LONG-DURATION FIXED INCOME: MARKET CONDITIONS AND IMPLICATIONS FOR PENSION PLANS & INSURERS

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LONG-DURATION FIXED INCOME CAN PLAY AN IMPORTANT ROLE IN PORTFOLIOS ATTEMPTING TO HEDGE AGAINST PENSION OR LONG INSURANCE LIABILITIES, DEFLATION, EQUITY RISK OR SIMPLY TAKING A VIEW THAT LONG-DURATION YIELDS WILL DECREASE.

Some investors spent many years worrying that long-duration bond yields had nowhere to go but up, so they were likely hesitant to add to this segment. In the meantime, investors that participated in this market were largely rewarded with strong returns and desirable outcomes in terms of hedging risk as evidenced by a 10% annualized return for the Bloomberg Barclays Long Credit Index for the trailing 5 year period as of 31 December 2020.

Now, in an environment of Treasury yields trending upward in 2021, this paper explores the long-duration market, considers the supply/demand dynamics and discusses potential implications for pensions and insurers.

RESEARCH & PERSPECTIVES

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KEY TAKEAWAYS

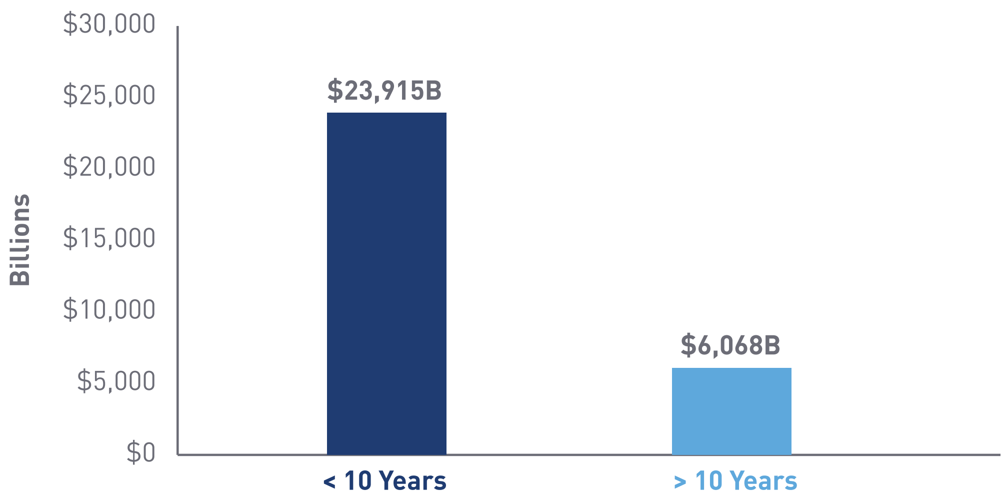
- With broad funded status measures having been boosted by solid equity returns and rising rates, we expect continued interest in long-duration issues from pensions.
- The outlook for long-duration supply over the next six to 12 months appears uncertain as cash builds up on corporate balance sheets and long-term interest rates have been ticking up.
- While US investment grade corporate bonds and US Treasurys make up the lion's share of the long-duration market, as of 29 January 2021, there was still $1.1 trillion of applicable securities in other sectors.
- Beyond establishing an investment structure focused on hedging and return objectives, we believe it is critical for investors to incorporate the flexibility of allocating to "plus" sectors, idiosyncratic risk and derivatives.

Long-Duration Market

Broadly, we define the long-duration market as US-dollar-denominated fixed income securities with maturities of 10 or more years.[1] At $6 trillion in assets, the long-duration segment is significantly smaller than the universe of shorter-maturity bonds (see chart). However, the long-duration market can offer depth and breadth across many different sectors.

SIZE OF FIXED INCOME MARKET BY MATURITY

Sources: Bloomberg Barclays. As of 31 March 2021. See endnotes for list of indices.



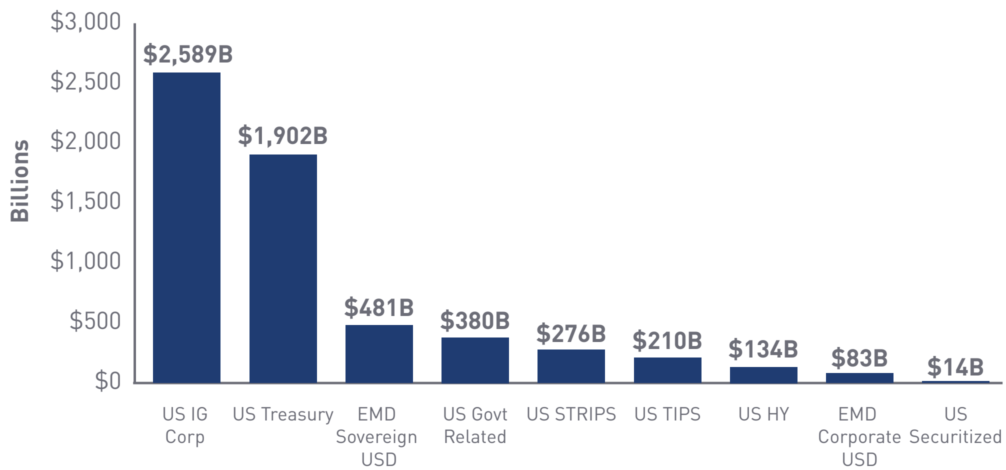
[1] *For purposes of this paper we used common Bloomberg Barclays fixed income indices which tend to exclude small issues (e.g., less than $300 million). See Endnotes for list of indices.*

Beyond Corporates and Treasurys

US investment grade (IG) corporate bonds and US Treasurys (including US STRIPS and US TIPS) make up nearly 82% of the long-duration market.[2] That means approximately $1.1 trillion of securities can be found across a variety of other sectors—emerging market (EM) sovereigns and corporates, government-related issues, high yield (HY), EM corporates and securitized.[3] We acknowledge there may be challenges and/or considerations in expanding into these sectors. However, depending upon client-specific objectives, it may be worth discussing how these sectors could play a role in hedging pension or insurance liabilities.

SIZE OF LONG-DURATION FIXED INCOME MARKET BY SECTOR

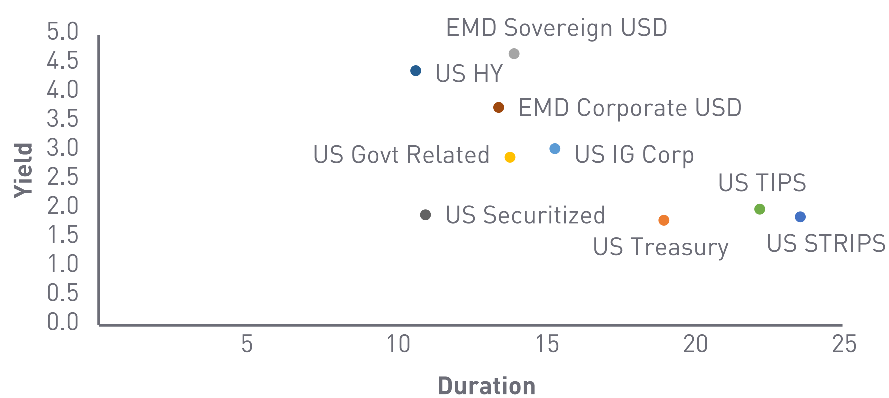
Sources: Bloomberg Barclays. As of 31 March 2021. See endnotes for list of indices.



In comparison to US IG corporates and US Treasurys, EM credit, HY and government-related issues have the potential to deliver a similar hedge in terms of long duration, but with potentially equal or better yields. A key to implementing these sectors is to assess the depth of these markets and to be able to deploy a robust credit research process to support security selection and risk management.

LONG-DURATION SECTORS BY DURATION AND YIELD

Sources: Bloomberg Barclays. As of 31 March 2021. See endnotes for list of indices.



[2] *STRIPS: Separate Trading of Registered Interest and Principal of Securities and TIPS: Treasury Inflation-Protested Securities. Data as of 31 March 2021.*
[3] *Note: The majority of long-duration HY debt is fallen angel debt originally issued into the IG market and is likely transitory.*

Supply and Demand Dynamics

Overall US corporate bond supply set a record during 2020. Many issuers sought to solidify their balance sheets, beef up reserves and pay off near-term maturities in order to persevere through the pandemic.

In the long-duration corporate space, issuance was nearly $400 billion during 2020 as compared to $200 to $250 billion in 2019 and 2018, respectively.[4] During 2020, there was a wide range of buyers seeking to take advantage of relatively cheap bonds at attractive yields—particularly in late March and much of the second quarter.

2021 NEW ISSUANCE

Corporate issuance remained strong through 31 March 2021.[5] But the outlook for long-duration supply over the next six to 12 months appears uncertain as cash has been building up on corporate balance sheets and long-term interest rates have been ticking up. Most Wall Street estimates have 2021 gross issuance lower than 2020. On a net basis, the relative decrease could be exacerbated by a material wave of 2021 maturities. Furthermore, there is data suggesting that issuers are currently leaning away from the long end. The average maturity of 2021 new issues has been shorter than that of new issues in 2020. In turn, this has created an increase in trading activity in the secondary market for the long-duration segment.

The renewed availability of 20-year US Treasury bonds has contributed to new issuance of 20-year corporate bonds. (It may now be easier to price bonds off of an observable US Treasury price rather than interpolating between the 10- and 30-year maturities.) We view this as a positive development for pensions and insurers. These issues may offer another tool to fine-tune credit exposures at longer key rate durations.

PENSION AND INSURER DEMAND

With broad funded status measures having been boosted by solid equity returns and rising rates, we expect continued interest in long-duration issues from pensions. In some ways, this demand is almost yield-agnostic as many pensions have prescriptive glide paths built into their investment policies, which could dictate and telegraph moves toward long duration.

We also expect insurers to be active as higher rates may help in the never-ending search for yield. An additional factor is the potential interest in US-dollar long-duration bonds from non-US (particularly Asian) insurers—especially when the hedging costs appear favorable.

[4] *Citigroup, as of 31 December 2020.*
[5] *JP Morgan, Daily Credit Strategy & CDS/CDX AM Update, published 2 April 21.*

TECHNICAL SUPPORT AND WILD CARDS

With potentially less supply on the horizon and expected strong demand, we see technical support for long-duration prices in the near term. However, any major pandemic-related macro event could change this picture materially on the downside. On the supply side, merger and acquisition activity will be a wild card. But given the overall current dynamics of the long-duration sector, pensions and insurers might want to consider a more proactive approach to securing long-duration bonds sooner rather than later.

Implications for Pensions

We believe that understanding the long-duration market is critical to pension plan decision making. As mentioned, many plans have well-defined glide paths. They dictate rebalancing out of equities and other return-seeking assets into long-duration fixed income as funded status improves (or in some cases interest rates rise) over time.

At this point, the aggregate funded status in the pension industry is at or above pre-pandemic levels.[6] We have been seeing companies move along their glide paths and expect that long-duration fixed income demand could continue unless we see a significant selloff in risk assets near term.

CONSIDERATIONS FOR PENSION PLAN SPONSORS

1. **Continue to ensure allocation efficiency in credit versus Treasury issues**
   Last year shined a light on how quickly credit spreads can widen and snap back. Some strategies with somewhat flexible guidelines had the ability to access long-duration bonds at significantly wider spreads and captured strong returns. Given the potential supply/demand crunch at the long end, it is important to be able to move efficiently when dislocations happen—particularly with the relative value between rates and credit changing.

2. **Look outside of traditional corporates and Treasurys**
   We suggest broadening the universe of acceptable investments for liability-driven investment (LDI) portfolios by including asset classes, such as securitized, emerging markets, taxable municipals, convertibles and bank loans. If market depth is a concern in the 10+ maturity portion of these sectors, we would suggest loosening the maturity constraint and adding an interest rate overlay to bring duration back in line with long-duration targets. Such a multi-sector approach has the potential to efficiently invest during market dislocations while keeping the desired duration hedge versus the liabilities.

[6] *Mercer, S&P 1500 Pension Funded Status Increased by 5 Percent in March, https://www.mercer.com/newsroom/pension-funded-status-increased-by-5-percent-in-march.html*

3. **Secure physical long-duration bonds before a supply/demand crunch**
   Due to the supply/demand dynamics discussed, we could see a situation where there is less issuance in the long end just when pensions and insurers may be looking to allocate to this space (e.g., rising yields improve funded status and leads to increased demand when issuers are more hesitant to issue at higher yields). Long-duration bonds also tend to be sticky, or held long term, once purchased by pensions and insurers. Plans might consider purchasing physical long-duration corporates in advance of hitting specific glide path triggers and using Treasury futures to adjust duration to meet plan-specific risk targets. If this is done in concert with overall plan equity and credit risk, we believe this can help plans limit having to buy long bonds at the same time as everyone else.

4. **Allow managers flexibility to maintain or access fallen angels**
   There are typically few long-duration HY issuers. However, a few recent high-profile fallen angels have created an interesting dynamic whereby the HY market has had to digest a significant amount of long-duration bonds (see chart). While these issuers may eventually get back to investment grade, we believe it can be beneficial to allow portfolios to hold fallen angels through cycles, while also allowing the ability to purchase potential "rising stars." An asset manager that can effectively navigate crossover names can seek to provide diversification and return potential to an LDI portfolio.

SIZE OF HIGH YIELD 10+ MATURITY MARKET

Sources: Bloomberg Barclays. As of 29 January 2021. See endnotes for list of indices.

Ultimately, each of these factors needs to be considered within the broader context of a pension plan's lifecycle, risk tolerance and specific asset-liability nuances. But as plans continue along glide paths and seek to allocate the majority of their portfolios to long-duration securities, analyzing the dynamics of the long-duration market is typically central to successful plan outcomes.

IMPLICATIONS AND CONSIDERATIONS FOR INSURERS

In light of the market dynamics we have laid out, we believe insurers—especially life insurers and long-duration liability writers—should have the following on their radar:

1. **Duration positioning in reserve and surplus portfolios**
   Asset liability management (ALM) mismatches
   Reinvestment rate risk
   a. With the steepness of the curve returning, insurers could position reserve assets longer than liabilities to seek the higher potential yield of longer-duration assets. Yield curve steepness also has the potential to increase yield in a surplus portfolio

   b. Introduce/add to asset duration barbell in the reserve portfolio. If insurers feel a majority of rates may trend higher over time, they can seek to alter key rate duration positioning while retaining overall ALM duration. (Adding to positions with short and long key rate durations, while reducing those in the intermediate range – 5 to 10 years. In a steep yield curve environment, this trade would likely mean giving up some yield. However, an insurer can utilize certain sectors that may offer more spread to offset the give-up in yield. Sectors including esoteric securitized, CLOs, short EMD, HY and bank loans can offer more spread and help replace the yield give-up in the shorter-duration space. This portfolio positioning may help allow an insurer to potentially turn over more assets in the short term and reinvest as rates rise.

2. **Fallen angels**
   Investing in fallen angels could be a tactical opportunity that insurers, working with their asset managers, could be proactive about. As noted above, recent fallen angels into the long-duration HY market is likely transitory, but could offer wider-spread long-duration paper in the short term. This high spread and long-duration paper gives not only the potential to add yield and spread, but through a high duration times spread (DTS), could present a good total return trade should the fallen angel regain investment grade status.

3. **Municipals**
   Life insurers have been large buyers of taxable municipals since their introduction, but not tax-exempt municipals due largely to the unfavorable tax implications. However, current tax law sets the life insurer policyholder rate at 30%, thus resulting in an effective tax rate for life insurers on tax-exempt municipal income at 6.30%. This low rate could mean some long-duration tax-exempt municipals are currently better on an after-tax relative basis when compared to certain long-duration taxable securities.

4. **EM sovereigns/corporates**
   We believe insurers with long liabilities should consider initiating or adding to EM sovereign allocations, despite the asset class being a small portion of the long-duration universe. These sectors can offer yields similar to and potentially above comparably-rated US corporates. They can also help increase portfolio diversification.

5. **Idiosyncratic risk/ diversification**
   Insurers often look to maintain a large amount of diversification to reduce idiosyncratic risk. Similar to a HY fallen angel opportunity, asset managers with deep credit skills could reduce portfolio diversification within an insurer's portfolio to seek to increase idiosyncratic risk and total return potential in addition to yield.

Derivatives

Insurers with the ability to use derivatives could seek to port the spreads available in the shorter-duration universe (esoteric ABS for example) to the long-duration space using US Treasury interest rate derivatives. The short-duration universe has a broader and deeper spectrum of securities beyond the standard long-duration universe of US corporates and US governments. The insurer would likely have to analyze the potential impact on portfolio DTS to determine the tolerance for any slippage relative to the desired liability-centric DTS.

Conclusion

Long-duration fixed income is likely to remain a key focus for many investors, particularly pension and life insurance plans. With demand projected to remain strong and future supply levels uncertain, understanding the factors that could drive long-duration prices will be necessary for effective outcomes. Beyond establishing an investment structure focused on hedging and return objectives, we believe it is critical for investors to incorporate the flexibility of allocating to "plus" sectors, idiosyncratic risk and derivatives. However, all these factors should be couched within each investor's specific asset-liability framework.

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Endnotes

Per footnote one:
Bloomberg Barclays US Corporate Statistics Index (Statistics, Unhedged)
Bloomberg Barclays US Treasury Total Return Unhedged USD (Returns, Unhedged)
Bloomberg Barclays EM USD Aggregate: Sovereign Statistics Index (Statistics, Unhedged)
Bloomberg Barclays US Aggregate: Government-Related Statistics Unhedged USD (Statistics, Unhedged)
Bloomberg Barclays US Strips Statistics Index (Statistics, Unhedged)
Bloomberg Barclays Global Inflation-Linked: U.S. TIPS Statistics Index (Statistics, Unhedged)
Bloomberg Barclays US Corporate High Yield Statistics Index (Statistics, Unhedged)
Bloomberg Barclays: EM USD Aggregate: Corporate (Statistics, Unhedged)
Bloomberg Barclays U.S. Securitized: MBS/ABS/CMBS and Covered Statis (Statistics, Unhedged)

Disclosure

MALR027204

Additional notes

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