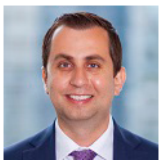
PENSION SERIES

LIABILITY HEDGING IN RESPONSE TO PANDEMIC CRISIS



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The notion that interest rates are dynamic in nature and notoriously difficult to predict has been demonstrated in spades by the uptick in market volatility during the COVID-19 pandemic. The economic impact from the virus has been swift, creating a dichotomy between "risk-free" Treasury interest rates and corporate spreads.

Even though the ultimate funding impact for pension plans from the pandemic won't be known for quite some time, some key observations can be made:

- Treasury yields have fallen to historic lows with 10- and 30-year yields, dropping below 0.55% and 1.00%, respectively, at the beginning of March, while exhibiting higher-than-normal levels of volatility;
- Credit spreads have widened to levels last seen during the global financial crisis; and
- Significant interest rate movements have created liquidity challenges for rebalancing and adjusting hedging programs.

While hedging programs may need to re-align their strategies given the current circumstances, they should continue to lean on the basics:

1. **HEDGING INTEREST RATE RISK IS CRUCIAL TO PENSION PLAN MANAGEMENT.** Based on recent events, it should be clear that there is no longer a bottom for any sovereign yields in the world. Plan sponsors that believe there is now potentially more upside to rates rising than before should understand that protection from the risk of further rate declines is still important.
2. **BE MINDFUL OF CREDIT SPREAD RISK.** Plan sponsors that calculate their liabilities in this environment may be pleased to see that they have decreased. While true, this decline is all due to widening credit spreads, given that pension plan liabilities are based on effective yields of Aa corporate bonds. Credit spreads tend to revert to means rather quickly, and plan sponsors inattentive to credit-spread hedging will be left in the dust when the world settles to the new normal.

So, what should plan sponsors do in these times when it comes to hedging liabilities? Most plans generally hedge liabilities with a combination of Treasury securities (e.g., physicals such as Long Government bonds and STRIPS and synthetics such as Treasury Futures or Swaps) and spread securities (e.g., Long and Intermediate Credit). Recent

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interest rate movements have created a situation in which the Treasury component of the portfolio is now generally overweight and credit underweight, relative to target, with the entire liability-hedging portfolio slightly to greatly overweight relative to growth assets.

In this environment, first and foremost, rebalancing is important. Given current market liquidity considerations, careful thought should be given to how and when to sell securities like off-the-run Treasuries and STRIPS. Bid-ask spreads have risen to five to ten times normal levels in this climate. Selling at an inopportune time could result in a 2.5%–5% or more reduction in the value of the security. While not always obvious, fund investors—including those holding individual securities—bear these transaction costs as well. Nonetheless, many plan sponsors will rebalance this allocation to add to their credit portfolios, which have generally fallen in price.

Plan sponsors that can use derivatives should consider synthetically rebalancing allocations to address the poor liquidity conditions. For instance, to tactically lower the interest rate hedge ratio (or rebalance from Treasuries to equities), plan sponsors don't have to incur the transaction costs of selling Treasuries. Instead, they can sell Treasury futures (and/or buy equity futures). When liquidity conditions improve, they can implement the asset allocation using physical securities and unwind the derivative positions.

Plan sponsors should also consider what the appropriate interest rate and credit spread hedge ratios should be given current market conditions and dislocations. How—and if—to benefit from any potential reversion of risk-free rates and credit spreads may be contemplated for plan sponsors more comfortable with bearing interest rate risk. This leads back to the topic of a hedge path and, more importantly, the difference between interest-rate and credit-spread hedging.

While weak economic data, new US Federal Reserve actions, or increased foreign demand could push Treasury yields lower, these yields may also bounce back. The common approach to take advantage of higher future yields is to tactically lower the risk-free interest rate hedge and wait for any reversion to happen. However, a word of caution is important; plan sponsors wishing to take the risk of assuming that interest rates will rise should do so with a clear and actionable plan.[1]

The focus of any tactical under-hedge should be risk minimization. To achieve this goal, plans should:

1. **RECALIBRATE THE HEDGE PATH.** Consider the appropriate interest rate level at which the tactical under-hedge should be lifted in favor of strategic, long-term hedge targets. For example, a maximum level of 2% on the 30-year Treasury, while questionable in the past, is likely more appropriate now.

1 For more information on a clear and actionable plan, please see Serge Agres, "Liability-Hedging Strategies for US Plan Sponsors in the Low Interest Rate Era," Cambridge Associates LLC, 2019.

2. **BE COGNIZANT OF THE TIME NEEDED FOR THE TACTICAL UNDER-HEDGE TO APPLY.** Given increased volatility in rates, the period should be perhaps six months to a year. If a reversion doesn't happen during this period, it becomes less certain that it will happen at all and we may be in a "new normal" of even lower interest rates. In such an environment, holding shorter-duration fixed income will create a drag on funded status due to lower yield.
3. **RECOGNIZE THAT FUNDED STATUS DYNAMICS HAVE CHANGED.** With increased interest rate volatility, actual funded status levels are more fluid than ever. Having an accurate sense of a plan's funded level at any point in time is critical in this environment to be able to adjust the hedge appropriately. Effective credit-spread hedging can reduce variability in funded status estimates and should make rebalancing easier to implement.

Overall, important guidance to remember during these turbulent times is to not make drastic changes to any investment program, but instead to continue taking a measured, pragmatic approach. Strategic hedging of interest rate risk is still critical, despite the potentially heightened opportunity to take a tactical approach. Having—and adhering to—a comprehensive hedging plan, including awareness of transaction costs, is more vital than ever. Also, don't forget about the credit spread![2] ■

2 Alex Pekker, "Don't Forget the Credit Spread," Cambridge Associates LLC, September 2016, and Alex Pekker, "Credit Spreads Take Pensions for a Wild Ride," Cambridge Associates LLC, April 2020.