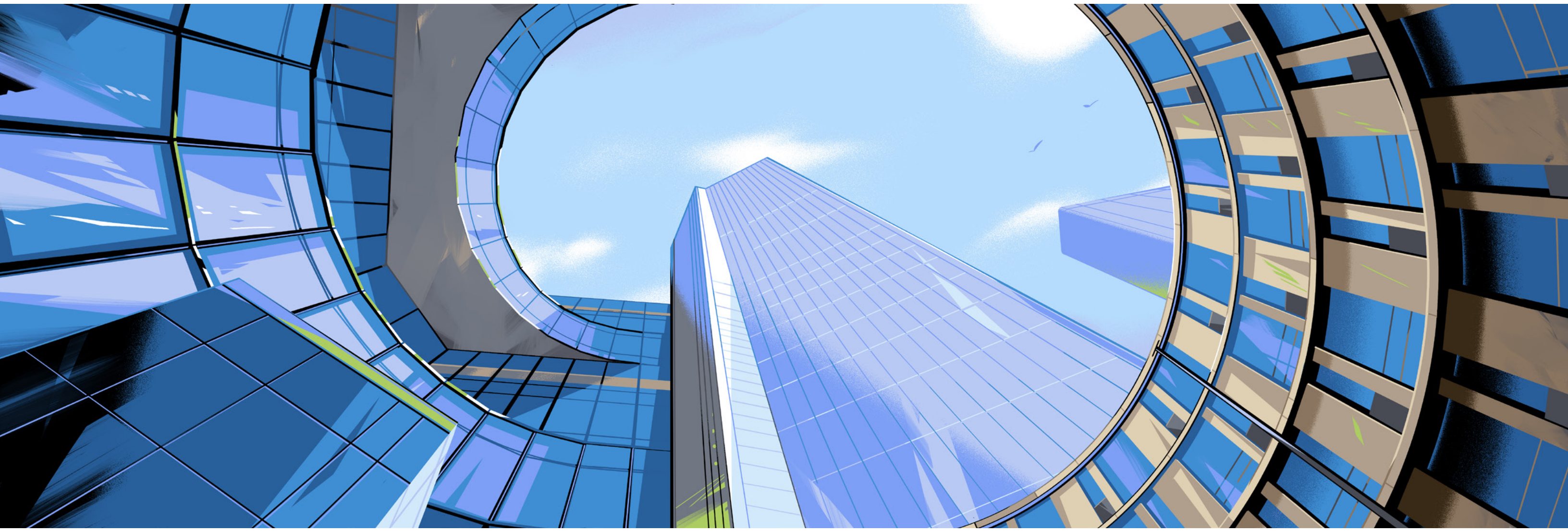


A New Era of Corporate Pension Investing

As corporate pension plan funding levels rise, sponsors are looking to cut risk and adopt new bond strategies.

Years of strong market gains have changed the landscape for corporate pensions. The average corporate pension is fully funded for the first time in more than a decade, and plan sponsors are responding with new investment approaches.

"We are really at a watershed moment for corporate pensions," says Jeff Passmore, lead liability-driven investment strategist at MetLife Investment Management. "Today's strong funding levels have allowed pension managers to derisk, and for the first time their fixed income allocations have surpassed stock holdings."

How pensions grew funding—and decreased risk

The last time corporate pension funds were fully funded was in 2007, just before the market downturn following the financial crisis hurt pension balance sheets and led to funding rule changes. Corporate pensions reacted by adopting liability-driven investment (LDI) strategies, in which portfolios are designed to meet specific funding needs while exposed to as little risk as possible.

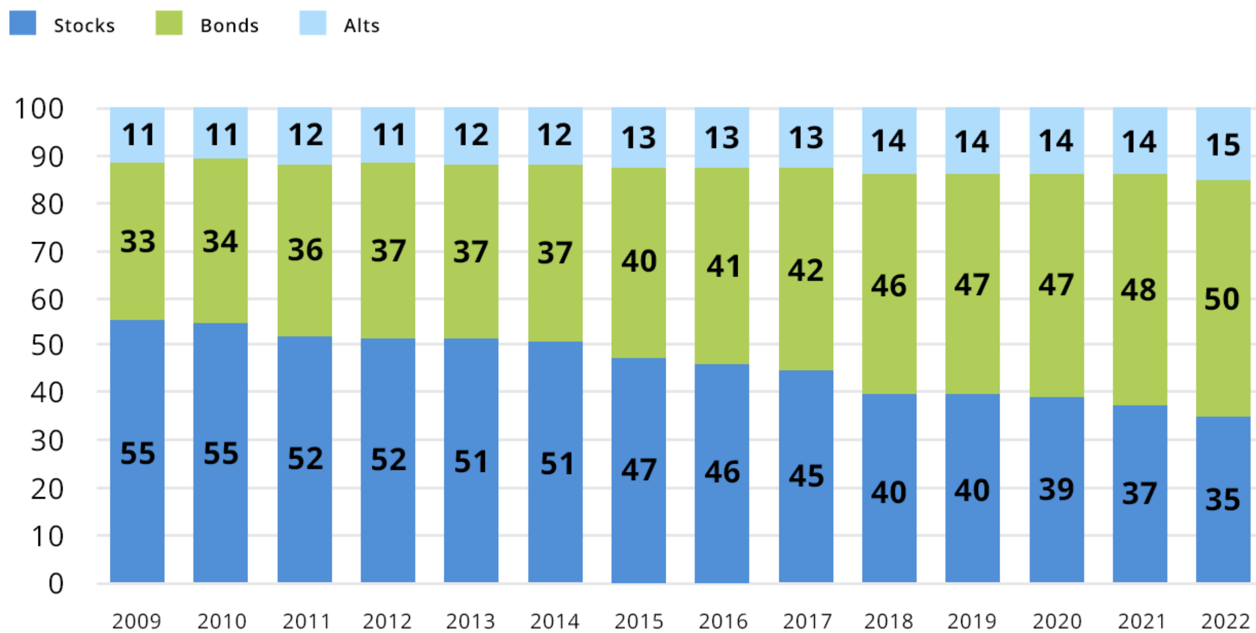
However, underfunded pensions needed to maintain significant stock allocations to achieve their funding goals. That dynamic led to cycles of volatility, with funding levels rising and falling alongside equity markets' movements.

"For years, pension plans have wanted to be able to derisk. The strong market performance finally put them in a position to build bond portfolios that mirror their liabilities."

— Jeff Passmore, Lead LDI Strategist, MetLife Investment Management

Beginning in 2019, a strong run of market performance brought the average plan to full funding levels. As a result, many plan sponsors felt comfortable reducing stock exposure and increasing bond holdings: Corporate pensions' fixed income allocations grew from 41% in 2008 to 50% by the end of 2022.[1]

Corporate Pension Asset Allocation



Source: Bloomberg, MIM analysis.

Pensions are those companies in the Russell 3000 as of Dec. 31 of the given year that, in their most recent 10-K, reported they had more than $50 million in pension projected benefit obligation (PBO) and their pensions were at least 60% funded. Asset data are those companies with pensions that reported asset allocation information.

"For years, pension plans have wanted to be able to derisk," Passmore says. "The strong market performance finally put them in a position to build bond portfolios that mirror their liabilities."

Strategies for today's markets

As pensions focus more of their investments in fixed income, they are adopting more sophisticated strategies, including the addition of new sub-asset classes. "On one hand, pensions want to closely match the characteristics of their benefit payments," Passmore says. "But they also want their investments to perform in order to maintain the funded status that's so important."

Passmore advises clients to use a combination of corporate bonds from AAA- to BBB-rated credits and to include a significant allocation to U.S. Treasurys, often up to 30% of a fixed income portfolio. The Treasurys provide liquidity to meet plan distributions and facilitate reallocation during times of market stress.

Today's unique circumstances are changing the way corporate pensions invest in fixed income. Many corporate pension plans are closed to new participants, meaning that as time passes, participants age and the duration of liabilities grows shorter. As plan duration shortens, plan liabilities are increasingly matching intermediate-term corporate bonds—making that asset class increasingly attractive to pensions.

"At the beginning of the LDI era, most allocations were to long-duration credit or to long Treasurys," says Passmore. "Now we are seeing the beginnings of allocations into intermediate credit, and we believe that trend is going to continue as more plans become shorter; however, long credit is still the foundation of LDI allocations."

Plans are also looking at allocations to less traditional fixed income investments, including private placement bonds, according to Passmore. Private placement bonds are issued as private transactions between debtor and financer and have different characteristics than the bonds in the public markets. Passmore says he sees pensions allocating 5%-10% of their portfolios toward private placement debt.

An active approach

One approach pensions use with fixed income is providing managers with a broad mandate that allows analysts to adjust the portfolio actively based on market conditions.

Passmore says an active management approach can be particularly effective in fixed income. In the longer-dated corporate bond market, many investors are required to buy and hold securities, giving active managers the potential to outperform the market average.

"Our expectation and historical averages suggest that the best credit managers can add about a hundred basis points of excess return per year in a long-duration corporate bond portfolio," Passmore says. "Strong, fundamental credit analysis helps achieve that rare combination of lower risk and higher return through better bond performance."

Source

1. Bloomberg and MIM analysis.