Principal Asset Management℠

Looking beyond traditional LDI instruments as de-risking gathers steam

The time may be here to lock in healthy funding levels

FOURTH QUARTER 2024

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Key takeaways

1. It has taken almost 15 years for many private defined benefit plans to finally see higher average funded ratios. This was mainly driven by a large fall in liability values that are discounted on a high-quality corporate bond yield curve.
2. Equity markets are at an all-time high and based on the recent decade, long duration bond yields are higher. Pension plan sponsors must seriously consider taking advantage of this market opportunity, swapping out equity/equity-like exposure in favor of fixed-income assets with a goal to help lock in the funded status gains and de-risk their investment strategy.
3. Plan sponsors who have already added public market investment grade credit and Treasury securities should consider a new toolkit when it comes to incrementally adding to their liability-driven investment (LDI) portfolio. We favor adding esoteric assets such as private investment grade credit, commercial mortgage loans, and non-agency collateralized mortgage-backed securities to help uplift the overall quality of a LDI strategy.

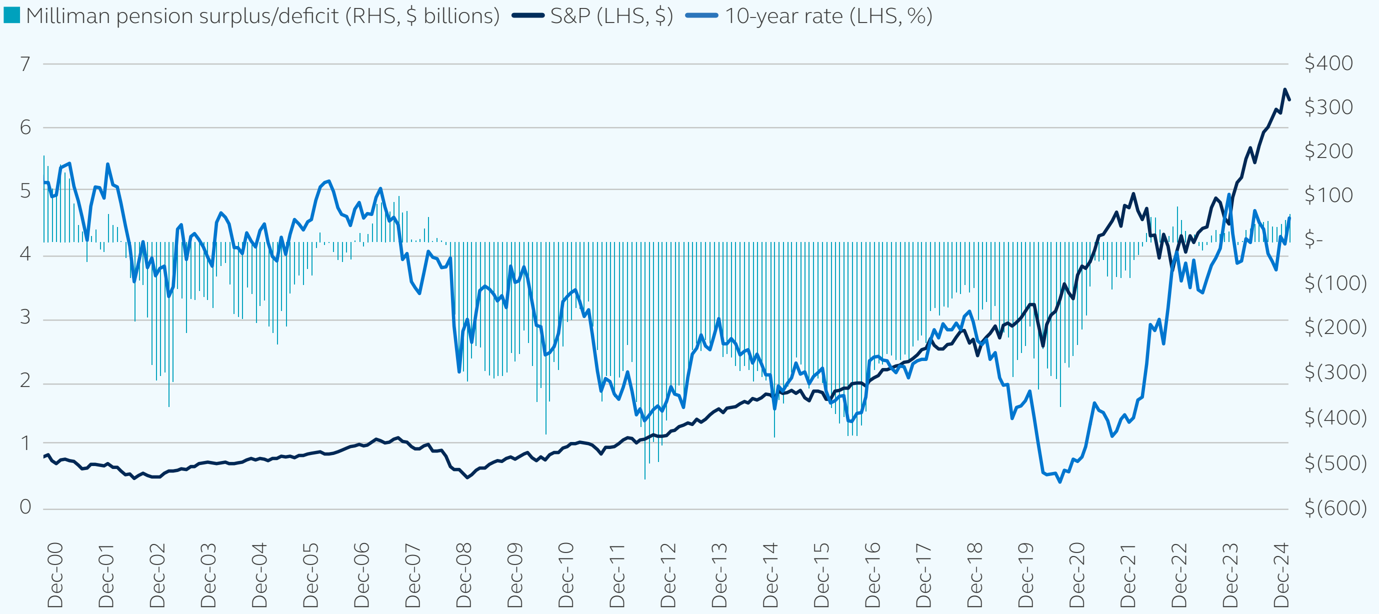
In 2022, we saw one of the most unprecedented movements in global financial markets in modern history. A combination of global geopolitical problems and supply-demand imbalances of goods and services due to the pandemic left the Federal Reserve (Fed) with no option but to try and slam the inflationary brake by hiking short-term interest rates to stop the economy from overheating. The capital markets across the board went downward, with U.S. S&P 500 returning -19.4% and U.S. Treasurys returning -12.5% over 2022.

As most asset owners were in despair having seen their wealth significantly depleted, there was a silver lining for at least one group of asset owners that had waited for such a scenario—the private defined benefit (DB) plan sponsor. This group of plan sponsors had been eagerly waiting for the value of long-dated high quality corporate bond securities to drop in value (rise in the bond yield curve). As a result, the average funded ratio as of December 31, 2024 stood at 105.0%, according to the Milliman Pension Index.

Indeed, it has taken almost 15 years for private DB plans to finally see higher average funded ratios. This was mainly driven by a large fall in liability values that were discounted on a high-quality corporate bond yield curve. Even the explosive equity bull market era following the Global Financial Crisis failed to drive the industry's average funded status into positive territory because a commensurate rally in the long-dated Treasury (hence corporate bond) market kept increasing the plans' liability values.

For those plans that have patiently waited for the long-dated interest rate to rise, the time may be here to de-risk by swapping out equity-like exposure in favor of fixed-income assets with a goal to help lock in the funded status gains and defease the asset-liability mismatch risk. For those new to the DB pension industry, one thing to learn from the recent years' market experience is that the long-dated interest rate is one of the main drivers of risk in liability values. In our view, this is an uncompensated risk and most of it should be hedged as part of an asset allocation strategy.

Historical funding levels, interest rates, and equity returns



As of December 31, 2024. Source: Principal Asset Management, S&P 500, Milliman Pension Surplus/Deficit.

New environment, new toolkit

We recognize that not all pension plans are built the same in terms of their liability structure, sponsor's risk appetite, investment/risk management objectives, and governance structure. It's critical to understand a plan's circumstances and develop a custom liability-driven investing strategy that's based on their specific requirements and objectives.

The first level of investments needed to develop a custom LDI strategy are high-quality public market credit and risk-remote assets, such as Treasury bonds, STRIPS, and interest rate derivatives. These instruments can be structured to mimic the risk exposures of the liability term structure. This toolkit can be further enhanced by taking the "blunt" credit strategies and breaking them down by maturity buckets to enhance the overall fit between assets relative to the plan's liability stream.

After a plan has allocated a significant amount of its hedging assets to a public market credit portfolio, a second level of investments to consider are additional high-quality esoteric fixed-income assets. These include (but aren't limited to):

1. Private Investment Grade Credit
2. Commercial Mortgage Loans
3. Non-Agency Collateralized Mortgage-Backed Securities

These fixed-income securities are typically issued across the term structure but may have more appeal around the 10-year maturity mark given the yield and overall size of the issuance there. Therefore, a portfolio of these securities can be augmented effectively into an LDI framework that can typically uplift the overall quality of the LDI strategy without sacrificing its efficacy.

Learn more about the new investment considerations

PRIVATE INVESTMENT GRADE CREDIT

The private investment grade (IG) credit market, also known as private placements, is comprised of unregistered bond offerings to small groups of qualified investors. The private credit market is an extension of the public IG corporate bond market. The market is approximately $750 billion to $1 trillion in size, and issuances are mainly by middle market companies (approximately equivalent to $1-$5 billion market capitalization), some being large multi-nationals, and by both privately owned and publicly traded companies. Typically, up to 50-60% of the issuers are domiciled outside of the U.S., with about 80% of the market issuance denominated in U.S. dollars. Historically investors in private placements have been insurance companies and large asset managers. More recently private placements have seen increasing interest from pension funds and LDI portfolios.

Private Investment Grade Credit can offer several benefits for LDI strategies, including:

- Incremental yield potential over public bonds
- Covenant protections
- Improved recoveries in distress
- Diversification away from the public bond market

COMMERCIAL MORTGAGE LOANS

Core commercial mortgage loans (CMLs) are private, direct investments in senior debt secured by apartment, industrial, retail, office, and other types of income-producing real estate. Individual investments typically are not rated by public ratings agencies, but investment managers frequently assign credit ratings to individual CMLs based on each investment's credit metrics relative to historical asset class performance, with investment grade credit ratings of AA through BBB+ common for core CMLs.

Core CMLs can offer LDI investors several primary benefits:

- Attractive credit risk profiles, with multi-tenant properties providing diverse sources of repayment and high-quality collateral significantly reducing losses sustained after defaults
- Appealing relative value, with core CMLs frequently offering spreads 30-70 basis points greater than corporate bonds of comparable credit quality and tenor
- Attractive current income returns, considering the relatively large coupon component of core CML total returns
- Limited correlation of returns with other fixed-income asset classes
- An ability to tailor terms to help meet specific portfolio needs
- Effective call protection, with yield maintenance requirements standard in the market

NON-AGENCY COLLATERALIZED MORTGAGE-BACKED SECURITIES

Commercial mortgage-backed securities (CMBS) are bonds secured by first mortgages from commercial real estate properties located across the U.S.. The sector spans real estate and fixed income as the public market counterpart to investing in private commercial mortgage loans. From a fixed-income perspective, CMBS falls within the broader structured product universe as a component of the Bloomberg U.S. Aggregate Index. There are several different types of CMBS with fixed rate conduit CMBS being the most likely fit within a LDI framework with opportunities for 10-year durations, strong pre-payment protections, and diversified credit profile.

CMBS can offer three primary benefits for LDI investors:

- Yield enhancement is derived from the excess credit spread that CMBS offers relative to corporate bonds of similar duration and rating. This yield pickup can offer substantial as CMBS bonds from AAA to single-A can potentially out-yield corporate bonds rated at least a couple full ratings notches lower.
- Diversification complements yield enhancement as CMBS correlations vs. fixed-income alternatives are historically less than 1.0. Very high quality, lower yielding index-based CMBS strategies may offer less diversification, while more credit-oriented strategies may offer higher yields and lower correlations.
- Alternative credit exposure lies in the fact that CMBS are ultimately secured by commercial real estate properties. CMBS provides efficient and highly diversified access to real estate debt exposure without long investment ramp up periods or high commitment amounts.

Key characteristics

	Public market IG credit	Private market IG credit	Commercial mortgage loans	Non-agency CMBS
YIeld-to-worst	5.3-5.4%	5.5-6.0%	5.7-6.4%	5.8-6.5%
Liquidity	High	Low	Low	High
Average credit quality	A-	A-/BBB+	A/A-	A/A-
Covenant strength	Weak	Strong	Medium	Strong
Diversification vs. Public IG	—	✓	✓✓	✓✓
Attractive maturity points	5–10 year	7–15 year	5-, 7-, 10-year	5-year, 10-year
Prepayment option	None	None	With yield maintenance	None

As of December 31, 2024. Source: Principal Asset Management. For illustrative purposes only. Not intended to predict actual results.Greater number of ticks denotes better diversification against public IG.

Merits of adding these asset classes within the LDI framework can include:

- Improved diversification of the overall portfolio.
- Higher yield potential of the overall portfolio reflecting some illiquidity risk and some market dislocation.
- Private IG historically has had better convent protection given the terms negotiated bilaterally relative to public IG.

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Risk considerations

Investing involves risk, including possible loss of principal. **Past Performance** does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the **investment and the income** from it will vary and the initial investment amount **cannot be guaranteed**. **Fixed income investment options** are subject to interest rate risk, and their value will decline as interest rates rise. Potential investors should be aware that **Investment grade corporate bonds** carry credit risks, default risk, liquidity risks, currency risks, operational risks, legal risks, counterparty risk and valuation risks. Fixed-income options that invest in **mortgage securitie**s are subject to increased risk due to real estate exposure. **Private credit** involves an investment in non-publicly traded securities which are subject to illiquidity risk.

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MM13328-01 | 02/2025 | 4129506-022026