



2022 MID-YEAR

Global investment outlook

OUR SPECIALTY MANAGERS



CRESCENT





A letter from Steve Peacher

On behalf of SLC Management, I'm pleased to present our first-ever mid-year investment outlook for 2022. This report includes our macroeconomic views for the rest of the year, as well as our expectations for public and private fixed income, real estate, infrastructure, insurance asset management, and retirement plan solutions. Our investment professionals across SLC Management, BentallGreenOak, InfraRed, and Crescent Capital are specialists in their respective asset classes, and are uniquely qualified to provide specific, actionable insights across this diverse range of traditional and alternative investments. We've asked them to reflect on what surprised them so far in 2022 and what clients and consultants should be thinking about during the rest of the year ahead.

From an economic standpoint, 2022 has already been a year of both challenges and opportunities. Inflation has become a critical issue globally, and particularly in the U.S. Against that backdrop, we expect the Federal Reserve (Fed) to continue to increase the federal funds target rate multiple times during the year. This will have important implications for fixed income markets, as will the Fed's continued tapering of its asset purchase program. Markets have already priced in significant rate rises and this is beginning to create more attractive entry points into many fixed income asset classes than we have seen in a number of years. In addition, surging inflation and rising interest rates have already begun to create headwinds for public equity markets and other assets that are particularly sensitive to the interest rate cycle.

As Einstein once wrote, "In the midst of every crisis, lies great opportunity." We believe this sentiment is particularly true for investors who are willing to adhere to a disciplined, long-term investment strategy. Over time, financial markets tend to reward investors who can endure unexpected periods of volatility and remain committed to their financial objectives. Our role as an investment manager is to walk that sometimes challenging path with you, and to offer as much guidance and insight as we can along the way.

The COVID-19 pandemic and the sudden emergence of hostilities in Europe have made the past two years one of the most difficult periods in our country's history. The war in Ukraine has created a political and humanitarian crisis in Europe on a level not seen since the second world war, and as of this writing, the outcome of the conflict remains very much in question. Nevertheless, the Ukrainian people, the U.S., NATO, and many others remain committed to countering Russian aggression and restoring peace in Europe. Our thoughts are with the Ukrainian people at this difficult time.

Despite this, U.S. financial markets have remained resilient—sometimes stunningly so. While geopolitics and unexpected crises may yet produce more adversity for investors, we expect that the U.S. economy and the American people will meet any new challenges with calm determination. As your investment partner, we are honored to continue this journey with you, and we look forward to serving you in 2022 and beyond.

Sincerely,
Steve Peacher
President, SLC Management



Macroeconomic outlook

Inflation and geopolitical unrest are having a domino effect across global economies. The onus is on central banks across the globe to deliver a soft landing.

The biggest surprise from last year was the resilience of the global recovery. Massive monetary and fiscal support fortified demand and as a result inflation surged to forty-year highs in some regions. And that sets the table for the one of the biggest challenges for this year – containing inflation without igniting a hard landing.

Across developed markets, unemployment rates are close to pre-pandemic levels and expecting more gains this year. Given this robust recovery and uncomfortably high inflation, most major central banks are aggressively hiking rates.

Broad economic indicators suggest we are in the middle of the business cycle, but recession fears are rising. The war in Ukraine, spiking energy and food prices, and a potential slowdown in Europe and China’s activity via more COVID lockdowns are all weighing on growth and markets. Granted, not much of what has happened over the last several years is well aligned with textbook cycles. However, many economic prediction models, including our own, continue to see major economies well positioned for job creation and solid growth. But the war in Ukraine and China’s faltering growth are creating volatility, resulting in choppy markets.

Geopolitical risk is up but allies are unified

As the war in Ukraine intensifies and the humanitarian crisis grows, the U.S. and its allies have dramatically cut economic ties with Russia. There has also been a surge in western companies voluntarily pulling back from the region in protest.

Russia is becoming isolated as access to the global trade and financial system gets curtailed. The U.S. and its allies hope their portfolio of targeted sanctions brings a quick end to the human toll. While it is difficult to forecast how long it will take to reach a truce, global pressure remains intense.

Inflation pressure has yet to peak

Last year, across most economies, high inflation was expected to quickly fade as supply chains repaired and global demand switched from goods to services. But that has been slow to happen and with Russia’s invasion of Ukraine, and resulting sanctions, disruptions to energy and food supply intensified inflation pressure.

Those war related price spikes are now abating. Oil prices are back to preinvasion levels and global food prices, tracked by the United Nations FAO Food Price Index, are also reverting to beginning of year levels.

A measure of global chain stress, compiled by the New York Federal Reserve, is down significantly from the beginning of the year although still above pre COVID levels. In the U.S. prices paid by supply managers for goods and services has come off the boil. There will be some lag until these effects show up in everyday prices, but inflation pressure appears to be abating.

Central banks remain resolute

In most regions the persistent pace of inflation is compelling central banks to be aggressive. The Fed, the Bank of Canada and the Bank of England continue to execute on their tightening plans. The European Central Bank is expected to start raising rates at its next meeting.

Japan continues to be the only major central bank wedded to low rates and continuing asset purchases as it struggles to get inflation back to target.

Delivering a soft landing

Global financial conditions have noticeably tightened this year as central banks scale back. Inflation needs to be contained but arresting it without killing growth will take some maneuvering. History suggests these episodes don’t end well. On average a recession ensues approximately two years after the start of a tightening cycle.

Fortunately, across most developed economies labor markets are in good shape, household savings rates are high and corporate balance sheets are solid. *While we are starting from a strong place, it still requires deft central bank management and communication to deliver a soft landing over the next twelve to eighteen months.*

The opening salvo from central banks has resulted in rising bond yields and slumping equity prices as companies adjusted their view of growth, borrowing costs and the impact on earnings. This has resulted in volatile markets, which is likely to continue until markets are convinced that inflation has peaked.



Dec Mullarkey
Managing Director, Investment Strategy
and Asset Allocation, SLC Management

Fixed income: investment grade

Fed tightening will likely have a broad impact across fixed income markets. Investors must be prepared for higher rates to weather the cycle.

Inflation and the Fed prompt volatility and rising rates

Rising interest rates in 2022 reflect a combination of a retracement of the drop-in rates coinciding with the Covid shutdown, anticipatory increases in short term rates based on Fed tightening and current inflation figures. We view price increases as supply chains not keeping up with demand for goods, pushing prices higher rather than as a monetary phenomenon. In anticipation of the Fed’s more aggressive stance, short term rates already reflect likely Fed actions. And more interesting, the dollar has rallied aggressively. Historically inflation spikes in the U.S. have receded as the economy has adjusted to business and consumer demand, but this healing may take time.

Interest rate volatility and Fed expectations domestically as well as geopolitical uncertainty will drive risk assets going forward.

Tightening policy likely to affect all fixed income markets

In 2022, with the specter of Fed tapering and additional rate hikes on the horizon, many suspect “the game might no longer be played in easy mode.” While SLC Management does not focus on making macro and duration-based calls in our portfolios, we do expect that Fed tightening will impact every aspect of the fixed income market, from higher short-term rates and a flatter yield curve to wider spreads and more volatility. The question some investors have is: should we buy the dip in risk assets as has worked in the past or is this just the beginning of a steeper selloff come the fall?

Inflation outlook

It is important to note that inflation returning to normal levels after a surge of 7% does not mean that prices have returned to normal, as they have now simply compounded at a normal rate from an elevated platform. For prices to “truly” return to normal (e.g., the trajectory from 2019), there would need to be a period of deflation. While that is not what we are predicting, lower oil and commodity prices along with a de-escalation of the war in Ukraine would contribute to lower prices for most goods and services. In a sense the Fed has already done its job with short term rates moving higher and the dollar trading at levels not seen in 20 years versus a basket of currencies.

Considerations for clients and consultants

As plan sponsors and consultants position for 2022, the key is to be prepared for higher rate levels if they happen. For corporate pension plan sponsors this might mean having a glide paths in place to help lock in funded status gains, as higher rates could be fleeting. For non-liability-focused clients, short duration and floating rate assets might be the best performers. Similarly, with inflation easing and real rates rising, TIPS will likely underperform. Lastly, in a risk-off environment with more volatility, active management becomes more important as performance between stronger and weaker names diverges.



Rich Familetti

CIO U.S. Total Return Fixed Income,
SLC Fixed Income



Fixed income: below investment grade

Interest rate hikes prompted inflows into floating rate bank loans and significant outflows from fixed rate high yield bonds. While credit fundamentals are strong, continued geopolitical unrest and potential central bank missteps remain key risks.

So far this year, investors faced several headwinds, including Russia’s invasion of Ukraine, rising inflation in the U.S. and higher oil prices, triggering major losses across the board in equity and fixed income markets. Many investors are looking for an entry point to get back into U.S. high yield and corporate debt. The Federal Reserve raised the Fed Funds rate by a quarter point in March, the first rate hike since 2018, and followed with a half-point hike in May and three-quarter point hike in June. U.S. Treasury yields moved higher during the first half of the year, as did bank loan and high yield bond yields. Floating rate bank loans attracted massive inflows in the first half of 2022, as fixed income investors sought relief from rising interest rates that penalized fixed rate bonds. Fixed rate high yield bonds had significant negative fund flows so far in the first half of the year. The lack of demand and economic headwinds suppressed issuance which was a quarter of the previous year for high yield bonds and 39% of the previous year for bank loans. Default rates remain well below their historical averages.

Outlook

We see a repositioning opportunity as the current sell-off has knocked the average bond price down over 16% since the start of the year. The par weighted average dollar price of the Index was \$85.62 on June 30, presenting a good entry point based on historical experience. *Credit fundamentals remain positive. In 2022 we expect borrowers to continue to exhibit revenue and cash flow growth, resulting in declining leverage ratios*

and continued credit default rates near record lows. At the same time, we expect interest coverage to peak as rates (and floating coupons) are rising. Solid balance sheet liquidity combined with pent up demand for services should fuel a corporate ratings upgrade cycle if inflation begins to ebb in the second half of the year. Credit spreads appear fairly valued in light of expected benign defaults. We see heightened inflationary pressures and higher interest rates persisting through the first half of the year, leading to tightened financial conditions.

The Fed has all but acknowledged they are behind the curve. Bond and loan coupons are expected to rise to multi-year highs by early 2023, potentially resulting in elevated refinancing risk for low-rated, vulnerable borrowers. As a result, we prefer single-B and double-B credits. Key risks to our view include central bank policy missteps and geopolitical conflicts.



John Fekete

Managing Director, Head of Capital Markets,
Crescent Capital Group



Private credit: investment grade

Investment grade private credit continues to see inflows despite economic uncertainty. A shift in investor profile has impacted the types of deals and access available to investors, but unique opportunities are expected throughout the balance of the year.

The Investment Grade Private Credit Market: continued strength likely, with some caveats

The Investment Grade Private Credit (IGPC) market has had a strong first half of 2022 with year-to-date volume ahead of 2021. The IGPC market has shrugged off, at least for now, the Ukraine war, skyrocketing energy prices, geopolitical tensions, inflation, and rising Treasury rates, which is in line with our market's reputation of willingness to underwrite through uncertainty.

Why are investors in this asset class willing still active in an uncertain market? There are a number of reasons:

- A lengthy due diligence period which allows investors to better underwrite the long-term trends and competitive advantages of the issuer
- Structures with covenants and often times security which can be customized to a credit
- A pricing premium to comparable public bonds

While long term investors have been comfortable putting capital to work, we have heard that some issuers have postponed deals due to market volatility and some structured deals have been modified to account for higher interest rates.

Since the beginning of the pandemic, within the IGPC market we have been struck by the rapid growth in financial sector issuance (particularly from investment managers) and the changing profile of private fixed income investors, largely from insurance companies, to include asset managers and alternative credit investors with large investment capacity. This has had a strong impact on how deals are executed as transactions are completed with fewer investors.

Over the last two years financial sector issuance has more than doubled, driven by a four-fold increase in investment manager issuance. The flexibility and confidentiality of our market, as well as low interest rates, have all contributed to the growth in this sector. We expect that financial sector and investment manager issuance will continue to be strong for the balance of 2022.

The shift in investor profile has created more demand from larger investors, making allocations more difficult, but has also positively impacted our market's ability to complete larger deals, in some cases with fewer investors. While investor capacity has increased — driving larger deals to the market —larger, sophisticated investors are also attracting more complex transactions across sectors and structures.

An active market with a strong deal pipeline for H2 2022

Our market has been open and active throughout 2022 and we expect that to continue through the balance of the year. We remain focused on achieving our relative value targets. As public spreads widen, we will likely have fewer opportunities as the private market responds slowly. However, this market will allow investors willing to do heavy underwriting unique opportunities. We expect to see attractive opportunities in sectors such as asset managers, infrastructure, and credit tenant leases. We continue to see value in less competitive, bespoke transactions where we can leverage our strong origination platform, sector expertise and longstanding relationships to maximize allocations.

Considerations for clients and consultants

As we move further into 2022, some issues that investors in investment grade private credit should be thinking about include:

- Access to deals and getting reasonable allocations
- Finding reasonable relative value as supply struggles to keep up with demand and as our market pricing lags public bonds during volatility
- Maintaining a long-term investment horizon during a rising-rate period



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Private credit: below investment grade

Well-sourced and vetted private credit opportunities remain an attractive investment.

Strong opportunities for private credit

Private credit is well positioned to capitalize on compelling investment opportunities generated by volatility and dislocations in the public markets. Periods of dislocation will further accelerate the long-term secular shift towards private credit as the asset class continues to gain significant market share from syndicated public markets.

We believe the best tool to navigate today's extraordinary period of transition is what has worked through prior cycles: disciplined, bottom-up credit underwriting with a focus on capital preservation, strong free cash flow generation, and robust debt-service coverage. A broad and deep origination franchise with a long operating history and significant pipeline of new deals allows a manager to be highly selective and invest only in what they believe to be the best credits.

Strong diversification by end market, geography, and borrower should allow a private credit portfolio to not only weather supply-chain disruptions, labor shortages, and inflationary pressures, but should also help generate the higher absolute and risk-adjusted returns that private credit investors have come to expect.

Monetary policy and interest rates


Since private credit portfolios are typically comprised of floating-rate debt securities, rising rates will accrue to the benefit of the lender. Conversely, high rates will have a burdensome effect on borrowers. Increases in interest costs will result in lower free cash flow and subsequently lower interest coverage and fixed-charge coverage ratios. Each new investment opportunity needs to be evaluated in the context of a rising-rate environment with multiple downside scenarios examined to determine the effects on creditworthiness.

Supply chain and labor


Global supply chain disruptions and shortages have been well documented and continue to persist. This means sourcing parts and components could still be challenging, thereby increasing the cost of raw materials and inputs and affecting companies' ability to deliver their products on time and to generate growth. In addition, a borrower's ability to attract, develop, incentivize, and retain talent is a key element for success. Overall, building in potential supply chain disruptions, wage inflation, and their subsequent impacts to margins and top-line growth should be routine in modeling and evaluating downside scenarios today.

Inflation

Against this backdrop, the persistent challenges in manufacturing and shipping goods to customers as well as hiring and retaining talent have continued to fuel rising inflation. Market leaders with longstanding customer relationships that produce mission-critical goods or services should have the ability to pass through cost increases. They can point to their critical nature and value-add to be able to justify higher prices. Oftentimes, the ability to raise prices due to increased input costs is specified in contracts, and other times it is dependent on the management team's ability to negotiate with its customers. Assessing both contracts and management strength is critical when evaluating an investment opportunity.



Chris Wright
Managing Director & Head of Private
Markets, Crescent Capital Group



Chris Wang
Managing Director, Credit
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Real estate

While economic conditions are providing continued support in the rental market, challenges persist in office space. There is a steady recovery in retail real estate and a boon in industrial real estate as well.

The U.S. economy has recovered from the COVID-19 pandemic but faces headwinds due to high inflation and tightening monetary policy. Consumers remain healthy with significant excess savings and the strong labor market is supporting wage growth. Job openings are dramatically higher than the available supply of labor. We believe that inflation will remain persistently high in the near term, prompting the Fed to steadily raise the federal funds rate. Consensus expectations are for the economy to continue to expand, albeit with downside risks.

In residential real estate, we anticipate that prohibitively high home prices, a limited supply of housing, and strong demand will continue to support the rental market. As of December 31, 2021, RealPage data showed a 14.4% year-over-year increase in national rental rates, and among the 50 largest markets, none experienced year-over-year rent declines. At the same time, 12 of those markets had growth of 20% or more, and not surprisingly, many of those markets were in Texas, Florida, and Arizona (i.e., the states with the largest population gains from 2020 to 2021). We expect these trends to continue in 2022 as more Americans return to the workforce, particularly those in the 18–34 age range.

Office real estate remains challenged by the effects of the COVID-19 pandemic as many workers have yet to return to traditional office environments. Still, demand for unique, high-quality office space that caters to creative and collaborative knowledge workers remains high. We also see medical offices and life science buildings as strong alternatives for investment. Overall, we do not anticipate a significant revaluation of the office sector in 2022. While office investment rose 57% in 2021, according to RCA, considerable risks remain, and we expect that these risks will create opportunities to buy mispriced assets in the years ahead.

Retail real estate continues to benefit from U.S. economic growth and the easing of COVID restrictions, and we expect that merchants and investors will slowly increase their interest in the sector this year, albeit with a high level of selectivity based on location and asset type. The continued increase in e-commerce represents a headwind for the sector.

On the other hand, the continued growth in e-commerce has been a boon for industrial real estate, which returned more than 43% in 2021, as measured by the NCREIF Property Index. Other factors have pushed up demand for industrial real estate as well, such as the need for cold storage, data centers, and advanced manufacturing. Specific considerations for layout, clear-height, power availability, and slab specifications (among other factors) greatly limit supply for certain users, while increased automation within logistics facilities also enhances the need for modern buildings. With e-commerce adoption still in its early stages, and with demand for U.S. industrial production increasing, our outlook for the sector remains very strong.

Along with these trends, decarbonization will play an important role in the U.S. real estate market in 2022 and beyond. As more companies and consumers push toward net-zero emissions, real estate properties of all kinds will be pressed to reengineer the way they operate. This will be especially true in the U.S., which generally lags the European Union in adopting and achieving low-carbon targets.



Paul Briggs
Managing Director, Head of U.S. Research,
BentallGreenOak

Infrastructure

Demand for infrastructure investments will likely increase across both traditional and non-traditional projects, but investors should be aware of supply chain constraints.

Infrastructure is designed to be a resilient asset class, but even so we were surprised by its performance during the extraordinary events of the ongoing pandemic. Broadly speaking, infrastructure returns have been much less volatile than those of publicly traded equities or fixed income, and core infrastructure has been especially resilient. This is due in large part to the quality of its cash flows.

The speed with which more technologically advanced infrastructure has begun to roll out was surprising as well. This includes projects such as fiber optic cable and data centers intended to support broadband connectivity. In addition, we were surprised by the degree of political consensus around improving infrastructure in the U.S. and Europe. While economic policies can be politically divisive in the U.S. and Europe, the need to improve infrastructure through renewed investment seems to have been an exception and is widely accepted as a way to stimulate growth and accelerate recovery.

Finally, we were surprised by the degree of institutional interest in infrastructure as an asset class. Although we expected this interest to increase in 2021, the degree of institutional demand still exceeded our expectations. This increase is likely due in part to the fact that infrastructure assets tend to provide a strong hedge against inflation.

A positive outlook for infrastructure

From a return standpoint, we believe that the global macroeconomic environment will be favorable to infrastructure investments, and we expect infrastructure assets to be less volatile than most other asset classes. Generally speaking, we expect that the infrastructure equity risk premium will decrease as risk free rates normalize over time. We also expect that infrastructure assets will continue to provide a strong hedge against inflation, which will likely lead to greater institutional demand. The first few months

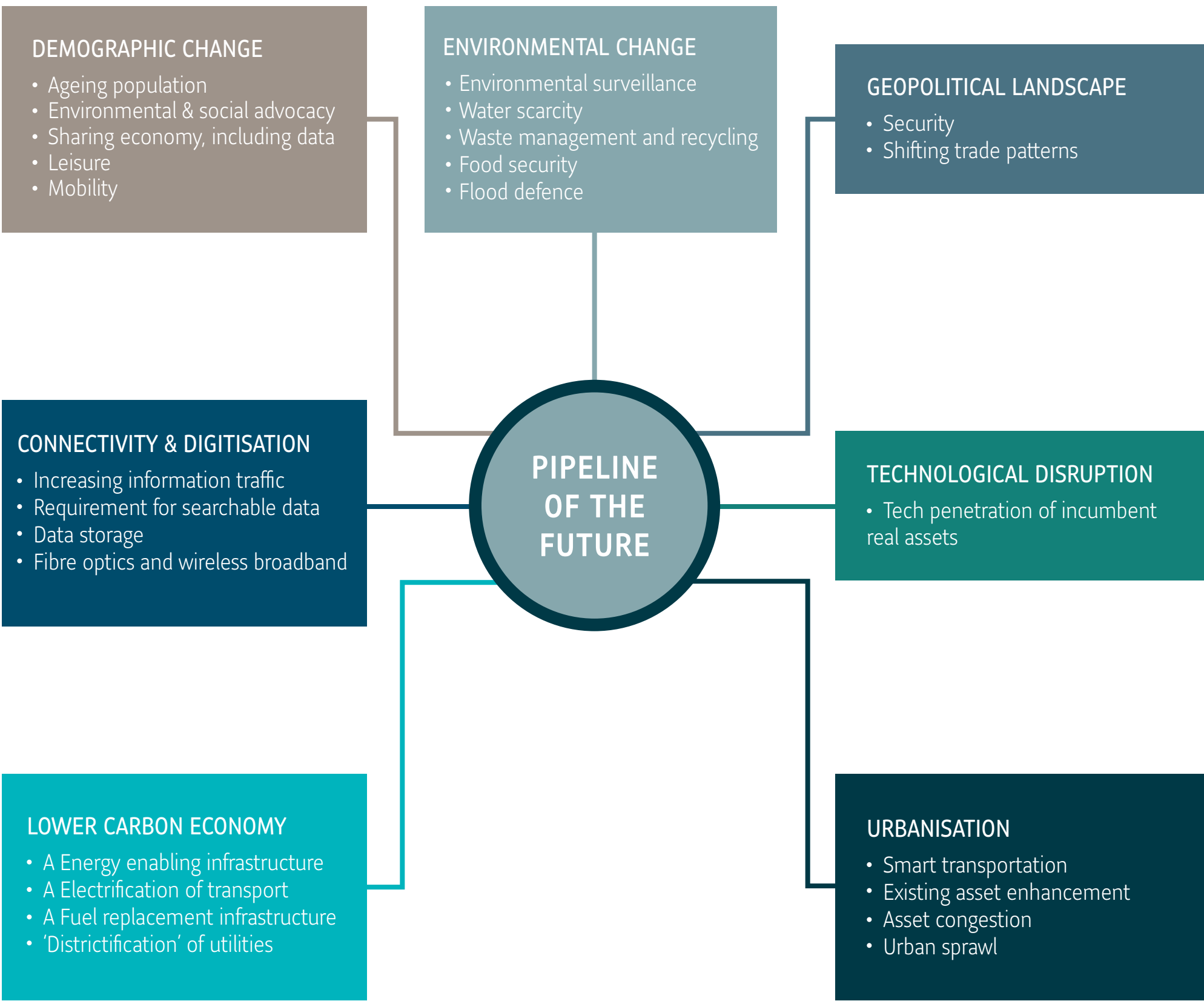
of 2022 have confirmed the pressing need for institutional investors to implement a revised asset allocation to mitigate unprecedented levels of inflation (as an example, inflation may hit a new 40-year high in Germany of 8 per cent).

While we anticipate that demand for core infrastructure investments will remain strong, we also expect greater emphasis on the development of less traditional infrastructure projects, including wind, solar, energy storage, green mobility, and digital infrastructure. This is particularly true in Europe and North America. Notably, many of these projects will benefit from continued government stimulus and a greater emphasis on net zero emissions. The trend to support net zero ambitions through clean energy is likely to further accelerate in Europe on the back of the geopolitical requirement of energy security and long-term energy independence.

Supply chain issues and portfolio allocations should be closely monitored

We would advise clients and consultants to stay informed of the ongoing supply chain issues in the U.S., which will likely continue to foster inflation and disproportionately affect the development of more advanced infrastructure projects with complex international logistics. Given that we expect both inflation and market volatility to continue to increase in 2022, we would also suggest that clients carefully consider their infrastructure asset mix and ensure that their portfolio is sufficiently diversified. More specifically, we would advise clients to assess whether their portfolio mix will provide the kind of inflation hedging that investors typically seek from infrastructure investments. Manager selection and asset quality are, of course, essential in allowing clients to achieve their objectives, so we would encourage clients to review each of these factors carefully.

As society continues to be shaped and influenced by the powerful mega-trends set out on the diagram below, so too will its infrastructure requirements. Increasingly the infrastructure market will evolve in line with these themes, creating a subset of attractive core infrastructure investment opportunities across the 'modern economy'.



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Director, Infrastructure,
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Edward Hunt

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Insurance asset management

Insurance company portfolios have taken a hit on both sides of their balance sheets due to high inflation and rising interest rates so far in 2022. Higher reinvestment yields, a comeback for tax-exempt municipal bonds, and opportunities in alternatives can provide a silver lining for investors.

A tough 2022 so far for insurers with inflation hitting both sides of their balance sheets

High inflation and the resulting rise in interest rates in 2022 have had a negative impact on insurance companies on both sides of their balance sheets. On the liability side, higher than expected inflation has produced higher claim costs than what was priced into the policies, which has translated into elevated loss ratios. On the asset side, the majority of insurance company investments are held in bonds, and the dramatic rise in interest rates has led to the worst year-to-date bond market performance on record, putting a dent in the market value of insurance company investment portfolios.

However, there is a silver lining: higher reinvestment yields

Unlike equity markets, in the bond markets there is a silver lining that comes with the negative returns we've seen thus far this year, and that is higher reinvestment yields. For most of our insurance company clients, they are happy with that tradeoff for two reasons:

- 1. the higher reinvestment yields will lead to a greater amount of investment income going forward, and*
- 2. for those companies who utilize statutory accounting, the negative price movements have not flown through surplus since bonds are carried on the balance sheet at amortized cost.*

This means that the rise in rates has resulted in a positive impact on the income statement with no negative impact to the balance sheet. In turn, many companies have reached an inflection point in their book yield after years of decline.

All that said, the negative total return performance does matter for companies who have weaker cash flow from operations and may need to sell bonds to generate funds to pay for claims or expenses, as those bonds sales will likely result in realized losses which negatively impacts surplus.

Core bond portfolios: positioning for continued volatility ahead

With the Fed committed to curtailing growth in the pursuit of lower inflation, we're likely looking at a challenging environment for the U.S. economy over the near term. Against that backdrop, core fixed income investment

focus is up in quality and up in the capital structure. Structured products, like AAA and AA rated asset backed securities and commercial mortgage-backed securities, check both of these boxes. Collateralized loan obligations (CLOs) do as well, with the added benefit of possessing floating rates, which largely provide protection against rising short-term rates.

Lastly, tax-exempt municipal bonds are starting to look attractive again for the first time since before tax reform several years ago. The first quarter selloff resulted in tax-exempts offering comparable value to similarly rated taxable alternatives, and the higher overall yields increased the value of the tax multiplier enjoyed by investors in this asset class. Furthermore, municipals are defensive and generally hold up well during economic slowdowns, especially today with many municipalities having built up strong surplus positions over the recent past. The combination of improved relative value and strong fundamentals should create investment opportunities going forward.

Nontraditional assets gaining increasing interest in this environment

Prior to the recent spike in rates, alternative asset classes were generating increased interest from insurance company investors in their search for yield. While that's still the case, many investors are now also intrigued by how some of these asset classes perform during periods of rising rates and inflation.

Within fixed income, leveraged loans come with floating rates and typically outperform during these environments. Outside of fixed income, real estate, and infrastructure both offer good inflation hedges given their exposure to real assets. We expect to see increased allocations to these asset classes by year end.



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Managing Director, Client Solutions, SLC Management

Retirement plan solutions

Amid market volatility, pension plan sponsors are seeing their funded status climb. It will be important to revisit de-risking strategies and review opportunities to incorporate higher yielding alternatives.

2022, a good year so far for solvency focused pension plan sponsors

As we enter the summer months, the average funded status for U.S. corporate DB plans is hovering around 107%. This is about 9% higher than at the beginning of the year and close to 16% higher since the close of 2020. For almost all plans, the biggest driver has been a sell-off in both rates and corporate spreads fueled by central bank policy. This led to long credit yields breaching 5% in May, a level not seen since November 2018. Additionally, typical AA-rated corporate discount rates have increased by nearly 200bps since December 2020.¹

Funded status improvements typically drive de-risking from plan sponsors, either through risk transfer activity (we saw an estimated \$35 billion of pension buyout transactions priced in 2021 and we expect to see similar volumes this year) or by reallocating to assets that better hedge their liabilities. While we have seen some sponsors looking to lock in these historic funded status improvements, we still hear some concern from investors about the potential for further rate rises over the remainder of the year. It's worth remembering that markets have already priced in significant future rate rises and so the decision to sit on the sidelines is really about whether the investor believes rates will rise further or faster than the general market consensus, in our experience a difficult prediction even in less volatile times. While understanding that plan sponsors have very differing abilities to take risk in their plans, it does feel like a time when many have more to lose than to gain by keeping their chips on the table.

Increased uncertainty ahead

Volatility will likely persist through the remainder of the year as the Fed continues tightening the ultra-loose monetary policy set at the beginning of the pandemic and the war in Ukraine endures. We expect plan sponsors who have already made significant improvements in funded status to start to evaluate their asset allocation and hedging programs to ensure they do not reverse that progress. Many plan sponsors already have a de-risking glidepath in place that dictates flows from "growth" to "hedging" assets as funded status improves. In many cases, these were developed under very different economic conditions and so it may be a good time to re-evaluate the makeup of those

portfolios to ensure they remain optimal given the dramatically different environment we find ourselves in today. For those who are yet to put a de-risking plan in place, understanding what has contributed to funded status improvements to date and what drivers could cause future funded status volatility, can be a great starting point to re-evaluating the asset allocation strategy.

Plan sponsors are looking to diversify their liability-hedging portfolios

Historically, the Liability-Driven Investing (LDI) world has narrowly defined growth assets (typically equity-like investments) and hedging assets (typically investment-grade fixed income). This year we have seen more plan sponsors looking to the gray areas in between to build efficient asset allocations, and we expect this trend to continue. That broader spectrum of assets includes long-dated securitized credit, investment-grade private credit (IGPC), real estate debt, infrastructure, and other long-term yield-oriented investments. For most plan sponsors the majority of their assets are likely to remain in more traditional asset classes. However, the introduction of even a small allocation to alternatives can lead to significant improvements in expected returns while still maintaining a strong correlation to plan liabilities. Insurance companies have historically utilized alternatives to back long-term liabilities, and this has been a major contributing factor to the attractive rates available for pension risk transfer pricing. We have seen a similar evolution in LDI portfolios, as plan sponsors have adopted similar practices.

Private assets are becoming more popular, but vehicle choice is key

Investment-grade private credit can be an attractive option to hedge pension liabilities. In the last two years, we saw a number of the largest Outsourced Chief Investment Officer (OCIO) providers and plan sponsors add investment-grade private credit (IGPC) to their lineup, and we expect flows to accelerate in the remainder of 2022. Of the asset classes previously mentioned, IGPC is perhaps the most natural first extension of a liability-hedging portfolio given its high correlation to pension discount rates, attractive yields, and lower default rates compared to similarly rated public issuance. The challenge for many plan sponsors has been accessing this insurance-industry dominated asset class in a way that provides the required diversification and liquidity profile. Daily-

valued fund vehicles with enhanced liquidity are helping them achieve these goals.

Continued funding relief reduces pressure on plan sponsors

The American Rescue Plan Act of 2021 extended previous funding relief, smoothing and potentially deferring minimum required contributions for corporate plan sponsors. This short-term downside protection to cash contribution levels may have given plan sponsors more freedom to increase their allocations to growth-oriented assets. However, sponsors will need to consider the potential impact on both accounting results and Pension Benefit Guaranty Corporation (PBGC) premium levels. Similarly, many multi-employer pension plans stand to benefit from the Special Financial Assistance (SFA) program that aims to top-up underfunded multi-employer plans and nudge them toward a liability-driven investment approach. Given the significant impact of the SFA funds, as well as the restrictions attached, plan sponsors may want to revisit asset allocation decisions at a total plan level to ensure an efficient approach.



Tim Boomer

Senior Managing Director, Head of Client Solutions, SLC Management



End notes:

1. Funded Status for the current month is estimated and subject to change as final numbers are released. Data from reference Bloomberg Indices.

Disclosure:

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There is no assurance that the objective of any private placement strategy can be achieved. The principal risks associated with the Advisor’s private placement strategies are described as follows. As with any strategy, the Advisor’s judgments about the relative value of securities selected for the portfolio can prove to be wrong.

(1) Interest rate risk involves the risk that interest rates will go up, or the expected spread to the benchmark will widen, causing the value of the portfolio’s fixed income securities to go down. This risk can be greater for securities with longer maturities and the widening of spreads can continue for an extended period of time. (2) Credit risk is the risk that the issuer of fixed income securities will fail to meet its payment obligations or become insolvent causing the market value of the securities to decrease. Private placements are not rated by the credit rating agencies. Any ratings assigned to this debt is the product of analysis performed by the Advisor and or Advisor’s affiliates. (3) Liquidity risk is the risk that Advisor may be unable to sell a given security at an advantageous time or price or to purchase the desired level of exposure for the portfolio. At times this market has experienced severe illiquidity and/or significant price impacts. (4) Counterparty risk involves the risk that the opposing party in a transaction does not fulfill its commitments.

Investment grade credit ratings of our private placements portfolio are based on a proprietary, internal credit rating methodology that was developed using both externally-purchased and internally developed models. This methodology is reviewed regularly. More details can be shared upon request. Although most U.S. dollar private placement investments have an external rating, for unrated deals, there is no guarantee that the same rating(s) would be assigned to portfolio asset(s) if they were independently rated by a major credit ratings organization.

The relative value over public benchmarks estimate is derived by comparing each loan’s spread at funding with a corresponding public corporate bond benchmark based on credit rating. Loans that are internally rated as “AA” are compared to the Bloomberg Barclays U.S. Corporate Aa Index, loans rated “A” are compared to the Bloomberg Barclays U.S. Corporate A Index, while loans rated “BBB” are compared to the Bloomberg Barclays U.S. Corporate Baa Index. For certain power and utility project loans, a best fit approach of a variety of Bloomberg Barclays’ indices was employed prior to September 30, 2016. After this date, these types of loans were compared to Bloomberg Barclays Utilities A Index and Bloomberg Barclays Utilities Baa Index, for “A” and “BBB” internally rated loans, respectively. Relative spread values obtained through the above methodologies were then aggregated and asset-weighted (by year) to obtain the overall spread value indicated in the piece.

Unless otherwise stated, all figures and estimates provided have been sourced internally and are as of March 31, 2022. Unless otherwise noted, all references to “\$” are in CAD dollars.

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