Institutional Insights

March 11, 2024
Marketing material

Pensions and Fixed Income: A Window of Opportunity to De-risk

IN A NUTSHELL

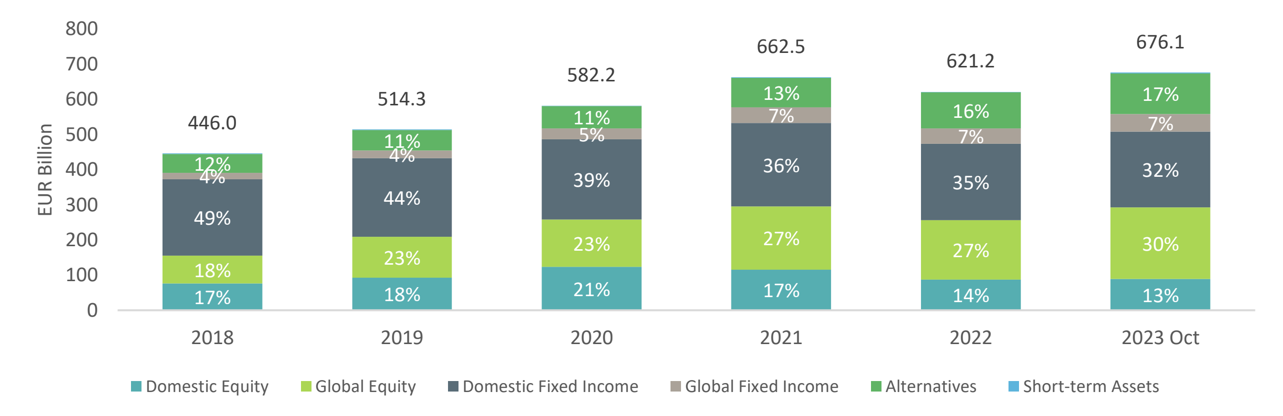
- Macro-economic factors have led to, although with regional discrepancies, a general improvement of funding status of pensions across the globe. Investors now have more flexibility to change their asset class exposure.
- Fixed Income represents a more attractive opportunity given higher rates. Pensions may want to consider taking the window of opportunity now to increase their fixed income exposure to hedge a larger portion of their portfolio to better manage their duration risks and reduce their future volatility of return.

1 / Status Quo Positioning for Pensions

1.1 Concentrated Position in Equities at the Expense of Fixed Income

Although different pension plans would take a different investment approach, the goal is to pay off their liabilities. In theory, they would therefore rely on asset liability management to match their long-dated liabilities with cash flows. A prolonged period of low yields prior to 2022, coupled with a shift to a growth portfolio approach and the promising returns of U.S. Equities in 2023, however, has motivated pensions to increase allocations to equities and alternatives in an attempt to achieve target portfolio returns to cover their liabilities (e.g. Korea NPS, as shown in Figure 1). While these riskier asset classes have historically helped pensions compensate for lower yields in the fixed income market, they can expose pensions to increased duration risk.

Figure 1: Asset Allocation of Korea NPS 2018 – 2023 October

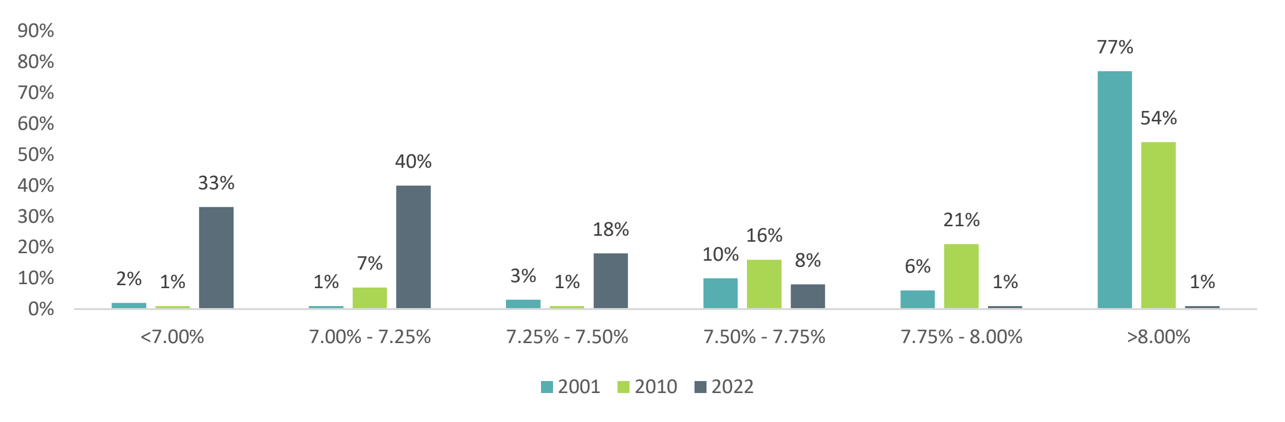


Source: Korea National Pension Service, as of October 2023. Allocations are subject to change without notice.

1.2 Lower Expected Return on Assets

Closely linked to the prolonged period of low interest rates is the fact that pension funds have adapted by lowering their return assumptions over the last 20 years, driven by lower return forecasts for many asset classes. As an example, target return on assets of most US public DB plans has declined from 8% to 7% over the last 20 years (Figure 2). After a series of rate hikes by central banks globally in 2023, pensions may be able now to obtain a relatively attractive return from high-quality core fixed income instruments, which could potentially make the 7% targeted return more achievable with lower investment risks.

Figure 2: Percentage of US DB plans with return targets in stated ranges: 2001 vs. 2010 vs. 2022



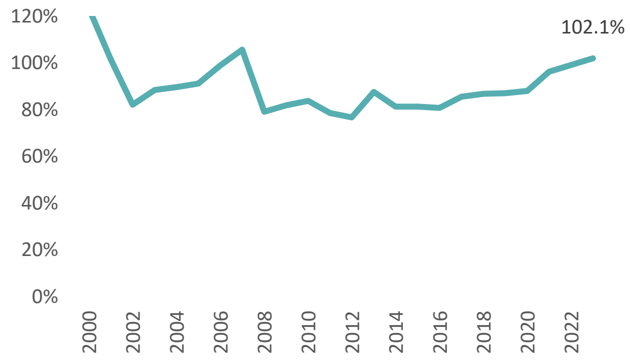
Source: BlackRock and Public Plans Database, June 2023. Assumed return targets represent 189 plans in FY '01, 214 plans in FY'10, 194 plans in FY'22. No assurance can be given that target will be achieved.

1.3 Funding Ratios improve, but not across all regions and countries

Not only do interest rate hikes have an impact on the return on assets, but they also lead to a decline in the present value of pensions' liabilities because a higher discount rate is applied to the expected pension payment to plan members in retirement. This decline in the present value of pensions' liabilities has led to an improvement in funding ratios for DB pensions, particularly in the US and Europe. The funded status of the US' 100 largest corporate pension plans stood at 102% as of the end of 2023 (Figure 3), indicating the assets of the US corporate DB plans are sufficient to cover their future liabilities, and they are now in a better position to reduce exposure to yield-enhancing assets (e.g., equities and private equity) and invest in hedging portfolios that could better match their duration risks.

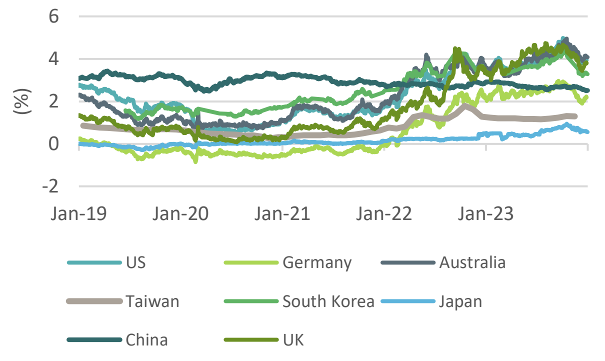
Although interest rates have generally increased for most economies across the globe to combat inflationary pressures in 2023, it is also worth noting that not all economies have decided to increase their policy rates. This is particularly true for Asia, where various APAC countries are often in different business cycles (Figure 4). Japan, for example, still maintains a negative policy rate as of January 2024, implying the funding status of Japanese pensions is likely still under pressure. This might improve slightly after April 2024 when the market widely expects the BoJ to drop its yield curve control policy and start raising interest rates gradually in 2025, which could bring the present value of liabilities down for Japanese pensions.

Figure 3: Milliman 100 Pension Funding Index



Source: Miliman, as of January 2024.

Figure 4: 10 Year Government Bond Yield across Key Asia Markets: 2019 - 2024 January

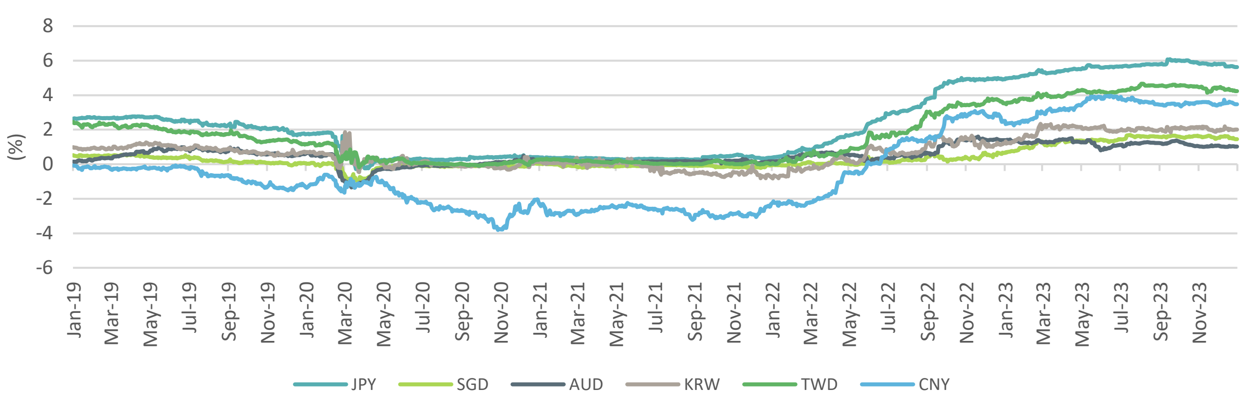


Source: Bloomberg, as of January 15, 2024.

1.4 Hedging costs remain elevated in key APAC countries

A unique challenge facing investors in Asia is often the high hedging costs that arise from interest rate differentials between USD or EUR and the local currencies, which intensified significantly in 2023 after the Federal Reserve (Fed) and European Central Bank (ECB) began the hiking cycle. This is the key obstacle for asset managers to market foreign offerings to investors in APAC especially in Japan where the hedging cost is close to 6% (Figure 5). Although there is always a diversification argument to invest in overseas assets, elevated hedging costs would eat into the return of foreign investments especially for foreign fixed income, making them unattractive for APAC investors.

Figure 5: Hedging Cost of Major APAC Currencies to USD: 2019 – 2024 January



Source: Bloomberg, as of January 15, 2024

2 / The Case for Increasing Fixed Income Exposure in Pension Portfolios

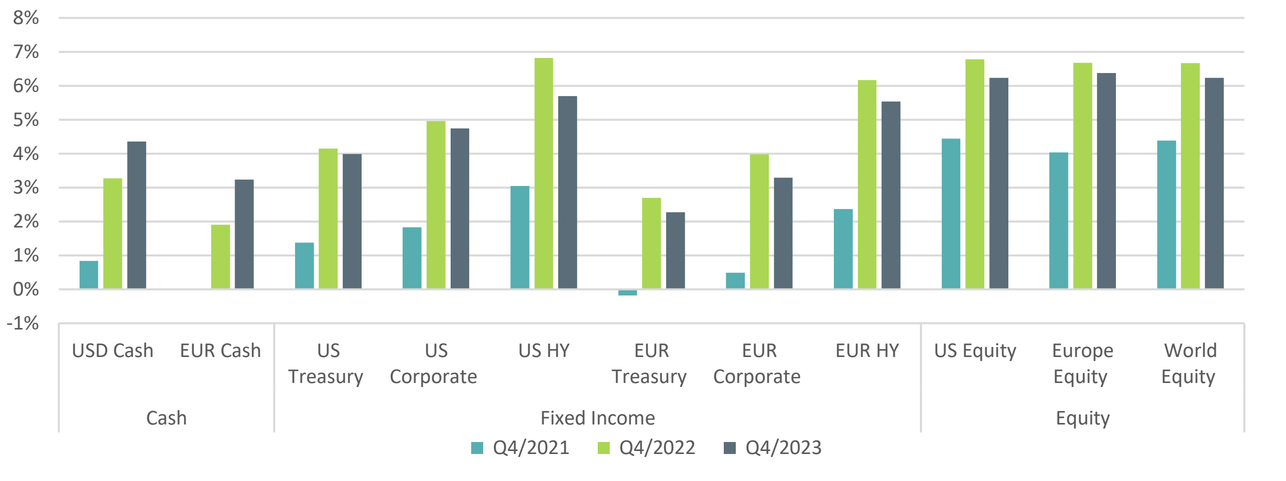
2.1 Macroeconomic Outlook

Although different asset managers have divergent views on how the macroeconomic environment is set to evolve in 2024, the consensus is a slower economic growth in 2024. Headline inflation is anticipated to remain high but is gradually falling in the US and Eurozone, supporting a loosening monetary policy in both the US and Europe. The DWS CIO View predicts a technical recession in Q2/2024 for the US and weak growth for Europe; 2.8% and 2.9% headline inflation for the US and Europe respectively; and 3 cuts (i.e. 75 bps) by the Fed (@4.75%) and ECB (@3.25%).

These macro-outlooks indicate:
- Softer equity market performance in the US and Europe in 2024, which is currently believed to be a large part of pensions' portfolios.
- Our expectation for interest rates to stay 'higher for longer' would make fixed-income instruments relatively more attractive from a return perspective.
- Pension liabilities in selected countries (in particular the US and Europe) would likely deteriorate again if interest rate risks are left unhedged.
- In Asia, hedging costs are expected to fall as the market is pricing in faster rate cuts in the US and Europe than in APAC countries from H2 2024 onwards. Opportunities for US and European fixed income might therefore arise in APAC in 2025.

As seen below in Chart 6, DWS' Long Term Capital Market Assumptions have reflected the shifting macro environment over the preceding two years, with improved return assumptions across most major asset classes. In particular, several fixed income asset classes are expected to deliver similar level of returns as equity over the longer term.

Figure 6: DWS Long Term Capital Market Assumptions (next 10-year return, local currency)

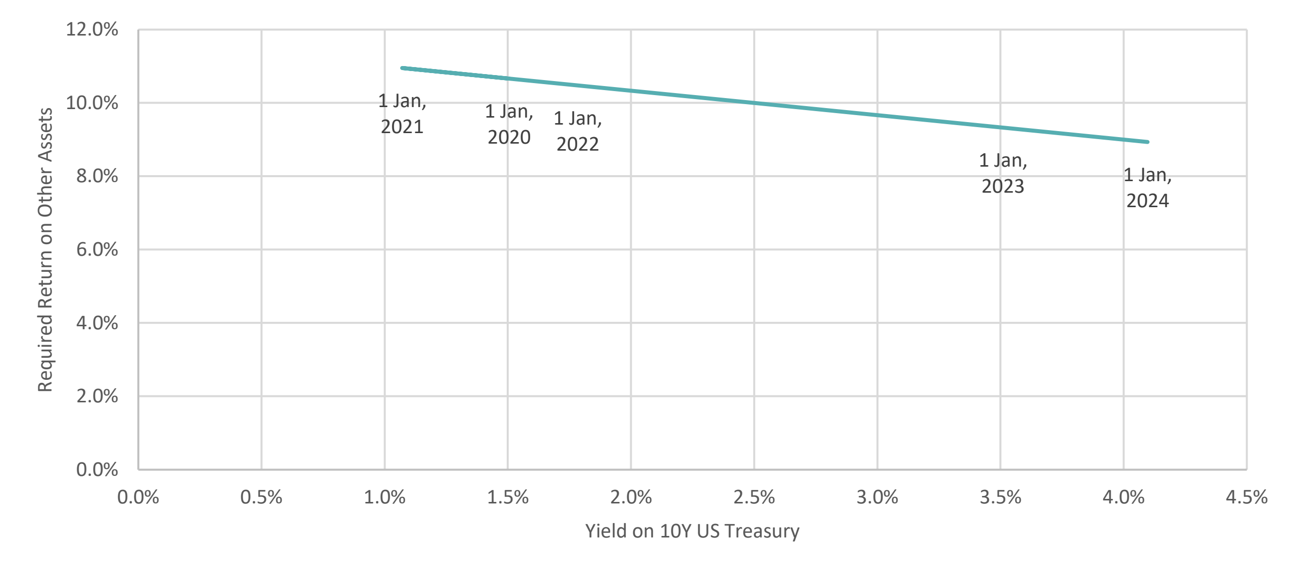


Source: DWS, as of December 31, 2023. Forecasts are not a reliable indicator of future returns.

2.2 The Case for Increasing Fixed Income Exposure Now

Due to increases in the expected return on fixed income over the longer term, it is now easier for pension investors to achieve their 7% expected return on assets. Assuming a 60 (other assets) / 40 (fixed income) portfolio, the required return on non-fixed income assets stands at 8.9% compared to 11.0% a mere 3 years ago. In other words, pension investors are now in a better position than any time in the last 5 years to allocate a larger proportion of their investment portfolio into fixed income, which could assist in managing their interest rate risks while still being able to achieve their 7% target return. With the market widely expecting the end of the hiking cycle in the US and in the Eurozone, this is arguably a window of opportunity for pension plans to increase their fixed income exposure before the beginning of the loosening cycle to reduce their future volatility of return on the asset side.

Chart 8: Required Return on other assets in order to achieve 7% return on assets assuming a 60/40 portfolio, 2020 – 2024 January



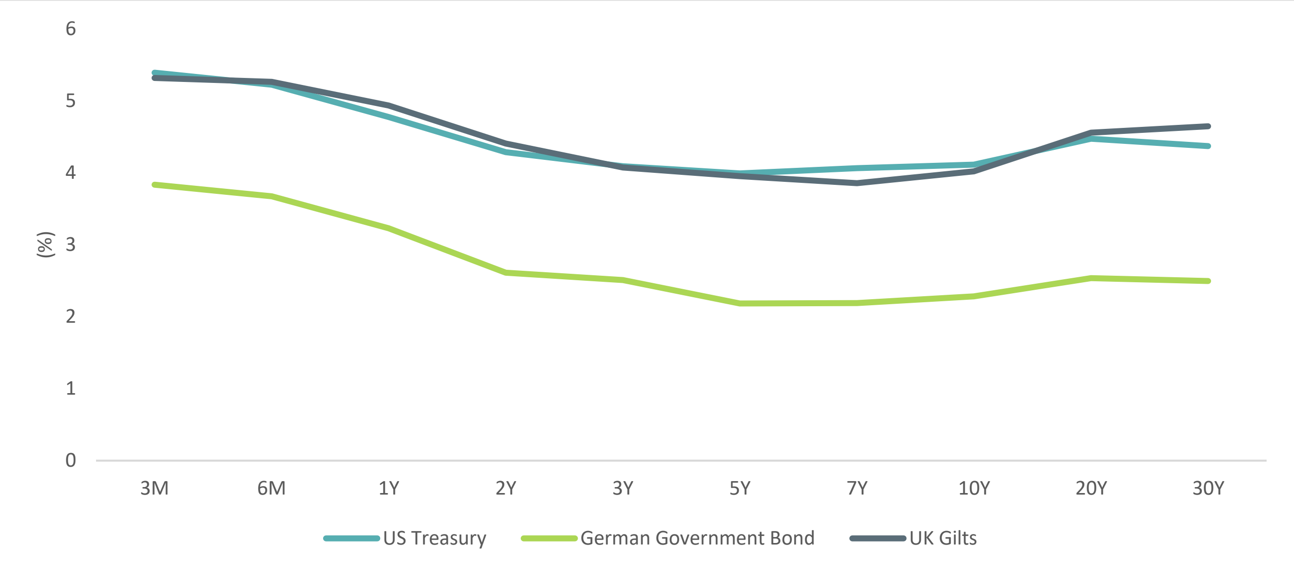
Source: World Government Bonds. Forecasts are not a reliable indicator of future returns.

3 / Fixed Income Investment: Considerations for Pensions

1.1 Physical Bond Portfolio: The Short vs. Long Duration Debate

If pension investors decide to increase their fixed income exposure, the next most important consideration would be where along the yield curve to invest. While the yield curve is sharply inverted for many major bond markets, with the US 3M Treasury yielding 1.3% higher than the US 10Y, it would be tempting to arrive at the conclusion to invest in the shorter end of the curve. However, pensions also have a bulk of long-dated liabilities to hedge and tend to be very hesitant to allocate to short-duration debt instruments due to duration mismatches. The decision to go short vs. long duration would therefore be dependent upon pension allocator’s assessments of reinvestment risks, along with the individual investment approach of the plan, availability of fixed income instruments in the domestic market, as well as their tolerance of deviating from the asset liability management approach.

Chart 8: Yield curve of US Treasury, German Government Bond and UK Gilts, as of 26 January 2024.



Source: World Government Bonds.

1.2 Synthetic Credit (CDS)

In addition to holding cash bonds, we believe there are also innovative routes that could help investors access exposure to credit spreads more efficiently. Pensions could therefore use Credit Default Swap (CDS) to create synthetic corporate bonds that would allow them to earn credit spreads on a diverse range of international corporate bonds while better matching their liabilities. By doing so, investors could:

- Diversify their portfolio.
- Trade tenors where cash bonds do not exist.
- Adjust the CDS notional to respond agilely to the changing market environment without the inconvenience of cash management.
- An additional advantage particularly for APAC investors is that synthetic credit strategies could help pension investors reduce their FX exposures significantly, thereby minimizing currency hedging costs.

4 / Summary

Macro-economic factors have led to, although with regional discrepancies, a general improvement of funding status of pensions across the globe. They now have more flexibility to change their asset class exposure and de-risk their portfolio. With the higher yields that Fixed Income is now able to offer, which are comparable to Equity for selected Fixed Income asset classes, pension investors should consider taking the window of opportunity now to increase their Fixed Income exposure to hedge a larger portion of their portfolio to better manage their duration risks and reduce their future volatility of return.

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Important information – EMEA, APAC & LATAM

Important information – North America

as of 3/11/24; 100148_1 (03/2024)