July 30, 2024

Dodge & Cox®
Investment Focus

Q2 Pension Perspectives[1]

Key Takeaways

- Aggregate single-employer plan funded status rose by 1.5 percentage points to 103.7% in the second quarter, thanks to strong equity market returns and a modest increase in discount rates.
- We believe that the current macro environment supports maintaining or possibly slightly overweighting target interest rate hedge ratios and underweighting credit spread hedge ratios. Allowing credit managers the flexibility to reduce credit spread risk via U.S. Treasuries or credit-adjacent, out-of-benchmark exposures may also be additive.
- Now may be an opportune time to consider spread diversification strategies, bearing in mind the correlation (or lack thereof) to the liabilities as well as liquidity, complexity, and plan fit and ensuring the ability to pivot back into corporate credit should spreads widen.
- In the pension risk transfer space, the Department of Labor maintained its existing annuity provider selection guidance in its much-anticipated report to Congress, but litigation risk remains.

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Quarterly Funded Status Drivers

Figure 1. Funded Status Drivers

	June 30, 2024	March 31, 2024	December 31, 2023
Milliman 100 Funded Status	103.7%	102.2%	99.5%
Discount Rate (Aa)	5.46%	5.24%	5.00%
U.S. 10-Year Treasury Yield	4.40%	4.20%	3.88%
U.S. 30-Year Treasury Yield	4.56%	4.34%	4.03%
Bloomberg U.S. Long Credit Spread (OAS)[2]	115 bp[3]	109 bp	117 bp
Global Equities (MSCI ACWI Index) Net Total Return		Q2 2024: 2.87% YTD 2024: 11.30%	

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

Continuing the trend from last quarter, global equity markets delivered positive returns and corporate bond yields rose in the second quarter. Consequently, the aggregate funded status of the 100 largest corporate pension plans continued its march upward, reaching 103.7%.[4] (These figures account for the standard annual restatement and reconstitution of the Milliman 100 Pension Funding Index that occurs in April.)

Long U.S. Treasury yields traded in a roughly 50 bp range, reflecting conflicting economic indicators, evolving Federal Reserve (Fed) pronouncements, and shifting market sentiment. As of mid-June, Treasury yields were poised to end the quarter relatively unchanged but then bounced sharply higher in the last two weeks of the month. This sharp increase appeared to be at least partly driven by the market's perception of Donald Trump's favorable performance in the first presidential debate and the potential inflationary implications of his economic policy.

Unlike Treasury yields, credit spreads traded in a narrow 10 bp range, widening 3–6 bp, with larger increases at longer maturities. Investment-grade (IG) corporate issuance continued at a break-neck pace: according to JP Morgan, IG corporate bond issuance in the first half of the year totaled $874 billion, the second highest on record after the first half of 2020. The new supply was well absorbed by an array of yield-focused buyers.

Macro Backdrop and Interest Rate Positioning

In our base-case macro scenario, we believe that in the United States, a "soft landing" is in progress. Both economic growth and inflation are moving toward targets, and labor market and wage growth are moderating. Notably, the Consumer Price Index[5] (CPI) trended downward in May and June, with a particularly welcome deceleration in housing and services inflation. The slope of the soft landing may be tempered by strong economic momentum related to consumption, immigration flows, and/or productivity gains related to artificial intelligence (AI). We anticipate that the Fed will start cutting interest rates later this year, leading to a bull-steepening of the yield curve[6] over the next two years.

A "hard landing" remains a possibility owing to, for example, faster-than-expected lagged effects of the Fed's past hikes, negative geopolitical shocks, or election results fueling social or market instability. On the other hand, global energy prices, supply disruptions, or policy outcomes—such as higher tariffs under a Trump administration or fiscal expansions under either party's clean sweep in the elections—could result in higher inflation, leading to a "higher-for-longer" regime.

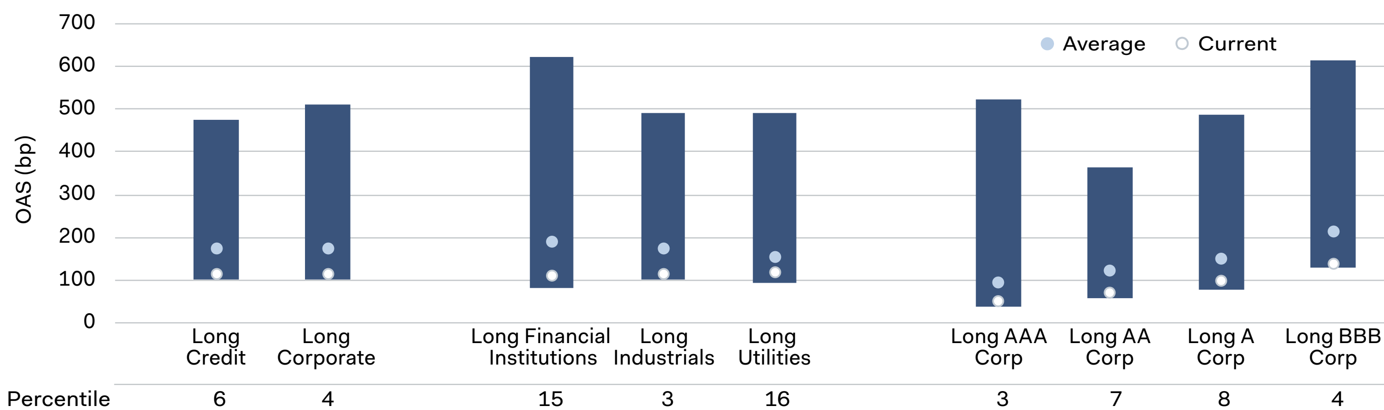
Given the uncertainty in the U.S. election outcomes, we believe plan sponsors are best served by maintaining their target interest rate hedge ratios. Depending on the level of conviction in a soft (or hard) landing, a modest duration[7] overweight, especially at the front end of the curve, may also be reasonable.

Credit Positioning

Corporate fundamentals, the macro environment, and supply-demand dynamics remain supportive of credit spreads, especially at long maturities. However, despite the modest up-tick in spreads at the end of June, long credit spreads remain extremely tight by historical standards across all major sectors and quality buckets (see Figure 2). Whenever starting long credit spreads were at their current levels, average spread returns in subsequent 1- and 3-year periods have been substantially negative. Please see Figure 3, which shows excess-of-curve returns for the Bloomberg U.S. Long Credit Index,[8] but the results are directionally the same even after accounting for the quality changes in the Index over time (e.g., by looking solely at the BBB-rated component).

Consequently, plan sponsors with a sufficiently long investment horizon, or those concerned about the potential for a more precipitous economic slowdown and/or exogenous shocks, may wish to underweight their credit spread hedge ratios. The latter is *not* our base-case scenario, and indeed spreads could remain range-bound for some time. Longer term, however, history suggests that spreads are likely to widen. Since 1990, there has been a material spread widening event approximately every four years, often absent an economic recession. Examples include the Long-Term Capital Management blow-up in 1998, European debt crisis in 2011, oil-related concerns in 2014-2015, China/trade policy concerns in 2018, and inflation-related spike in 2021.

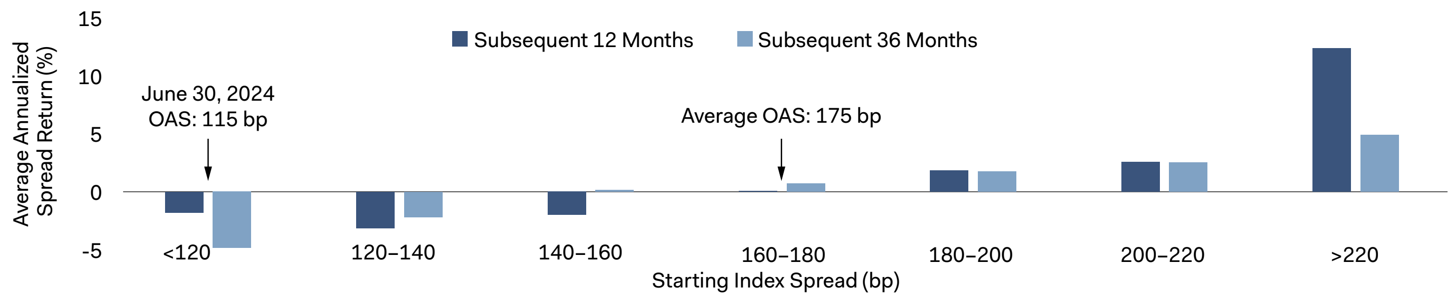
Figure 2. Bloomberg U.S. Long Credit Spreads and Valuations



Percentile	6	4	15	3	16	3	7	8	4

Source: Dodge & Cox, Bloomberg Index Services. Data reflects weekly observations for the 20-year period ended June 30, 2024. The bar represents the range of spreads.

Figure 3. Bloomberg U.S. Long Credit Index Annualized Spread Returns by Starting Spread Level



Source: Dodge & Cox, Bloomberg Index Services. Based on monthly observations for the 20-year period ended June 30, 2024.

Figure 4. Excess-of-Curve Returns in Recent Non-Recessionary Periods

	Spread Widening (bp)		Spread Widening Percent		Spread Return		
	Long Corp A	Long Corp BBB	Long Corp A	Long Corp BBB	Long Corp A	Long Corp BBB	Difference
6/30/2021 to 9/29/2022	77	103	80%	73%	-6.47%	-7.64%	1.17%
2/1/2018 to 1/3/2019	59	97	59%	63%	-8.81%	-10.13%	1.32%
6/24/2014 to 2/11/2016	97	179	79%	105%	-13.44%	-22.96%	9.52%
2/8/2011 to 10/4/2011	94	135	67%	74%	-13.37%	-16.05%	2.68%

Source: Dodge & Cox, Bloomberg Index Services. Data reflects the Bloomberg U.S. Long Corporate Index.

At the asset allocation level, plan sponsors can implement a reduction in the credit spread hedge ratio by underweighting credit versus Treasuries and high-quality securitized assets, overweighting Intermediate Credit versus Long Credit, or shifting toward defensive credit managers.

At the portfolio level, providing investment managers with flexibility to maintain higher non-corporate exposures (particularly in Treasuries) and to invest in corporate-adjacent, lower spread-risk sectors—such as U.S. dollar-denominated non-U.S. bonds, taxable municipal bonds, and high-quality structured products—may also reduce credit spread risk. Finally, up-in-quality trades can be additive as the performance of higher-quality segments relative to lower-quality segments during non-recessionary periods of spread widening can be quite meaningful (see Figure 4).

Last quarter, we maintained a duration-neutral stance across our discretionary liability-hedging strategies and further reduced spread risk via a combination of the tools described above.

Spread Diversification Strategies

As part of their de-risking journeys over the last few years, some plan sponsors have incepted spread diversification strategies to diversify growing corporate bond exposures within their liability-hedging assets. Based on client conversations, these strategies appear to be gaining additional interest in the current tight spread environment due to their lower credit beta compared to traditional IG credit strategies.

When evaluating and sizing these strategies, we would encourage plan sponsors to carefully balance the opposing goals of (1) diversifying *portfolio* corporate spread risk with (2) hedging *pension liability present values*, which are valued with corporate bond yields. In principle, *any* strategy that exhibits interest rate risk (which can be easily achieved with a Treasury derivative overlay) and positive correlation to AA credit spreads may qualify as a spread diversification strategy. In addition, some diversifiers, like core real estate, may generate attractive cash flows that can offset liability benefit payments but may not necessarily hedge liability interest rate and credit spread risk.

Other considerations include:

- Liquidity relative to benefit payments, rebalancing, and potential lump sum windows and/or pension risk transfers;
- Operational complexity, cost, and benchmarking; and
- Ability to implement tactical versus strategic positioning.

We believe spread diversification strategies may be additive in certain situations, particularly for well-resourced plan sponsors, but are not necessarily critical to implement a liability hedge effectively. Some of the spread diversification benefits can be achieved by providing traditional credit managers with flexibility to maintain modest non-corporate exposures, including securitized assets and taxable municipal bonds.

Plan sponsors invested in these lower credit-beta strategies may wish to ensure that they can easily pivot toward traditional, full-beta IG corporate bond strategies should credit spreads widen. As sharp spread widening events are often followed by sharp spread-tightening events, the ability to move quickly is paramount to hedging the decrease in the spread component of the liability discount rate. As shown in Figure 3, spread returns subsequent to wide spread levels can be quite material. In addition, active credit managers may be able to add value during volatile spread environments.

Pension Risk Transfer: A Mixed Regulatory Environment

In June, as required under SECURE 2.0, the Department of Labor (DOL) released its report on IB 95-1, its long-standing guidance for selecting the "safest annuity available" in pension risk transfer (PRT) transactions. The report acknowledged a range of stakeholder concerns, including insurer private equity ownership structures, offshore reinsurance arrangements, and administrative capacity. However, the DOL did not recommend any changes to existing guidance and noted a need for further study.

On the other hand, lawsuits alleging that Alcoa, AT&T, and Lockheed Martin acted imprudently when they selected Athene (a private-equity-backed insurer) for their PRTs continue. In June, plaintiffs represented by the same law firm sued GE over its 2022, $1.7 billion retiree lift-out with similar allegations. Thus, while the DOL report removes one potential hurdle for plan sponsors pursuing PRT, litigation risk—at least with respect to selecting certain insurers—remains elevated.

Given the timing of these developments, there has been no observable impact on PRT activity. According to LIMRA,[9] first-quarter PRT activity set a record at $14.6 billion and was more than double any of the first quarters in the prior five calendar years. With 30-40% of insurer capacity (estimated at $40–50 billion) spoken for just in the first quarter and several transactions over $1 billion announced in the second quarter, insurer selectivity and pricing may be firming up earlier than in prior years.

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. 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.
3. One basis point is equal to 1/100th of 1%.
4. Unless otherwise specified, all weightings and characteristics are as of June 30, 2024.
5. The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.
6. A yield curve is a graphical representation of the interest rates on debt for a range of maturities. It shows the yield an investor expects to earn for lending money for a given period of time.
7. Duration is a measure of a bond's (or a bond portfolio's) price sensitivity to changes in interest rates.
8. The Bloomberg U.S. Long Credit Index includes investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate, and government-related bond markets. It is composed of the Bloomberg U.S. Corporate Index and a non-corporate component that includes non-U.S. agencies, sovereigns, supranationals, and local authorities. Securities must have a maturity equal or greater than 10 years.
9. Life Insurance Marketing and Research Association (LIMRA).