

Three Questions on Liability Hedging

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1. HOW COULD PENSION PLANS CONSIDER HEDGING DURATION RISK IN LIGHT OF RECENT RATE RISES?

Rising Treasury yields during the first quarter of 2021 boosted funding ratios to recent highs, benefiting many pension plans. This long-awaited shift has some plans reconsidering glide paths, risk transfers and fine-tuning liability hedges via overlays or completion mandates. Our conversations with clients have focused on how best to lock in funding ratio gains and whether action is needed over and above physically rebalancing along glide paths. Often the question is whether to simply extend overall duration or to implement a completion mandate that targets hedge ratios across the maturity spectrum to help reduce yield curve risk. We generally find that plans that continue to maintain modestly large allocations to return-seeking assets (RSA) see the largest risk reduction benefit from simply extending duration through long-duration Treasuries, STRIPS or Treasury futures. For these plans, we typically suggest delaying completion across the yield curve until the plan has a significant overweight to liability-hedging assets in relation to RSA. However, given each plan's specific situation, we believe it is most critical for plan sponsors to understand when full completion would likely become beneficial and to consider putting "the plumbing" in place now to ease implementation when the time comes.



2. WHAT SHOULD PLANS CONSIDER WHEN THINKING ABOUT CREDIT FIXED INCOME IN RELATION TO LIABILITY HEDGING?

Completion mandates tend to focus on Treasury exposure in order to hedge the risk of changes in Treasury yields. Should plans think about credit completion in the same way? Generally, we suggest focusing on overall credit risk of assets versus liabilities (via Duration times Spread, or DTS) but guide plans away from rigid completion of credit exposure across the maturity spectrum. There are two main reasons for this. First, targeting specific credit exposure at each key rate bucket can be expensive and can create unnecessary transaction costs. Second, credit spread hedging at each key rate tends to be much less reliable than Treasury hedging because bond quality influences price movements. DTS is a useful but imperfect metric from this standpoint. Instead, we believe plans should quantify the overall DTS of the fixed income assets versus the liability DTS and, critically, consider this in the context of the RSA in order to hone in on the appropriate risk/return positioning.

3. WHAT IS THE ROLE OF INTERMEDIATE FIXED INCOME IN LIABILITY HEDGING PORTFOLIOS?

We have seen a trend in plans considering intermediate fixed income mandates to help hedge liabilities. This is generally due to plans being better funded and looking to fill in gaps versus liability exposures or because closed or frozen plans have liabilities that are gradually shortening in duration (we estimate a frozen plan shortens in duration by approximately 0.2-0.3 years annually). In any event, we consider this a valuable approach because it can fill a sometimes overlooked part of liability hedging buckets and it also provides a larger universe of bonds to choose from. We suggest plans consider intermediate fixed income mandates with the quality and sector flexibility to expand outside of corporate bonds to potentially take advantage of dislocations. These types of mandates can help plans outperform their liabilities while maintaining reasonable tracking error risk and providing an additional hedge against liabilities in the belly of the curve.

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