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Pension Investing: The 2019 Rebalancing Dilemma

Sponsors of corporate defined benefit (DB) plans face a quandary. Traditionally, bouts of volatility have presented opportunities to rebalance allocations to stocks and bonds. But last year was unusual – stocks and bonds both fell. With sponsors unable to lock in significant fixed income gains, selling bonds now to buy equities is less appetizing. Instead, different approaches, including equity overlays and sitting tight, may offer the best solution in 2019.

What a difference a year can make! After a calm 2017, last year's markets turned volatile, leaving DB plan sponsors with difficult rebalancing decisions.

The first quarter of 2018 set the tone. In January and February, the S&P 500 sold off more than 10% over a 10-day period on the back of inflation fears and rising rates. In contrast, at no time in 2017 did the index experience a drawdown exceeding 5% – a first since the global financial crisis.

The volatility in 2018 was extraordinary. It saw both the largest one-day downswing (in Q1) and the largest one-day upswing (the day after Christmas) for the Dow Jones Industrial Average since its inception in 1886. For the year, large caps (S&P 500) and small caps (Russell 2000) ended down 4.4% and 11%, respectively, fixed income (the Bloomberg Barclays US Aggregate Index) was flat while cash, represented by the FTSE 3 Month T-Bill Index, finished up 1.9%. Cash had not outperformed both equities and bonds in a calendar year since 1994. Most notably, long Treasuries failed to hedge the volatile equity journey. The Bloomberg Barclays US Long Treasury Index ended the year down 1.8% and the Bloomberg Barclays US Treasury STRIPS (20+ year) Index finished down 4.1%.

THE 2019 DILEMMA

These drawdowns make for difficult decisions this year for DB plan sponsors, who typically rebalance toward asset allocation targets after significant bouts of volatility. In prior episodes of large equity market drawdowns (exceeding 15% from peak to trough), Treasuries returned handsomely, making the decision to rebalance from fixed income to equities straightforward. In 2010 and 2011, during the euro debt crisis and U.S. debt downgrade, the S&P 500 plunged 17.1% and 21.6%, while long Treasuries returned

11.9% and 29.5%, respectively. In other words, during those episodes investors got a great bang for their rebalancing buck: They could lock in significant Treasury (or fixed income) gains while accumulating equities at significantly reduced prices.

This time around, plan sponsors face a dramatically different situation owing to a couple of factors:

- **Initial yields:** At the start of 2010, yields on 30-year Treasury bonds were 4.5%. In 2011, yields started at 4.1%, leaving ample room for rates to rally in the face of volatile equity markets. In contrast, yields on the same instrument began 2018 at 2.7%, which isn't too far from the all-time low of 2.1% reached prior to the 2016 U.S. elections. With lower initial yields, there is naturally less room for interest rates to fall and provide meaningful diversification in response to an equity market downturn.
- **Fed policy:** In contrast with years prior, the Federal Reserve is hiking interest rates and has done so since year-end 2015, with a notable acceleration of the pace since 2017. As our quantitative colleagues demonstrated in their March 2018 piece "Treasuries, Stocks and Shocks," the directionality of Treasury returns in response to equity market drawdowns depends to a significant extent on the source of the decline. That is, when the stock market drawdown is driven by fixed income markets (e.g., inflation fears, rising rates), bonds and equities have tended to go down in tandem. On the other hand, when volatility originates in the equity market (due to disappointing earnings, fears of slower GDP growth, etc.), returns for the two asset classes tend to move in opposite directions. This has been especially true when equity valuations are frothy. In 2018, concerns about rising rates and inflation led the fixed income market to be the source of volatility when equities were very expensive on the back of 10 straight years of positive total returns, the longest streak since 1928.

WHERE DOES THIS LEAVE US?

In 2019, investors may get far less bang for their rebalancing buck by following the traditional rebalancing approach (selling physical fixed income and buying equities) given that both asset classes had negative returns in 2018. Said differently, there are no fixed income gains to be locked this time by selling bonds to fund equity purchases.

Other considerations, such as transaction costs on long bonds and new alpha opportunities arising from last year's fixed income performance, are also important for rebalancing decisions and may support a more measured approach this time around. To illustrate, consider that on 31 December 2017, 92% of CUSIPs in the Bloomberg Barclays Long Credit Index were trading at or above par, a ratio that nearly halved to 51% at year-end 2018. With performance dispersion across sectors expected to rise late in the cycle, this can become an added source of potential alpha in security selection.

In light of these considerations, our rebalancing toolkit for 2019 is as follows:

- **Consider equity overlays:** We believe equity overlays can be an effective solution that takes advantage of recent equity weakness by synthetically increasing exposure without selling fixed income (which offers no gains to be locked and shows little sign of weakness as we move into the late phase of the current hiking cycle). For context, this tightening cycle has lasted 36 months, the longest of the past 13 hiking campaigns going back to the 1950s.
- **Sit tight:** Depending on one's deviation from asset allocation targets, the best course of action might be to stay put. Despite significant equity market weakness, many plans will still be within about 5% of their asset allocation targets. This is especially the case given muted performance in fixed income and the fact that many started from a slight equity overweight position owing to strong equity market performance prior to the start of the downturn. Historical analysis suggests that a deviation of 5% or less from targets may be a bit early to pull the trigger. Be wary of the falling knife!

- **Rebalance from Treasury STRIPS:** If equity overlays or sitting tight aren't well-suited, consider rebalancing from STRIPS to equities instead of tapping the long credit allocation. The end of the year rally in rates brought Treasury yields to a relatively low range, while spreads on long investment grade credit continued to widen. Such rebalancing might also incur lower transaction costs.

A FLEXIBLE APPROACH

Markets will keep us on our toes in 2019. The traditional rebalancing approach, which may have been appropriate over the past decade given prevailing market conditions, will have to evolve in this new regime. Volatility is on the rise, correlations are increasingly unpredictable and valuations are lukewarm. Plan sponsors might be better off favoring a flexible toolkit that can address a range of outcomes across both asset classes instead of a more binary rebalancing framework.

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