The Impact of Rising Rates – LDI Client Update

For most plan sponsors, 2022 has been a story of funded status improvements as the sharp rise in interest rates led to higher discount rates and lower present values for pension liabilities

- The average corporate pension's funded status is up 9.1% since the beginning of 2022 and over 16% since 2021, reaching its highest level since 2001.
- Year-to-date, the yield on the 10 year Treasury has skyrocketed by nearly 200 basis points (bps), resulting in a roughly 22.5% drop in liabilities for the average plan.
- Despite a turbulent equity market, multi-decade high inflation and historic drawdowns in bond markets, higher liability discount rates have overwhelmed negative asset returns and spurred funded status improvements.

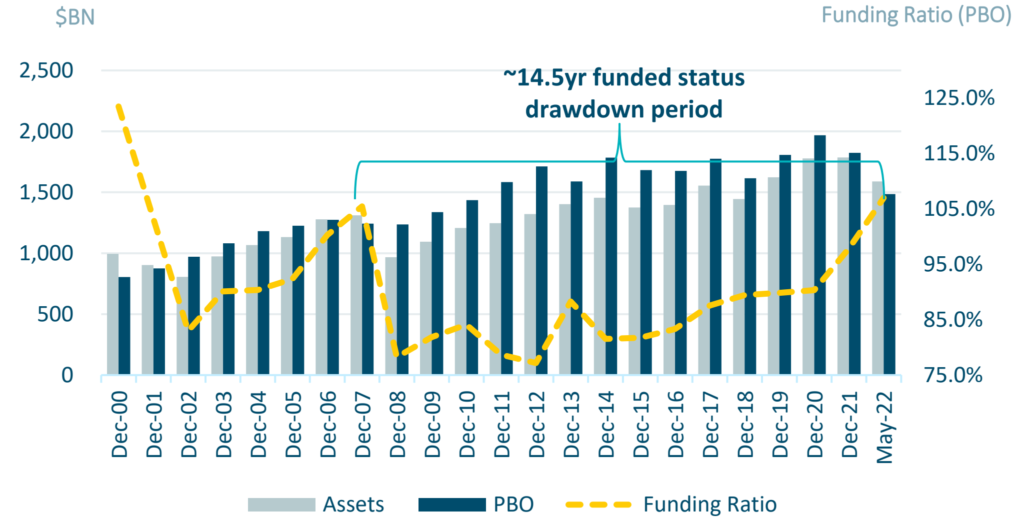
With funded status now at multi-decade highs, we believe all eyes should be on de-risking the plan to lock in those gains

- The last time funded status approached these levels in 2007, equity markets proceeded to fall by 37% in 2008 and funded status declined by over 27%. For the average plan, it took nearly 15yrs to regain those same funded status levels.
- While pension plans are in a different (and generally better) place today, it still serves as a reminder of the importance of having a de-risking plan in place, as funded status improvements can be fleeting and losses can take time to rebound from.

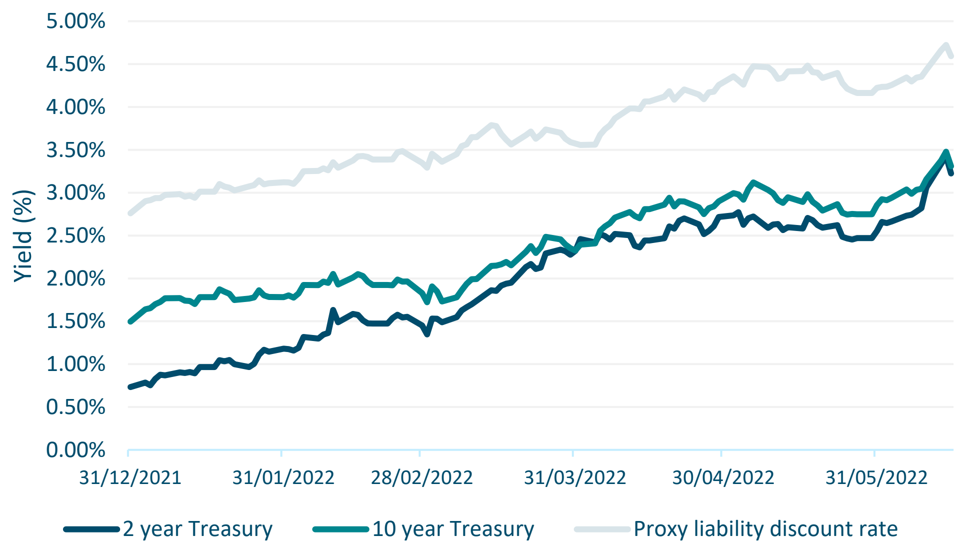
As sponsors weigh the decision to de-risk, consider diversification within the hedging portfolio

- Within traditional hedging portfolios, having long credit managers with different investment styles and low excess return correlation can improve portfolio diversification by providing alpha in different market environments.
- Additionally, we look at a few different ways plan sponsors can diversify their LDI portfolio with non-traditional hedging assets in the next section.

Milliman Pension Funding Index



2022 Interest Rate Environment



(1) Proxy liability discount rate: Bloomberg Long Aa Corporate Index
(2) Data as of 6/24/22

Three ways to diversify your LDI portfolio

1. Investment Grade Private Credit

- This asset class often comes with an excess yield to traditional corporate bonds while providing diversification within the broader LDI portfolio.
- Similar to corporate bonds, investment grade private credit has sensitivity to both duration and credit spread changes, making it a natural fit to hedge corporate liability discount rates.
- In addition to excess yield and diversification, investment grade private credit has historically had lower defaults and higher recovery rates versus their public counterparts due to stronger loan covenants embedded within the deals.

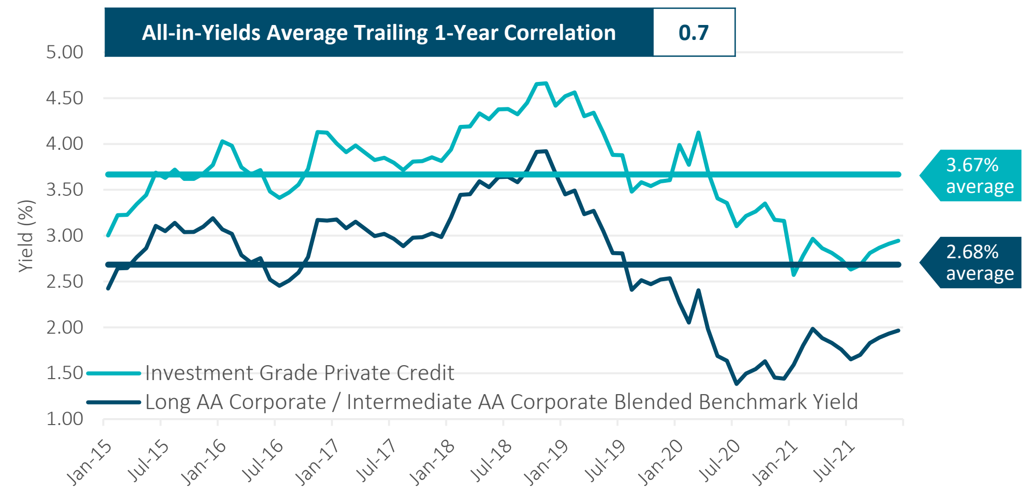
2. Securitized Fixed Income

- Securitized fixed income comes in many different flavors across the duration and credit spectrum.
- For those looking to hedge longer term liabilities, both collateralized mortgage obligations (CMO's) and commercial mortgage backed securities (CMBS) typically have longer dated cash flows with stable durations.
- Asset backed securities, which are typically geared towards consumer credit, are generally shorter in duration and can be utilized for plans looking to meet front end cash flows. These securities pay monthly income which makes them advantageous for liquidity purposes.

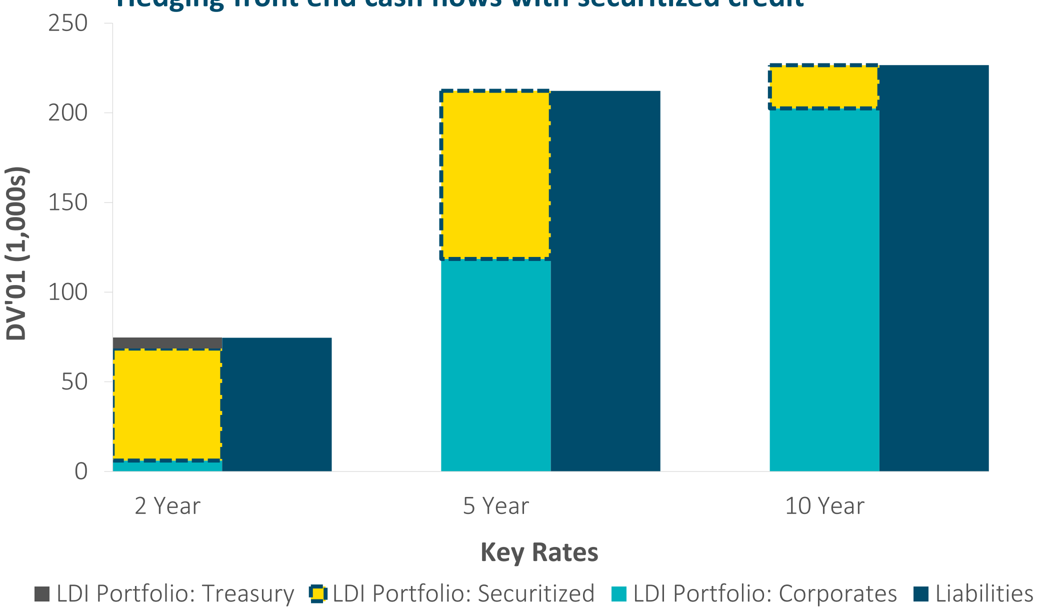
3. Real Estate and Infrastructure

- The long term nature of these assets coupled with stable income yields means they can align well with the cash flows of a defined benefit plan.
- For early stage plans with ongoing accruals or plans with cost of living adjustments included in the benefit structure, these assets can provide a hedge against inflation sensitive liabilities.

Private Credit yields exhibit high correlation to liabilities



Hedging front end cash flows with securitized credit



(1) Graph sources: Bloomberg, internal SLC data

The Impact of Rising Rates – LDI Client Update - Disclosures

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