the probability of distress as very low.

Junior/Subordinated Obligations

Hybrid securities, which are typically junior in the capital structure (but senior to common and preferred stock), have unique features, complicating (but not fully barring) index inclusion. Subordination, interest deferral features, and call provisions typically warrant a spread premium relative to traditional corporate bonds, making hybrids attractive alternatives when issued by strong companies in durable industries. Convertible bonds and preferred stock may also be appropriate, depending on their "bond-like" characteristics, but generally we have found them to be less suitable than hybrids for our credit portfolios.

Maturity Limitations

In Intermediate and Long Credit strategies, managers often include securities outside the benchmark maturity range to express a view on credit spread valuations and credit curve steepness or implement a relative value preference for individual issuers based on maturity. For example, the Dodge & Cox Intermediate Credit strategy included more exposure to long IG credit securities in the summer of 2020, when credit spreads were wide and curves were steep. In contrast, the Long Credit strategy has partially shifted toward intermediate maturities in 2024-2025, as credit spreads tightened to historic lows and curves flattened (see Figure 4).

In addition, strict adherence to benchmark maturity rules can lead to unnecessary turnover and elevated transaction costs. It may also force managers to exit positions with attractive total return prospects, such as aging taxable municipal bonds in Long Credit mandates.

Figure 4. Difference Between Long Corporate BBB and Intermediate Corporate BBB Spreads



Source: Bloomberg Index Services, Dodge & Cox. We are showing BBB spreads rather than IG index spreads for more of an apples-to-apples comparison that avoids differences in quality composition between the indices.

Duration and Curve Risk

Investing in OOB maturities—and, often, outside the benchmark in general—has implications for duration and curve risk contributions to TE and can be especially relevant when interest rates are volatile, as they were in 2024-2025. To mitigate these risks, managers may use OOB tools, such as U.S. Treasuries and interest rate derivatives, or adjust other credit holdings. A holistic approach to portfolio risk management is critical to successfully implement OOB exposures.

Portfolio Management Tools: Derivatives and ETFs

Although derivatives are often associated with complexity and leverage, they can also reduce risk and TE, improve execution, and allow managers to add value via OOB allocations (see Figure 5). Given their market depth and efficiency, U.S. Treasury futures are particularly effective for managing duration and curve risk, while credit ETFs and index credit default swaps can help efficiently manage portfolio credit beta, especially during portfolio transitions and market dislocations.

Implementation Considerations

We believe that investors are well served by allowing some degree of OOB exposure, even in mandates with low alpha targets. Allowing U.S. Treasuries, broad maturity limits, and some below-IG exposure (or, at a minimum, a downgrade bucket⁵) can create opportunities for managers to enhance potential return, manage risk, and increase liquidity, without necessarily materially increasing TE.

We encourage investors to keep an open mind and evaluate these opportunities in the context of both the overall fixed income allocation *and* individual mandates. For the latter, key considerations include:

- Understanding a manager's systematic and tactical OOB exposures, their expertise in the various OOB security types, and their ability to manage the risk of OOB exposures;
- Analyzing performance attribution and TE decomposition in ways that illuminate OOB contributions;
- Ensuring that the OOB exposures do not detract from alpha derived from IG credit or transform the mandate into a portable alpha strategy;
- Evaluating the types of OOB exposures in the context of overlap with other mandates in the IG credit sleeve; and
- Comparing the magnitude of OOB exposures to benchmark construction criteria.

We would welcome the opportunity to speak with you or your advisor about how OOB exposures fit into Dodge & Cox's credit-benchmarked and liability-hedging strategies and solutions.

Figure 5. Common Derivatives and ETFs

	Type	Typical Use and Considerations
Interest Rate Derivatives	U.S. Treasury futures	Duration and curve risk management; exchanged-traded, very liquid and efficient
	Other interest rate derivatives	Duration and curve risk management, opportunistic views, potential counterparty and basis risk
Credit Derivatives	Index credit default swaps (CDX)	Credit beta exposure in portfolio transitions or unique market environments; opportunistic alternative to physical IG or BIG credit
	Single-issuer credit default swaps (CDS)	Opportunistic alternative to an issuer's physical bonds, issuer-specific relative value
Exchange-Traded Funds	Broad IG market	Credit beta exposure in portfolio transitions or unique market environments
	Sector or quality-specific	Opportunistic expression of sector or quality views
Currency	Currency forwards and swaps	Hedging non-dollar exposure; expression of currency views

Source: Dodge & Cox. This is not meant to be a complete list of common derivative and ETF types or their characteristics.

High-Level Considerations for Liability-Hedging Investors

Some plan sponsors hedging corporate pension liabilities express a preference for IG *corporate* benchmarks over IG *credit* benchmarks, and may constrain common OOB exposures. Such restrictions are typically inspired by an actuarial perspective, seeking a “like-for-like” hedge.

While we sympathize with this philosophical view, we note that most liability discount curves cannot be hedged directly, as they reflect a narrow sliver of the market, exhibit a constant downgrade headwind,⁶ and rely on opaque curve construction techniques. Instead, we believe that these challenges are best met by investing in a wider IG credit universe, coupled with an appropriately sized U.S. Treasury allocation. This approach remains highly correlated to AA corporate bonds, but is more diversified, and offers a higher yield, helping offset the downgrade headwind.

Moreover, in large liability-hedging (LH) allocations with multiple LH mandates, permitting government-related bonds in addition to corporates can reduce issuer overlap across LH mandates and increase diversification. As many managers incorporate government-related bonds into corporate mandates, IG credit benchmarks often lead to more transparent relative performance attribution and TE decomposition.

Limiting OOB exposures is often a way to reduce potential TE, and it is ultimately a risk management decision based on plan sponsor objectives, asset allocation, and the composition of the LH sleeve. In our experience, plan sponsors are generally more willing to incorporate higher alpha/higher-TE mandates when:

- The plan is underfunded, and the plan sponsor seeks alpha from all asset classes to help close the asset-liability deficit;
- The return-seeking allocation is small, and the plan sponsor seeks alpha from LH assets to offset administrative expenses, mortality improvements, and plan experience headwinds; and
- There are several corporate or credit mandates in the LH allocation, and the plan sponsor seeks diversification in manager styles and risk postures.

We encourage plan sponsors to use an IG *credit* benchmark and actively consider the potential benefits of including OOB exposures in their portfolios.

Appendix A

Figure A1 summarizes key characteristics and sector allocation of the Bloomberg U.S. IG credit and corporate bond indices. Credit indices include all securities in the corporate indices as well as U.S. dollar-denominated non-U.S. government-related bonds, including sovereigns, quasi-sovereigns (Foreign Agencies), taxable municipal bonds (Local Authorities), and supranationals.

Figure A1. Index Characteristics as of September 30, 2025

	Long Credit	Long Corporate	U.S. Credit	U.S. Corporate	Intermediate Credit	Intermediate Corporate
Corporate Weight (%)	89.8	100.0	86.6	100.0	85.2	100.0
Financial Institutions	15.5	17.2	28.9	33.3	34.9	41.0
Industrials	62.0	69.0	49.3	56.9	43.5	51.0
Utilities	12.3	13.7	8.5	9.8	6.8	8.0
Government-Related (%)	10.1	-	13.3	-	14.8	-
Sovereign	5.7	-	3.8	-	3.0	-
Foreign Agencies	0.4	-	2.2	-	3.0	-
Local Authorities	3.9	-	2.5	-	1.9	-
Supranationals	0.1	-	4.8	-	6.9	-
Number of Issuers	661	550	1,006	862	816	750
Number of Issues	3,437	3,100	9,392	8,553	5,955	5,453
Duration (Years)	12.66	12.76	6.75	6.90	4.07	4.10
Yield to Worst (%)	5.53	5.53	4.75	4.81	4.40	4.47
Option-Adjusted Spread (bps)	91	90	70	74	60	66
Average Quality (MSF)	A-	A-	A-	A-	A-	A-

The above information is not a complete analysis of every material fact concerning any market, industry, or investment. Data has been obtained from sources considered reliable, but Dodge & Cox makes no representations as to the completeness or accuracy of such information. Opinions expressed are subject to change without notice. The information provided is historical and does not predict future results or profitability. This is not a recommendation to buy, sell, or hold any security and is not indicative of Dodge & Cox's current or future trading activity. Any securities identified are subject to change without notice and do not represent a Fund's entire holdings. Diversification does not ensure a profit or guarantee against losses.

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See dodgeandcox.com/disclosures for a full list of financial terms and Index definitions.

1. According to Moody's, over the last 30 years, the average cumulative 5-year default rate for corporate BB-rated bonds is 3.14%, five times higher than the 0.59% default rate for BBB-rated bonds.
2. Indices used in the analysis: **Long Credit**: Bloomberg U.S. Long Credit Index, **Long Corporate BB**: Bloomberg Long Ba U.S. High Yield Index, **Long Treasury**: Bloomberg U.S. Long Treasury Index. Futures: Ultra-long contract, sized so that total portfolio duration matches the duration of the Bloomberg U.S. Long Credit Index.
3. Indices used in the analysis: **Long CMO**: ICE BofA 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; **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 Credit, U.S. Credit, Intermediate Credit**: Bloomberg U.S. Long Credit, U.S. Credit, and Intermediate Credit Indices, respectively; **Long Corporate AA, U.S. Corporate AA, Intermediate Corporate AA**: Bloomberg U.S. Long Corporate AA, U.S. Corporate AA, and U.S. Intermediate Corporate AA Index.
4. Securities issued under SEC Rule 144A are unregistered and available only to qualified institutional investors, including many plan sponsors and insurance companies.
5. A downgrade bucket consists of IG securities that have been downgraded to below-IG and allows the investment manager to hold these securities for some time (or indefinitely) and not be a forced seller. Forced selling can result in worse performance as other forced sellers, such as index funds, rush to sell the security immediately following the downgrade.
6. If a high-yielding AA-rated bond is downgraded to A or lower and thus falls out of the discount curve universe, the discount rate is likely to decrease, and the liabilities are likely to post a positive return. On the other hand, a portfolio holding the exact same bonds as the discount curve universe prior to the downgrade will hold the downgraded bond after the downgrade and therefore will not experience the same up-lift as the liabilities and may, in fact, experience a negative return if the bond's yield rises further on the downgrade.