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DB investing

in a time of market volatility

In light of falling equity markets, significant declines in US Treasury yields, and widening corporate bond spreads, there is much to consider regarding the path forward for DB plan sponsors. While we do not have all the answers, we thought it would be helpful to discuss the steps that plan sponsors may consider.

Is now the time to rebalance?

In general, we believe that a disciplined rebalancing approach is important, especially when equity markets decline significantly. For DB plan sponsors, who are typically long-term investors, rebalancing halfway to asset allocation targets is a reasonable first step. While it may be prudent to trade back to target over a number of days or even weeks, consideration should be given to starting the process now, as we do not believe it is possible to time the market bottom. Mercer recently published an article on **rebalancing in troubled markets**, which provides insights on rebalancing key concepts.

Should investors take on more funded status risk to recover funded status?

The impact of recent market conditions has resulted in a significant decline in funded status for many plans with a meaningful equity allocation. One option is to take on more risk to help close what is very likely a more significant funding shortfall. There are two major categories of market risk pension plans take: equity (or growth) asset risk and interest rate risk. Equity risk is typically rewarded over the long term with higher returns, so increasing the allocation to equities is a reasonable first consideration. Deciding how much to increase the equity allocation can be determined in a variety of ways, but a natural approach for plans with a glidepath is to re-risk by shifting to the allocation appropriate for lower-funded status. When discussing this option, the ability to bear risk should be considered from a fiduciary point of view.

Increasing the allocation to equity

Pros

- Higher equity returns are expected
- Equity valuation levels are now closer to long term historical averages, in contrast to bond and cash yields which are at historic lows.

Cons

- Equity markets could continue to be volatile, potentially resulting in more risk than anticipated and further deteriorations in funded status.
- In the current environment, sponsor ability to make future contributions or bear downside balance sheet outcomes could be compromised in the current environment.

Another way to take on more funded status risk to close the funding gap is to increase interest rate risk, by lowering the amount of the interest rate risk being hedged. In general, we believe plan sponsors should have a long term goal of hedging most of their interest rate risk, as it is an unrewarded risk in the long term. However, most underfunded plan sponsors are not currently at that level. The rationale for lowering the interest rate hedge ratio is the expectation that interest rates will rise from current levels, lowering the liability more than the hedging assets. Therefore, prerequisites for this action are confidence that rates will increase and the risk tolerance, patience and fortitude to hold the risk while waiting for the rise. The question is if conditions are right today to lower the hedge ratio in an opportunistic fashion, betting on a reversal of rates in the future.

Lower the fixed income portfolio duration?

Pros

- Treasury yields are at their lowest levels in history. Even if rates were to rise to the low levels we saw going into 2020, a lower hedge ratio today could generate a larger improvement in funded status, all other things equal.
- The liability used to determine cash funding requirements, the PPA Funding Target, is currently based on a stable discount rate because of pension funding relief. If rates do rise, there will not be a corresponding decrease in the PPA Funding Target. A shorter duration fixed income portfolio will result in greater PPA funded status improvement and lower contributions.
- It's not necessary to be right in the near term if you are in a position where funding relief will result in no contributions over the near term. As long as rates have risen by the time the liability calculations reflect market rates (generally three to five years from now), the shorter position can be beneficial.

Cons

- It's very difficult to predict the direction of interest rates. If rates do fall further, a lower duration fixed income portfolio will not provide the same level of protection as a longer duration portfolio. While Treasuries are at all-time lows, a similar argument could have been made several times over the past decade at previous all-time lows.
- There may be more benefit in "allocating" an increase in funded status risk to a higher allocation to equity. Over the long term, we expected equity risk to be better compensated.
- Higher interest rate hedge ratios have been very beneficial in 2019, especially over the past months. Now may not be the time to change this position given the continued market volatility.

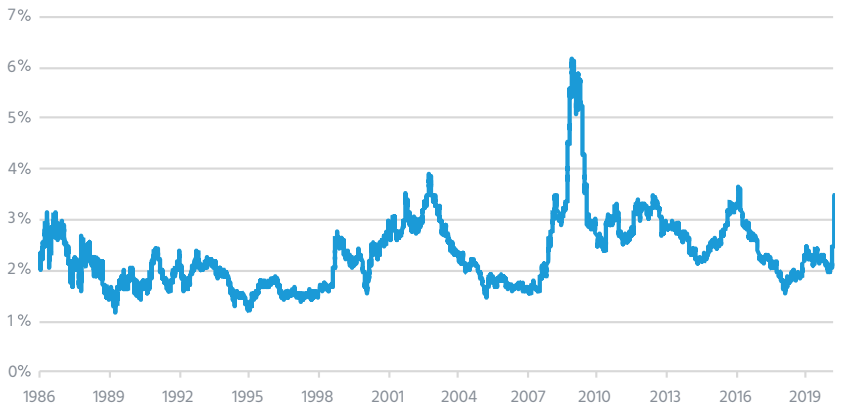
We are not suggesting plan sponsors consider drastic reductions in their interest rate hedge ratio. However, for those who feel a modest decrease to be worthwhile, there are a few avenues that plan sponsors can explore to incrementally reduce the portfolio duration:

- Moving from investments in Treasury STRIPS to long Treasuries
- Reducing rate exposure through an overlay strategy or derivatives
- Changing the mix of physical bonds to tilt more toward long corporate bonds and away from long Treasuries. The duration of the Bloomberg Barclays Long Government index is longer than the Bloomberg Barclay's Long Credit index, which will result in less interest rate risk being hedged. This could be taken as part of a rebalancing action, and is explored on the next page.

Move from Treasury to high quality corporate bonds?

Credit spreads in the current environment have widened to levels rarely seen in recent years, as shown in the chart below.

Credit speeds between 10-year Treasury and Baa corporate bonds



Source: Bloomberg

Should the market for high quality corporate bonds relative to Treasuries continue to deteriorate, we believe investors who plan for risk transfers could discover opportunities to purchase high-quality insurance ready portfolios. This could be prudent for plan sponsors who prepared for the current environment with fixed income portfolios composed of meaningful Treasury exposure for liquidity and interest rate for hedging purposes. It could also be appropriate for investors who want to ease into increasing risk without changing interest rate hedge or equity allocation policies (after the rebalancing actions discussed above are taken).

Pros

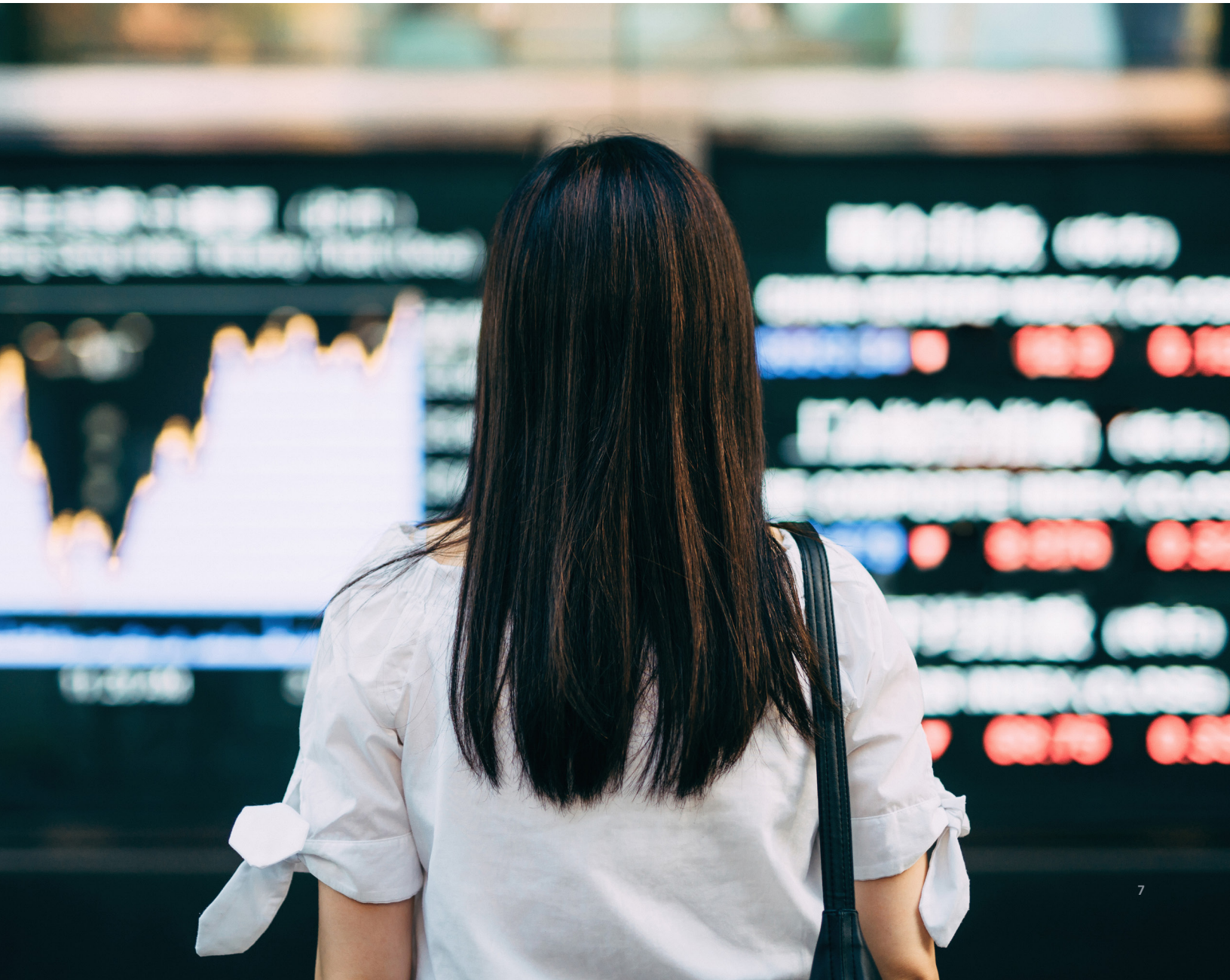
- Spreads have widened to more attractive levels given recent market volatility.
- Being a provider of liquidity in times of market stress can accrue benefits to long-term investors.
- Adding corporate credit improves the credit hedge ratio.

Cons

- Volatility likely will remain high, which could lead to additional spread widening.
- Downgrades and defaults may increase over the coming months and quarters.
- Transaction costs in the long duration corporate bonds are quite material relative to the Treasuries.

This is a brief summary of various approaches that plan sponsors might use to increase hedging portfolio risk in order to take advantage of current market events. Key considerations should be investment return goals, as well as the ability and tolerance to assume additional market risk and funded status risk. After carefully considering these issues, plan sponsors may use these action items as a starting point for next steps.

We are continuing to monitor market conditions and work closely with our clients to address these important issues. Please do not hesitate to reach out to your consultant if you would like to discuss further.



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