August 2, 2023

Dodge & Cox®
Investment Focus

Q2 Pension Perspectives[1]

Key Takeaways

- Aggregate single-employer plan funded status increased 2.1% in the second quarter, reaching 102.2% as liability discount rates rose and global equity markets delivered positive returns.[2]
- While the near-term path of interest rates may be biased to the upside, the market is pricing in lower long-term U.S. Treasury yields over the next 12-24 months, and maintaining target interest rate hedge ratios may be appropriate.
- Given average-to-tight credit spreads, strong demand for corporate credit, and measured corporate issuance, plan sponsors may consider modestly underweighting credit spread hedge ratios and relying on active management to manage specific issuer exposures.
- On a relative value basis, Intermediate Credit appears attractive relative to Long Credit. Now may be an opportune time to incept or overweight an Intermediate Credit allocation.

Contributors

Alex Pekker, Ph.D., CFA, ASA

Liability Hedging Solutions Strategist

Tony Brekke, CFA

Investment Committee Member and Credit Analyst

Mike Kiedel, CFA

Investment Committee Member and Credit Analyst

Quarterly Funded Status Drivers

Figure 1: Funded Status Drivers

	June 30, 2023	March 31, 2023	December 31, 2022
Milliman 100 Funded Status	102.2%	100.1%	101.9%
Discount Rate (Aa)	5.20%	5.00%	5.22%
U.S. 10-Year Treasury Yield	3.84%	3.47%	3.88%
U.S. 30-Year Treasury Yield	3.86%	3.65%	3.97%
Bloomberg U.S. Long Credit Spread (OAS)[3]	148 bp[4]	159 bp	157 bp
Global Equities (MSCI ACWI Index) Net Total Return	Q2 2023: 6.18% First Half of 2023: 13.94%		

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

Although the second quarter began with concerns about U.S. regional bank turmoil and U.S. debt ceiling negotiations, the U.S. economy and capital markets proved to be quite resilient. Global equity markets posted strong positive returns, Treasury yields rose, and investment-grade (IG) credit spreads tightened. According to Milliman, the aggregate funded status of the 100 largest corporate pension plans rose to 102.2%, an increase of 2.1% for the quarter and 1.3% for the first half of 2023. Plans with large allocations to return-seeking assets and low interest rate hedge ratios likely fared particularly well.

Figure 2. Long and Intermediate Credit Yield and OAS as of June 30, 2023

		Index	AAA	AA	A	BBB
Yield (%)	Long Credit	5.42	4.64	4.91	5.23	5.77
	Intermediate Credit	5.39	4.63	4.84	5.33	5.71
	Difference	**0.04**	**0.00**	**0.07**	**-0.10**	**0.06**
OAS (bp)	Long Credit	148	71	97	129	183
	Intermediate Credit	97	7	35	92	133
	Difference	**51**	**63**	**62**	**37**	**51**
Percentile	Long Credit OAS	20	14	17	30	22
	Intermediate Credit OAS	60	9	15	72	53
	Long Credit OAS — Intermediate Credit OAS	**5**	**24**	**36**	**7**	**7**

Source: Bloomberg Index Services. Percentiles calculated using weekly observations over the last 10 years. Figures may not add up due to rounding.

After declining in the first quarter, Treasury yields resumed their upward trajectory in the second quarter reflecting receding banking and debt ceiling risks, decelerating but entrenched inflation, a strong labor market, and a hawkish tone from the Fed. The 2-year yield rose 87 basis points (bps), while 10- and 30-year yields rose 37 and 21 bps, respectively, leading to further inversion in the curve. Long Credit spreads traded in an 18 bps range and ended the quarter 11 bps lower; Intermediate Credit spreads were slightly more volatile. Global equities returned 6.2%, with U.S. equities, and particularly large technology-related stocks, significantly outperforming non-U.S. equities.

Staying the Course

While the Fed and many market participants are projecting that interest rates are likely to stay higher for longer and any Fed tightening may not occur until 2024, we believe that in the current environment the potential risks of being underweight target interest rate hedge ratios outweigh the potential benefits. As illustrated by heightened volatility in Treasury yields over the last six months (for example, the 10-year yield moved by at least 35 bps in January, February, and March), it may be particularly difficult to time the "top" in interest rates. In our full-discretion liability hedging strategies, we remain duration-neutral relative to benchmarks.[5]

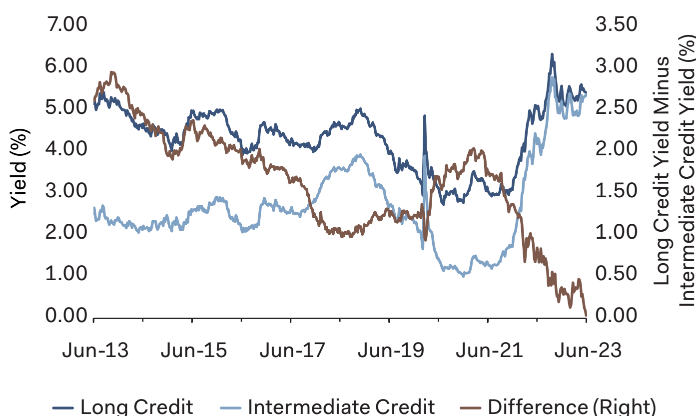
On the credit side, overall corporate balance sheets remain strong and, in our view, well-positioned to withstand a modest economic downturn or a mild recession. As we discuss below, credit spreads have also been supported by a strong technical backdrop, which may continue into the second half of the year. We believe active management is particularly important now as range-bound spreads may mask spread dispersion across issuers and issuer-specific opportunities to add value.

That said, Long Credit spreads are 23 bps, or 13%, below their 10-year average (based on weekly observations) and could drift wider due to a number of macro and technical factors. Spreads are particularly tight in the AAA and AA quality buckets (see percentiles in Figure 2). Consequently, plan sponsors concerned about potential spread widening may wish to consider modestly underweighting Long Credit in favor of Treasuries, Intermediate Credit, or high-quality securitized assets. For example, in our full-discretion Long Credit strategy, we initiated such a defensive position via long-duration Agency[6] commercial mortgage-backed securities, which have higher yields than comparable duration Treasuries but slightly lower yields than AA corporates. We have also increased exposure to AAA-rated asset-backed securities in our full-discretion Intermediate and U.S. Credit strategies, where the duration fit is more appropriate.

Time for Intermediate Credit?

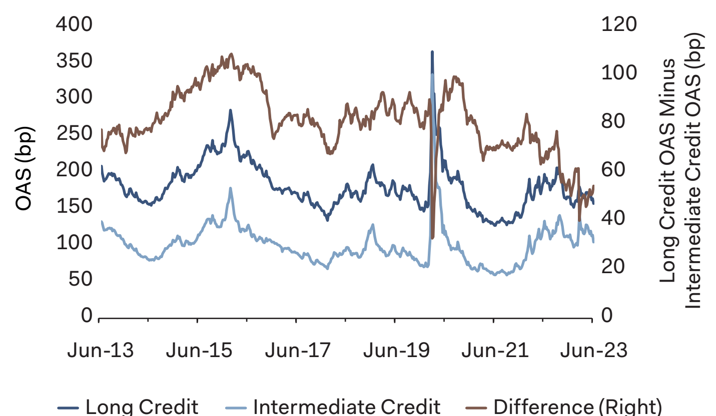
Now may also be an opportune time to consider Intermediate Credit either to more granularly hedge liability credit spread risk or to take advantage of relatively flat spread curves. Any reduction

Figure 3. Long and Intermediate Credit Yield to Worst



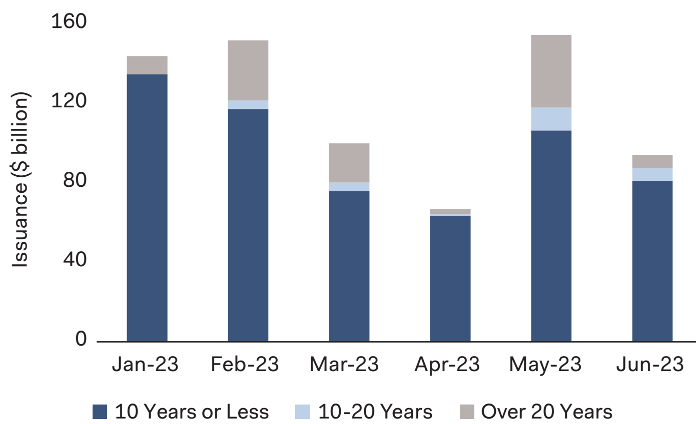
Source: Bloomberg Index Services.

Figure 4. Long and Intermediate Credit Option-Adjusted Spread



Source: Bloomberg Index Services.

Figure 5. Investment-Grade Bond Issuance: First Half of 2023



Source: J.P. Morgan.

in the interest rate hedge ratio resulting from such a move can be offset via Treasury futures or by shifting some Long Treasury exposures to Long STRIPS.

The yield and spread advantages of Long Credit over Intermediate Credit have been declining over the last 18 months, with the yield advantage standing at just 4 bps as of quarter-end and the spread advantage falling to just 51 bps, or the fifth percentile based on the last 10 years of weekly observations (see Figures 2, 3, and 4). While admittedly the June 30 figures may be somewhat suspect due to poor price discovery heading into the July 4 holiday weekend, the trend is decidedly downward, reflecting yield curve inversion, yield-oriented buyers in the middle part of the curve, and constrained issuance relative to demand at the long end. After accounting for quality differences across indices and noting that over 80% of both indices is rated A or BBB, Intermediate Credit appears attractive relative to Long Credit.

Fixed Income Flows and Corporate Issuance

Robust flows into IG fixed income and measured corporate issuance have contributed to keeping credit spreads range-bound. According to JP Morgan, IG mutual fund and exchange-traded fund (ETF) flows reached $116 billion in the first half of 2023, offsetting 70% of the $164 billion in outflows for 2022 (though trending below 2019, 2020, and 2021 annual flows of roughly $319 billion). Flows have been positive every single week in 2023 except for two weeks in March during the turmoil in the banking sector. Retail and other total-return-oriented investors are likely attracted by the asset class' highest yields in over a decade, and corporate defined benefit plan sponsors and insurance companies may be accelerating bond purchases due to de-risking and pension risk transfer activity. On the other hand, foreign investor demand is under pressure from high currency hedging costs; in particular, hedging costs for Japanese and Taiwanese investors reached their highest level in a decade.

While overall on track to match 2022 levels, IG corporate issuance has been choppy (see Figure 5). March and April were particularly weak thanks to wider spreads and tepid demand in the wake of the U.S. regional bank turmoil; issuance rebounded in May and included a well-received $31 billion Pfizer offering, the fourth largest on record. As a percentage of total issuance, issuance of IG corporate bonds with more than 20 years to maturity is similar to 2021 and 2022 (at roughly 15%), but below 2019 and 2020 (at 18%-19%), when issuers sought to lock-in historically low yields for longer. Issuance in the Financials sector is down compared to the prior two years and may be ripe for a rebound in the second half of 2023, potentially providing opportunities to add to the sector.

De-Risking or Re-Risking?

The majority of our client conversations continues to focus on incremental de-risking and tighter alignment of assets and liabilities. This includes increasing hedge ratios, managing credit spread risk more granularly, potentially matching key rates, and re-visiting custom benchmarks.

On the other hand, we have also had several conversations about re-risking, especially for plans that have become significantly overfunded. Indeed, with sufficient assets and a well-defined hedging strategy, these plan sponsors may have sufficient "excess" assets to take on some funded status risk to generate excess returns to fund future accruals or retiree medical payments (if relevant), build up an asset cushion for a potential merger which may include an underfunded plan, or generate pension income (instead of pension expense). In these instances, a U-shaped glide-path or a separation of liability-hedging and return-seeking assets by market value rather than percentage of assets may be appropriate.

Pension Risk Transfer

Pension risk transfer (PRT) activity continues to be robust, totaling at least $15 billion so far this year. Following in the footsteps of IBM, Lockheed Martin, and HP, whose PRTs over the last 2 years ranged from $5 to $16 billion each, AT&T transferred $8 billion, covering 96,000 retirees and roughly 20% of its total pension liabilities in May. While these mega-deals account for the lion's share of PRT premiums, the average transaction is much smaller: excluding IBM, it was just $63 million in 2022.

Although PRT premiums are highly dependent on individual transactions, according to Milliman, average retiree buyout costs relative to accounting liabilities have been declining for much of the year but rose sharply in May, potentially reflecting debt ceiling jitters. We expect PRT demand to remain strong through the end of 2023, although as the year progresses, insurer capacity may diminish and PRT pricing may become less competitive.

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 June 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. 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.