Q3 Pension Perspectives[1]

Key Takeaways

- Aggregate single-employer plan funded status increased 1.1% in the third quarter, reaching 103.6% as declines in liabilities outpaced declines in assets.[2]
- With long U.S. Treasury yields reaching 15-year highs, long credit spreads tightening further, and increased expectations of a soft landing, plan sponsors may wish to adopt a modestly defensive posture and focus on security selection rather than large macroeconomic bets.
- Given stable or increasing funded status, it may be timely to reconsider the broad range of strategic and tactical options afforded by the asset-liability surplus and adjust the investment strategy accordingly.
- Pension risk transfer activity continues to be robust and plan terminations are increasing, though given their complexity, plan terminations may be too costly for larger plans.

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Quarterly Funded Status Drivers

Figure 1. Funded Status Drivers

	September 30, 2023	June 30, 2023	December 31, 2022
Milliman 100 Funded Status	103.6%	102.5%	101.9%
Discount Rate (Aa)	5.84%	5.20%	5.22%
U.S. 10-Year Treasury Yield	4.57%	3.84%	3.88%
U.S. 30-Year Treasury Yield	4.70%	3.86%	3.97%
Bloomberg U.S. Long Credit Spread (OAS)[3]	133 bps[4]	148 bps	157 bps
Global Equities (MSCI ACWI Index) Net Total Return	Q3 2023: -3.40% YTD through 9/30/2023: 10.06%		

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

The third quarter was characterized by a sharp rise in long Treasury yields and a modest drawdown in global equity markets. Notably, the Bloomberg U.S. Long/Government Credit Index returned -9.4% for the quarter, its fourth-worst quarterly return in the last 20 years, while the MSCI All Country World Index (Net) returned -3.4%. As a result, aggregate pension assets declined less than aggregate pension liabilities and funded status rose to 103.6%.

Macro drivers (e.g., better-than-expected U.S. economic performance, stubbornly-high inflation readings, expectations of a "higher for longer" monetary policy) and fiscal considerations (e.g., elevated Treasury issuance, potential U.S. fiscal deterioration, sovereign debt downgrade) both contributed to the substantial increase in long-end Treasury yields. Yield curve inversion abated significantly, with 10- and 30-year Treasury yields rising 73 and 84 basis points (bps), respectively, and 2-year yields rising only 15 bps (see Figure 2). Plans that were underweight duration[5], particularly at the long end, benefited.

Despite the rate volatility, investment-grade credit fared well, with credit spreads tightening 2 bps. Long Credit spreads tightened 15 bps, reflecting high demand and light issuance in the long end of the curve. Indeed, third-quarter issuance of corporate bonds with 10 or more years to maturity came in at only $31 billion or 11% of all supply compared to at least $65 billion and 17% in each of the first two quarters of the year. This leaves Long Credit spreads 37 bps below their 10-year average. In contrast, Intermediate Credit spreads widened 5 bps, ending the quarter 9 bps above their 10-year average (see Figure 3).

Adopting a Defensive Posture

We continue to believe that the macroeconomic environment warrants maintaining target interest rate hedge ratios because potential macro risks over the next 12 to 24 months are skewed to the downside:

- Long-term inflation expectations appear to be anchored, despite labor market and consumer resilience;
- Markets are pricing in at most one more Fed hike before year-end;
- Should U.S. economic growth surprise to the downside, the Fed is likely to adopt a more accommodative stance than what is currently priced into the market; and
- Geopolitical risks are elevated.

Consequently, in our full-discretion liability hedging strategies, we remain duration-neutral relative to benchmarks. More pessimistic investors with appropriate risk tolerance may wish to consider whether and when to overweight target interest rate hedge ratios, particularly at the front end of the curve.

On the credit side, corporate balance sheets remain strong and, we believe, well positioned to withstand both a modest economic downturn and the implications of higher-for-longer interest rates. That said, at current levels, spreads may be more sensitive to a weakening macro backdrop, and an underweight to credit spread hedge ratios may be warranted. Any such credit underweight likely needs to be balanced with the need to generate yield relative to the liability discount rate, something that could be achieved via other spread sectors or asset classes. For example, in our full-discretion liability-hedging strategies, we have shifted some credit exposure to high-quality securitized assets.

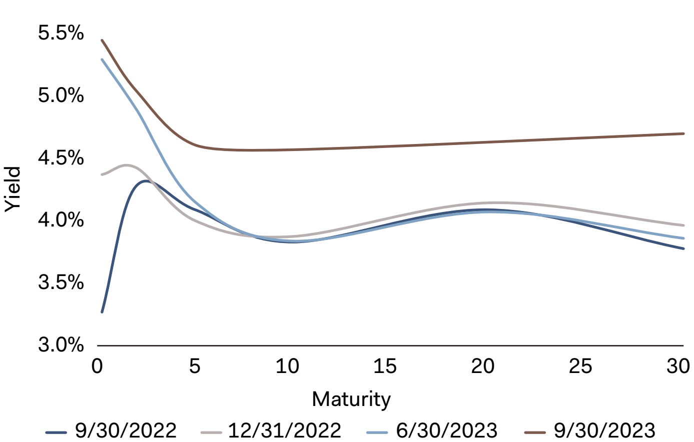
While Long Credit Index spreads are not particularly compelling, valuations vary across sectors and issuers. As shown in Figure 4, some corporate sectors—such as REITs and Electric Utilities—exhibit spreads that are relatively close to their 10-year averages, while others—such as Energy and Transportation—are trading well below long-term averages. This dispersion is even more pronounced in the intermediate-duration space, given a broader universe of issuers (see Figure 5). This is precisely the type of environment where issuer selection may be a key driver of absolute and relative performance going forward.

Year-End Planning and Surplus Opportunities

Thanks to the substantial and sustained asset-liability surplus, many plan sponsors may be contemplating a broad range of tactical and strategic opportunities, many of which were likely off the table until recently. In the near term, the surplus could be used to offset cash contributions (for accruing plans) or fund a lump sum window or a pension risk transfer even if the cost of doing so exceeds the accounting liability, without overall plan funded status falling below 100%. Long term, the surplus can help generate higher pension income, enhance employee benefits, and potentially serve other corporate strategic objectives. With all these options, we could foresee changes to asset allocation and hedging strategy, especially if they were put in place long before the recent funded status gains.

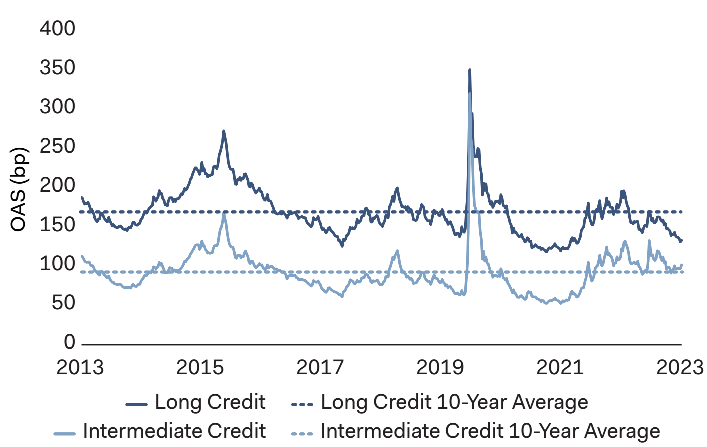
For example, since lump sum conversion rates are typically fixed a year in advance, a sizable lump sum window in 2024 may necessitate shifting a portion of the assets to cash (to fund the lump sums) and adjusting the remaining assets' duration to match that of the remaining liabilities. Since lump sums are typically elected by younger participants, the remaining liability likely has shorter duration and may require further integration

Figure 2. U.S. Treasury Yields



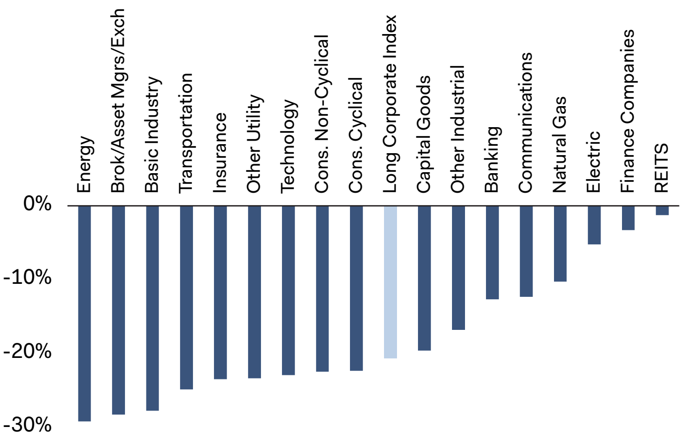
Source: Bloomberg Index Services.

Figure 3. Bloomberg U.S. Long and Intermediate Credit Spreads



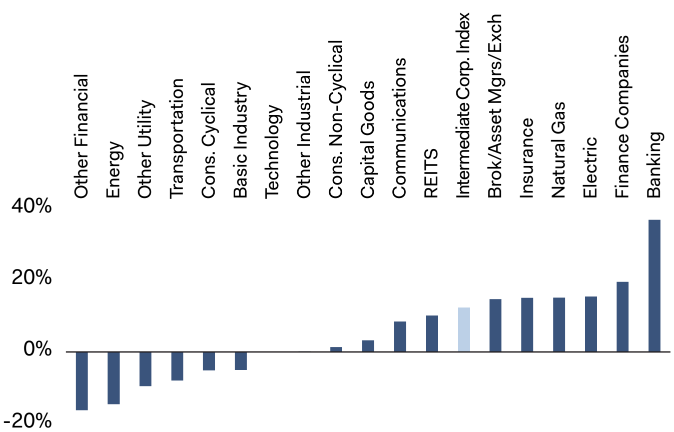
Source: Bloomberg Index Services.

Figure 4. Long Corporate OAS Relative to 10-Year Average by Sector



Source: Bloomberg Index Services, Dodge & Cox.

Figure 5. Intermediate Corporate OAS Relative to 10-Year Average by Sector



Source: Bloomberg Index Services, Dodge & Cox.

Long-Term Solutions for Overfunded Plans: Stay the Course, De-Risk, or Re-Risk?

Many plan sponsors are experiencing asset-liability surpluses and may want to re-assess end-game objectives, especially for frozen plans. We recently published an Investment Perspectives paper that:

- Describes how the asset-liability surplus may serve strategic corporate objectives;
- Examines alternatives to plan termination and hibernation; and
- Discusses considerations for staying the course, de-risking, or re-risking once a terminal point on the glide path is reached.

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of shorter-duration strategies, such as Intermediate Credit. A pension risk transfer, which typically involves older participants, would likely have the opposite ramifications.

As another example, a sufficiently overfunded, frozen plan may seek to generate incrementally higher pension income while still controlling funded status risk by re-risking the asset allocation and maintaining target hedge ratios. If the funded status is sufficiently high, the plan may remain in surplus and avoid minimum required contributions and variable-rate PBGC[6] premiums even in periods of market stress.

Pension Risk Transfer and Plan Terminations

Pension risk transfer (PRT) activity continues to be robust, reaching $23 billion in the first half of the year, compared to $18 billion in the first half of 2022 and $52 billion for calendar year 2022.[7] According to Aon[8], plan terminations have picked up after the pandemic and account for over half of all PRT transactions in the first half of the year. However, they comprise only $5 billion, or less than 25% of all PRT premium *dollars*. This suggests that plan terminations are concentrated primarily among smaller plans.

Indeed, compared to smaller plans, terminating larger and more complex plans may be particularly costly. In particular, PRT premiums for vested deferred participants are likely to be higher due to greater uncertainty associated with these participants' future mortality and behavior, especially if there are multiple participant groups, benefit formulas, benefit form options, or early retirement subsidies, which often result from past M&A activity. These complexities can also lead to higher one-time administrative costs, including data cleaning, participant communications, and legal expenses.

Two other considerations may discourage large plan sponsors from pursuing plan termination: 1) heightened sensitivity to settlement accounting, and 2) the ability to effectively manage the plan via a well-resourced internal investment team and/or a delegated investment partner. Indeed, a solid investment strategy can help hedge liabilities and generate sufficient excess returns over the liabilities to offset ongoing administrative expenses and adverse plan experience, which are often seen as key reasons for plan termination.

Consequently, instead of terminating the plan in a single transaction, it may be more sensible to reduce the pension obligation over a number of years via tactically timed lump sum windows and PRTs. This approach may allow plan sponsors to offer lump sums when the differential between accounting discount rates and lump sum conversion rates is attractive and to seek retiree lift-outs when they are likely to be well-priced.

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 September 30, 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. Pension Benefit Guarantee Corporation (PBGC).
7. PRT activity includes both buy-outs and buy-ins.
8. Aon. U.S. Pension Risk Transfer | 2023 Mid-Year Update. https://insights-north-america.aon.com/retirement/aon-us-pension-risk-transfer-midyear-whitepaper