The Monthly Pension Review: September 2022

Funded status fell nearly 2% in September due to selloff in equity markets

September Market Summary

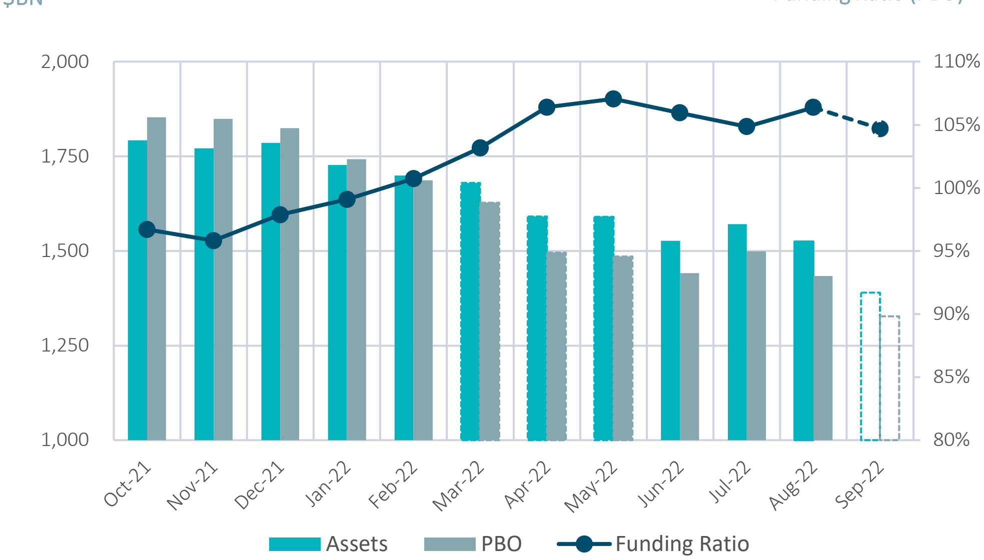
- Despite a rise in discount rates, funded status fell by 1.7% – Assets returned -8.9% while liabilities fell by 7.4%.[1]
- Equity markets gave back all of their summer rally – After a 9% rally in July, the S&P 500 Index fell by 4.2% in August and another 9.3% in September. Year to date, the index is now down roughly 25%.
- The yield on the Bloomberg Barclays Long Credit Index jumped by 74 basis points (bps) – A sticky inflation reading sent rates higher across the curve, with the 30-year Treasury selling off 48 bps month over month. Spreads widened in sympathy with rate volatility, with the Long Credit OAS increasing by 21 bps to 196 bps.

Market Watch [2]	Dec-20	Dec-21	Aug-22	Sep-22
Funded Status	90.3%	97.9%	106.4%	104.7%
FTSE Discount Rate	2.23%	2.63%	4.40%	5.14%
Long Credit Yield	2.78%	3.10%	5.15%	5.89%
US 30Y TSY Yield	1.64%	1.90%	3.29%	3.78%
S&P 500	3,756	4,766	3,955	3,586

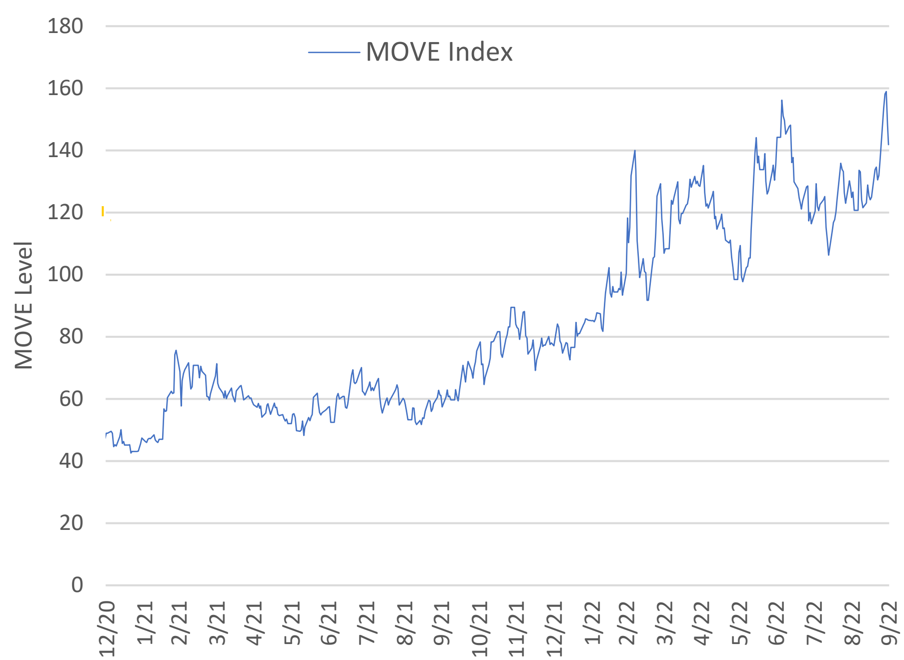
SPOTLIGHT: THE IMPORTANCE OF MANAGER DIVERSIFICATION

- Recent market turbulence has created divergent opinions among various market participants on the direction of interest rates, inflation and risk assets.
- For LDI investors, using multiple fixed income managers with different investment philosophies can provide alpha diversification and mitigate style concentration risk. This is particularly important in the current environment given the lack of consensus on the direction of markets.
- Below we look at some of the key tenets of managing long duration fixed income strategies and how we approach each one within our clients' portfolios.
- **Duration management** – Interest rate risk is one of the primary drivers of long duration portfolio returns. We always strive to manage portfolio duration neutral to the benchmark to ensure the broader LDI program remains near its target interest rate sensitivity.
- **Credit exposure –** In the long duration space, our philosophy is to add value by exploiting inefficient pricing relationships with a focus on bottom-up security selection. We typically avoid taking large macro positions or broadly overweighting credit spread exposure, as this can lead to macro movements swamping the more repeatable value-add of security selection.
- **Opportunistic style** – The volatile nature of long credit markets means opportunities can arise quickly and often be fleeting. In order to exploit short-term volatility, we typically maintain ample liquidity, which can include higher quality names as well as U.S. Treasuries. This posture gives us dry powder to deploy at attractive spread levels in the event of market dislocation.
- **Diversifiers** – Opportunities exist outside of traditional markets that can add value to an LDI program. We favor adding assets such as securitized or investment grade private credit to LDI strategies, assets that often provide additional yield and diversification relative to traditional fixed income.

Milliman Pension Funding Index (September Estimate)



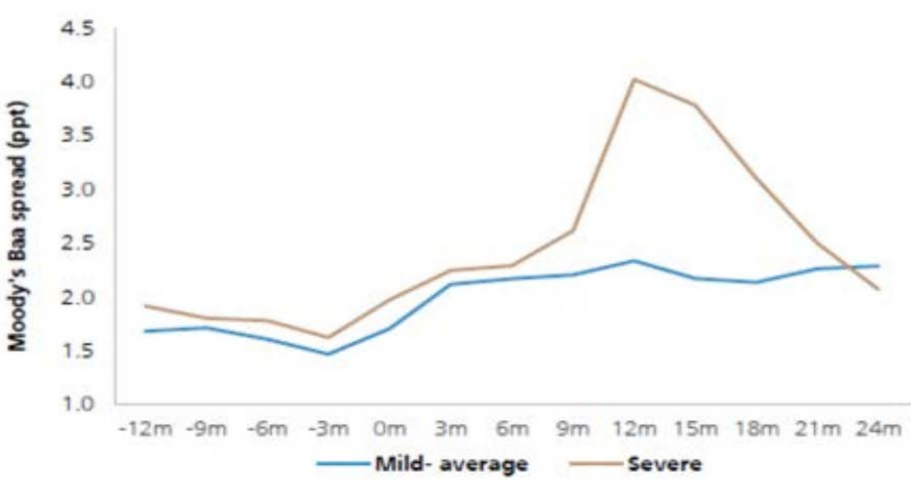
Market uncertainty is driving volatility and differing views among market participants



(1) Funded Status for the current month is estimated and subject to change as final numbers are released. Data from reference Bloomberg Indices. Funded status is in reference to the top 100 US corporate pension plans sourced from Milliman.
(2) Funded Status source: Milliman. FTSE Discount Rate source: FTSE. Long Credit Yield source: Bloomberg. US 30Y TSY Yield source: Bloomberg. S&P 500 source: Bloomberg.

The U.S. Long Corporate Index spread is 68 basis points wider since the start of the year

In the first few quarters of a recession IG spreads trade in a similar fashion



Market observations: credit spreads may not reflect a hard landing recession

- After fluctuating throughout Q3 2022, the U.S. Long Corporate Index spread closed the quarter at 198 bps, only 12 bps higher than where it closed at the end of Q2.
- Despite wider spreads, levels are still well below historical risk off periods.
- The market today is 50% BBB vs. just 30% in 2008. This emphasizes that spreads today might reflect a relatively better picture, as lower rated credit is hanging in compared to higher rated credit in the past.

SLC Management view:

- We believe the current environment reflects strong fundamentals across corporate issuers. Cash flow leverage is still positive and interest coverage ratios (a measurement of a company's ability to handle its outstanding debt) are at all time highs.
- While dollar prices on credit indices are at levels not seen since 2008 due to interest rates rising, the low absolute dollar price on certain bonds provides principal protection if spreads were to significantly widen.

Implications for plan sponsors:

- In volatile market environments, plan sponsors should pay extra attention to their spread duration exposure relative to their AA liabilities.
- Misalignment between asset and liability spread exposure (i.e., "credit spread mismatch") can result in unexpected funded status deterioration in turbulent markets.
- Sponsors should also keep a close eye on credit heavy managers who typically underperform in widening spread periods.

Source: Bloomberg, Moody's. Mild recessions: 1970, 1980, 1991, and 2001. Severe recessions: 1975, 1982, 2008.
A full list of data sources and indices can be found in the back of this presentation

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Market observations: Lack of obvious headwinds in sectors of credit market

- In previous downgrade cycles, there was one sector that accounted for half or more of the downgrades. Currently we don't see a sector under obvious and significant pressure relative to the broader market.
- This year, however, has been a record time for rising stars (upgrade from high yield to investment grade) vs. fallen angels (downgrade from IG to HY). There have been 20 rising stars totaling $89B, the largest annual total on record. There have only been seven fallen angels totaling $6.9B.

SLC Management's view:

- There is currently no sector big enough to overwhelm the market, although we are actively looking for the sector that will break the dam on spreads.
- Despite the market volatility we were still able to find good value in industrial new issuance due to the new issue concession offered; increased our allocation to the sector by almost 4% throughout the quarter.
- We moved from an overweight BBB position back to an underweight in Q3, trimming higher beta industrial and insurance names

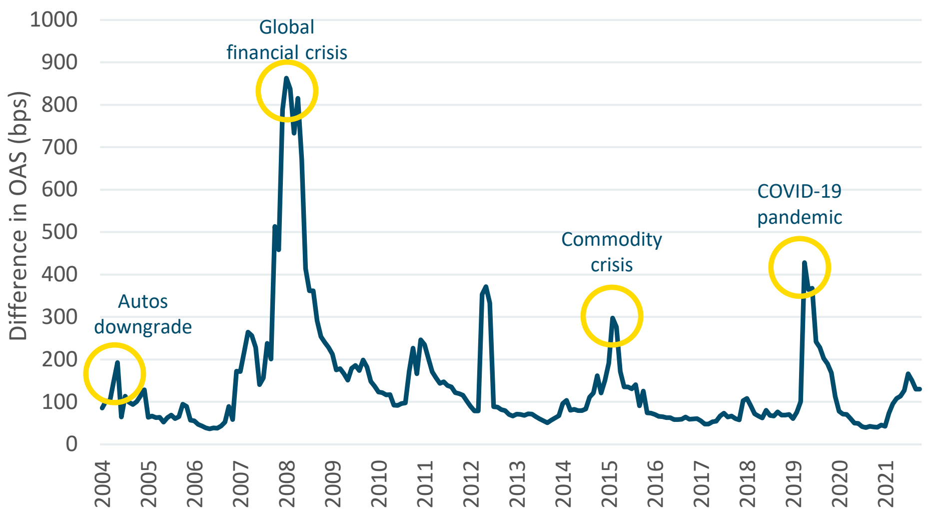
Implications for plan sponsors:

- As fixed income managers tend to differ on their investment styles and sector overweights or underweights, it is important to look at managers within a multi-manager framework to ensure diversification will help protect against a potential overwhelming credit sector.

A top sector dominated the downgrades during previous downgrade cycles before 2020

Period	Peak LTM* downgrade, share of BBB index	Top Sector	Event	Top Sector Share
July 2002	21%	Telecom	Dot com bubble	60%
Dec 2005	15%	Automobiles	Autos downgrade	84%
Aug 2009	17%	Banks/Brokers	Global financial crisis	45%
Nov 2015	7%	Energy	Commodity crisis	63%
Sep 2020	8%	Energy	COVID-19 pandemic	57%
Average	**14%**			**62%**

The difference between the widest sector spreads vs. the tightest sector spreads at each downgrade cycle



Source: Bloomberg. Bank of America Global Research. A full list of data sources and indices can be found in the back of this presentation.
*LTM = last 12 months.

Market observations: negative stock vs. bond correlation no more?

- The U.S. Aggregate Index and the S&P 500 Index have returned -15% and -24% year to date, respectively.
- With the trailing 5-year monthly correlation rising to ~0.4 from 0.0 since the start of 2022, stock–bond correlation has not been this high since 1999.

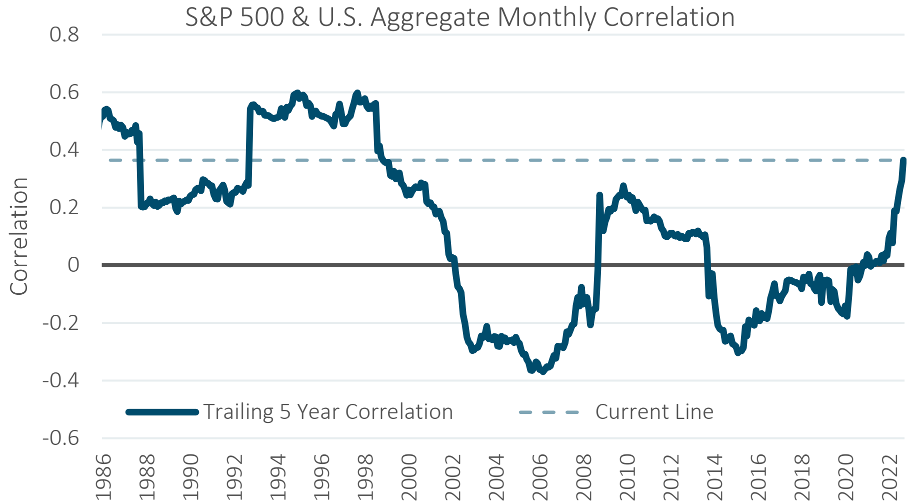
SLC Management's view:

- We have been built to think that bonds and equities have negative correlation. The current correlation suggests otherwise.
- As the stock–bond correlation continues to increase, portfolio volatility will also increase, forcing asset allocation to be adjusted as current expected risk and return targets will become unobtainable.

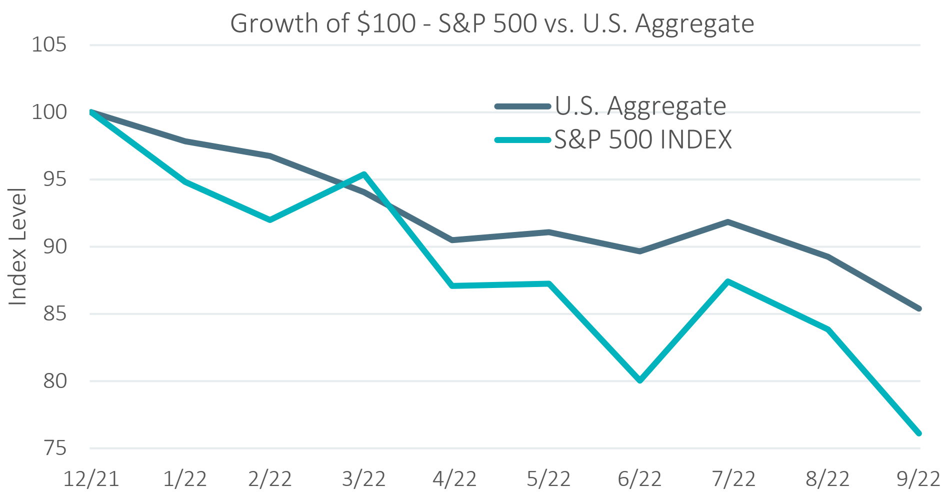
Implications for plan sponsors:

- The one area that has not been hit as hard from this correlation is corporate defined benefit plans, whose average funded statuses have increased 15% since 2020 due to the significant increase in discount rates.
- Given the increased market uncertainty and the excess funding relief, locking in gains and looking for LDI diversifiers will be key.

Trailing 5-year monthly stock vs. bond return correlation at levels not seen since before 2000



U.S. Aggregate & S&P 500 total return index continues to fall in tandem. Year to date monthly correlation = 0.76



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Market Chart Indices:
- Long Corporate Spreads sources: Bloomberg Long Corporate Index
- AA pension discount rate sources: FTSE Pension Discount Curve
- Average funded status source: Milliman
- Long end issuance source: Bloomberg
- Moody's Baa spread source: Moody's
- MOVE source: Bloomberg
- Monthly issuance source: SIFMA
- Top sector downgrade table source: Bank of American Global Research, Bloomberg
- Rolling 5-year monthly correlations and YTD index returns for S&P 500 and U.S. Aggregate source: Bloomberg

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