October 29, 2024

Dodge & Cox®
Investment Focus

Q3 Pension Perspectives[1]

Key Takeaways

- Aggregate single-employer plan funded status declined by 1.1 percentage points to 102.4% in the third quarter, as liability discount rates fell substantially and long-duration fixed income outperformed global equities.
- Following a significant drop in Treasury yields and continued credit-spread tightening last quarter, and considering the potential for heightened market volatility induced by the U.S. election and/or geopolitical risks, we believe maintaining target interest rate hedge ratios and underweighting credit spread hedge ratios heading into year-end remains prudent.
- Looking ahead, plan sponsors—especially those underweight credit exposure—may wish to re-visit their rebalancing processes and investment guidelines to ensure that they can efficiently reposition into credit, should credit spreads widen.
- Highlights in the pension risk transfer (PRT) space this quarter include the industry's first-ever multiemployer PRT and a $6 billion retiree lift-out by IBM. The latter suggests that re-opening a plan, as IBM did earlier this year, and executing a large-scale PRT need not be mutually exclusive.

Contributors

Alex Pekker, Ph.D., CFA, ASA
Liability Hedging Solutions Strategist

Tony Brekke, CFA
Investment Committee Member and Credit Sector Head

Mike Kiedel, CFA
Investment Committee Member and Credit Analyst

Quarterly Funded Status Drivers

Figure 1. Funded Status Drivers

	September 30, 2024	June 30, 2024	December 31, 2023
Milliman 100 Funded Status	102.4%	103.5%	99.5%
Discount Rate (Aa)	4.96%	5.46%	5.00%
U.S. 10-Year Treasury Yield	3.78%	4.40%	3.88%
U.S. 30-Year Treasury Yield	4.12%	4.56%	4.03%
Bloomberg U.S. Long Credit Spread (OAS)	108 bp	115 bp	117 bp
Global Equities (MSCI ACWI Index) Net Total Return		Q3 2024: 6.61% YTD 2024: 18.66%	

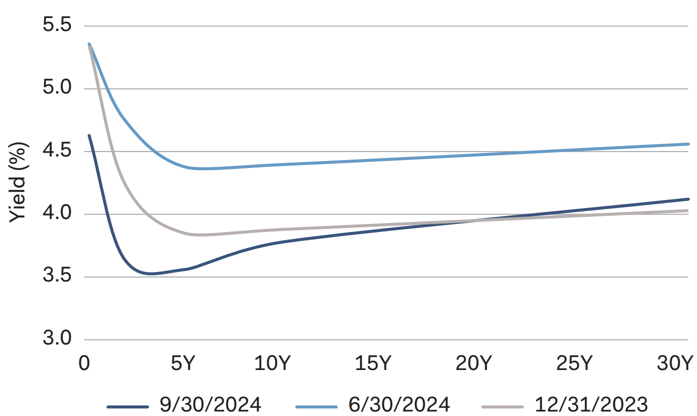
Source: Bloomberg Index Services, Milliman, MSCI. The funded status and discount rate are for the Milliman 100 Pension Funding Index.

In the third quarter, U.S. Treasury yields fell, corporate spreads tightened, and global equity markets rose. As a result, all major asset classes posted positive returns. Long-duration fixed income, proxied by the Bloomberg U.S. Long Government/Credit Index, returned 8.0% for the quarter, while global equities, proxied by the MSCI All Country World Index (Net), returned 6.6%. In this context, the aggregate funded status of the 100 largest corporate pension plans declined by 1.1 percentage points to 102.4% as asset returns were unable to keep pace with liabilities.[2]

Throughout the quarter, inflation and unemployment data suggested that the economy was decelerating, which set the stage for the Federal Reserve (Fed) to finally pivot and cut interest rates in September. The Fed's 50 bp rate cut signaled a shift in focus from fighting inflation to supporting economic growth, and the Fed communicated that further cuts are likely over the next 12-24 months. Since then, the market's expectations for the number and magnitude of rate cuts has varied; as of mid-October, the market was pricing in two 25 bp cuts by year-end and four more 25 bp cuts in 2025.

The associated decline in Treasury yields was quite uneven, with front-end yields falling substantially more than back-end yields and the 2-10 year yield curve disinverting (see Figure 2). Aside from a short-lived spike following a weak jobs report in early August, credit spreads remained generally range-bound and tightened in the weeks following the Fed announcement. Long Credit spreads ended the quarter at 108 bp, just four bp above the 20-year low achieved on January 25, 2024 and three bp above the prior low achieved on December 29, 2004 (see Figure 3). By mid-October 2024, Long Credit spreads tightened through those levels.

Figure 2. U.S. Treasury Yield Curve



Source: Bloomberg Index Services.

Figure 3. Bloomberg U.S. Long Credit Spread

Source: Bloomberg Index Services.

Potential Tactical Positioning

In line with last quarter, we continue to believe that in the United States, a "soft landing"—including slowing (but positive) economic growth and falling inflation approaching the Fed's 2% target—is in progress. However, potential geopolitical shocks, election-related volatility, and election outcomes may interrupt or even derail this trajectory. Considering these uncertainties, we believe that plan sponsors are well served by maintaining target interest rate hedge ratios as they look toward year-end financial disclosures. Taking a longer-term view, a duration overweight—especially at the front end—may be reasonable, although one of a smaller magnitude than before given the substantial decline in Treasury yields in the third quarter.

Similarly to last quarter, we believe corporate fundamentals and the macro environment are supportive of corporate credit. However, as of mid-October, credit spreads are at their tightest levels in 20 years, and, in our view, are unlikely to remain this low over the next two to three years. As we saw in August, even a single weak jobs report (or the unwinding of the Japanese yen carry trade) can easily send credit spreads nearly 20 bp wider! Consequently, plan sponsors may wish to tactically underweight credit spread hedge ratios if they can pivot back into credit quickly should spreads widen out sufficiently.

We previously advocated considering layering in high-quality securitized assets as tactical alternatives to high-quality investment-grade corporate bonds. While we believe existing exposures in these sectors remain prudent, further allocations to certain sectors may not be worthwhile, after accounting for tighter starting spreads, transaction costs (i.e., bid-ask spreads), and likely holding periods (see Figure 4). For example, the Agency[3] Commercial Mortgage-Backed Securities (CMBS) sector has experienced spread tightening that is comparable to high-quality corporates; in this case, it may be more advantageous to re-invest proceeds from any further credit trims into Treasuries rather than Agency CMBS. In intermediate-duration mandates, we remain constructive on high-quality Asset-Backed Securities (ABS) backed by credit card and auto loan receivables despite the slowing economy, as these securities' credit enhancements and overcollateralization can significantly mitigate a deteriorating consumer situation.

In our liability-hedging strategies, we continued to maintain our duration-neutral stance and further reduce credit risk. For example, in our Long Credit strategy, we brought both the strategy's credit weight and duration times spread (DTS) to their lowest levels in over a decade.

Figure 4. Select Index Data[4]

	Long Corp	Long Corp AA	Long Corp A	Interm. Corp	Interm. Corp AA	Interm. Corp A	Long Agency CMBS	Agency MBS	Agency CMBS	AAA Credit Card ABS	AAA Auto Loan ABS
Duration (years)	13.1	14.2	13.3	4.1	3.5	4.1	7.9	5.7	4.6	2.3	1.7
Current OAS (bp)	107	66	90	79	29	65	51	42	39	49	57
YTD OAS Change (bp)	-9	-4	-8	-10	-1	-13	-12	-4	-9	-5	-3

Source: Bloomberg Index Services. Highlighted spread changes are at least -5 bp. Data is as of September 30, 2024.

Looking Ahead to Wider Spreads

As Figure 3 shows, large spread change events tend to be relatively sharp, although spread tightening is generally more gradual than spread widening. For example, in 2020, it took six trading days for Long Credit spreads to widen 100 bp to their maximum of 358 bp (reached on March 23, 2020) and 13 trading days to tighten 100 bp. It took 18 trading days to widen 200 bp and 166 trading days to tighten 200 bp!

While calling the top in credit spreads is nearly impossible, re-investing into credit quickly and harvesting the higher spreads for longer, once spreads widen sufficiently, can help deliver the most alpha. This is true both in terms of an investment manager moving nimbly with the assets under their purview *and* the plan sponsor efficiently neutralizing any credit underweights from an asset allocation perspective. By communicating with the investment manager about market conditions on a regular basis, plan sponsors can help ascertain the appropriate time(s) to reposition into credit and, by adding the custodian to the process, ensure seamless rebalancing.

In addition, we encourage plan sponsors to verify that their investment guidelines provide for sufficient flexibility in large spread change events. This includes:

- **Appropriate tools:** Permitting investment managers to use portfolio trades, exchange-traded funds (ETFs), and/or index credit default swaps (CDX). These tools can help establish credit beta exposures quickly and potentially at lower transaction costs versus buying individual bonds. Further, at times, the basis and liquidity differences between ETFs and CDX and cash bonds can also add incremental alpha.
- **Downgrade bucket:** Allowing investment managers to hold on to securities downgraded below investment grade for some (and potentially indefinite) period of time to avoid forced-selling at what may be the widest spreads and lowest prices.
- **Below investment-grade bucket:** Adding to high-conviction "fallen angels" may yield additional incremental income and, potentially, price appreciation. In the 12 months following the COVID-related spread widening, fallen angels were a material contributor to relative returns in Dodge & Cox credit strategies.

Communicating with respect to these and other guidelines, such as sector constraints and/or weighted-average quality, may help address potential compliance violations ahead of time. "Future-proofing" guidelines and processes can serve plan sponsors well next time credit spreads widen materially.

Pension Risk Transfer

According to LIMRA, pension risk transfer (PRT) activity continues to be robust, totaling almost $26 billion in the first six months of 2024. More than half of this volume is attributable to three jumbo transactions: Verizon at $5.9 billion, Shell USA at $4.9 billion, and 3M at $2.5 billion.

In September, IBM jumped to the top of the 2024 jumbo transaction club by announcing a $6 billion retiree lift-out, covering 32,000 participants and over 30% of its U.S. pension liabilities. While perhaps somewhat surprising in light of IBM's re-opening of its defined benefit plan on January 1, this move appears to be indicative of IBM's dynamic corporate finance approach to managing its retirement obligations. This was IBM's second retiree lift-out in as many years; the company transferred $16 billion in retiree liabilities in 2022.

Last quarter, the pension space saw its first PRT involving a multiemployer plan. The Sound Retirement Trust, a Taft-Hartley plan covering grocery workers in Washington state, announced a $221 million lift-out covering 8,700 retirees. According to the Trust's Form 5500, the plan was 86% funded as of October 1, 2022 (using market value of assets and accrued liabilities discounted at 6.5%), and the amount transferred represented less than 10% of assets and liabilities. While conventional wisdom suggests that PRT is not as relevant for multiemployer plans as it is for corporate plans (e.g., the stakeholders are different, PBGC premiums are lower), the transaction illustrates that certain PRT aspects—e.g., reducing ongoing administrative costs—can be attractive to multiemployer trustees as well. With the overall health of multiemployer plans improving, thanks to strong capital markets and the government's Special Financial Assistance program, future PRT activity in the space may increase, though likely not enough to meaningfully influence the corporate PRT market.

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.

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. Information regarding yield, quality, maturity, and/ or duration does not pertain to accounts managed by Dodge & Cox. The above returns represent past performance and do not guarantee future results. Dodge & Cox does not seek to replicate the returns of any index. The actual returns of a Dodge & Cox managed portfolio may differ materially from the returns shown above. 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. The securities identified are subject to change without notice and may not represent an account's entire holdings.

Source: Bloomberg Index Services Limited. BLOOMBERG® is a trademark and service mark of Bloomberg Finance, L.P. and its affiliates (collectively "Bloomberg"). Bloomberg or Bloomberg's licensors own all proprietary rights in the Bloomberg Indices. Bloomberg does not approve or endorse this material, guarantee the accuracy or completeness of any information herein, or make any warranty, express or implied, as to the results to be obtained therefrom and, to the maximum extent allowed by law, shall have no liability or responsibility for injury or damages arising in connection therewith. The Bloomberg U.S. Long Credit Index measures the performance of investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate, and government-related debt with at least ten years to maturity. It is composed of a corporate and a non-corporate component that includes non-U.S. agencies, sovereigns, supranationals, and local authorities. The Bloomberg U.S. Long Government/Credit Bond Index measures the performance of the non-securitized component of the U.S. Aggregate Index with maturities of 10 years and greater. It includes investment-grade, U.S. dollar-denominated, fixed-rate Treasuries, government-related, and corporate securities.

The MSCI ACWI (All Country World Index) Index is a broad-based, unmanaged equity market index aggregated from 50 developed and emerging market country indices. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This publication is not approved, reviewed, or produced by MSCI.

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

1. The information in this paper should not be considered fiduciary investment advice under the Employee Retirement Income Security Act. This paper provides general information not individualized to the particular needs of any plan and should not be relied on as a primary basis for investment decisions. The fiduciaries of a plan should consult with their advisers as needed before making investment decisions.
2. Unless otherwise specified, all weightings and characteristics are as of September 30, 2024.
3. 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.
4. Indices used in the analysis: **AAA Auto Loan ABS**: Bloomberg ABS Auto AAA Index; **AAA Credit Card ABS**: Bloomberg ABS Credit Card AAA Index; **Agency CMBS**: Bloomberg U.S. Agency CMBS Agg Index; **Agency MBS**: Bloomberg U.S. MBS Agency Fixed Rate MBS Index; **Long Agency CMBS**: Bloomberg U.S. Agency CMBS 8.5+ Year Index; **Intermediate Corp**: Bloomberg U.S. Intermediate Corporate Bond Index; **Intermediate Corp A**: Bloomberg U.S. Intermediate Corporate A Index; **Intermediate Corp AA**: Bloomberg U.S. Intermediate Corporate AA Index; **Long Corp:** Bloomberg U.S. Long Corporate Bond Index; **Long Corp A**: Bloomberg U.S. Long Corporate A Index; **Long Corp AA**: Bloomberg U.S. Long Corporate AA Index.