Fixed Income Insights

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Taxable Municipal Bonds May Hold the Key to Better LDI Portfolios

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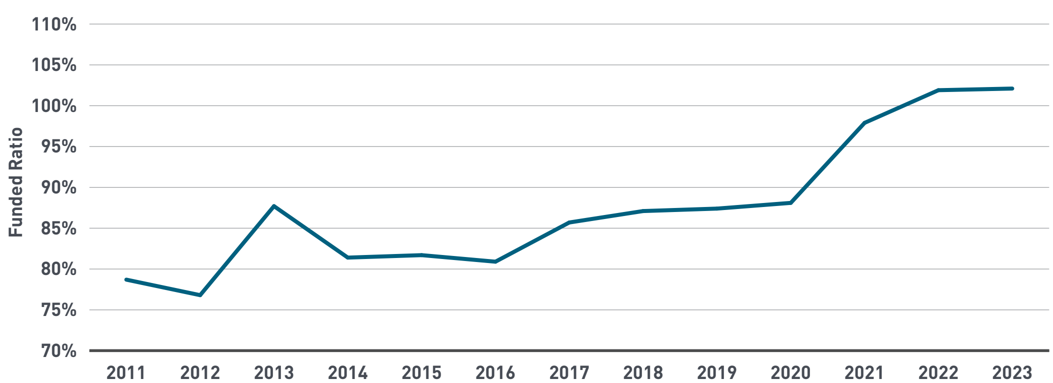
In brief

- With pension derisking activity on the rise, bonds with long duration, high quality and low default rate characteristics are in demand for liability driven investing (LDI) portfolios.
- With deeper representation across the long duration spectrum, lower historical default rates and higher yields relative to comparable quality corporate bonds, taxable municipal bonds can complement and potentially enhance LDI portfolios.
- Given their characteristics, they also are a worthy candidate for incorporation into buy-and-maintain strategies that are typically implemented in a broader liability-matching investment process.
- We believe an active approach that considers the broad universe beyond standard indices can potentially enhance returns while still retaining the attractive default and diversification characteristics of the asset class.

Pension Derisking Activity Continues to Rise

Defined benefit (DB) plans have seen a marked change in their fortunes since the end of 2021, as rising rates reduced plan liabilities and improved funded status. As a result, many plans are now at or above 100% funded status after more than a decade of funded status hovering in the 80% to 90% range.

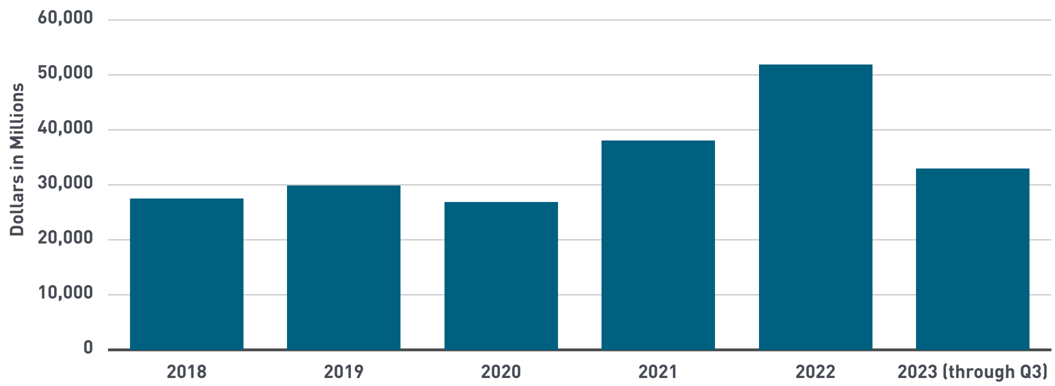
Exhibit 1: Aggregate Funded Status of 100 Largest US Corporate Pension Plans



Source: Milliman 2023 Corporate Pension Funded Study, April 2023, and Pension Funding Index, January 2024.

With improved funded ratios, many sponsors are accelerating derisking activity, whether it be increasing fixed income allocations or engaging in pension risk transfer (PRT) with a third-party insurer. PRT volume hit a record high in 2022, and the marketplace has seen nearly $200 billion of activity over the past five years as shown in Exhibit 2 below.

Exhibit 2: Pension Risk Transfer Activity, 2018–2023



Source: LIMRA Third Quarter 2023 US Group Annuity Risk Transfer Study.

As DB plans mature and participant populations age, liability duration naturally decreases. Higher interest rates have also reduced durations on typical plan liabilities from where they stood at the end of 2021 by two to three years.[1] Better funded status and lower liability duration profiles can potentially allow for more liability to be covered with physical bonds. While most LDI portfolios are constructed with treasuries and US investment-grade credit, we believe other asset classes, such as taxable municipal bonds, could also play an important role in LDI strategies.

The Potential Benefits of Taxable Munis in an LDI or Buy-and-Maintain Strategy

Traditional LDI approaches use a combination of treasuries and US investment-grade credit to create portfolios with duration and credit profiles comparable to the plan's liability. In many cases, derivatives are employed to extend duration beyond what is attainable with physical bonds and to fill gaps in the duration profile that cannot be covered easily with physical bonds.

Treasury bonds have broad representation across long durations; however, their yields are typically lower than pension discount rates, often resulting in a need for higher yielding assets. Investment-grade corporate bonds are attractive due to the size of the IG corporate market, reasonably broad duration representation and generally higher yields compared to treasuries. They also correlate with pension discount rates which are derived from high quality corporate bond yields. However, corporate bonds can introduce default risk and typically lack deep representation in the 10- to 20-year segments of the yield curve. These drawbacks can contribute to possible a mismatch between assets and liabilities.

Taxable municipals can help address some of the shortcomings of corporate bonds. Compared to corporates, taxable municipals

- are higher quality with almost 75% AAA/AA rated
- have lower historical default rates, with the default rate for A-rated taxable municipals lower than AAA- and AA-rated corporates
- have historically exhibited a yield premium versus similar quality corporates
- have deeper representation in 10- to 20-year maturities

Exhibit 3 illustrates that taxable municipals compare favorably to corporate bonds across several dimensions. Perhaps most compelling, the historically lower default rates of taxable municipals allow plans to allocate increased capital to lower quality credits, thus further enhancing yields without raising default risk.

Exhibit 3: Comparison of Taxable Municipals to US Investment-Grade Corporate Bonds

	Weight %		Default Rate %		Yield %	
	Taxable Muni	Corporate	Taxable Muni	Corporate	Taxable Muni	Corporate
AAA	15.8%	1.1%	0.0%	0.4%	4.7%	4.6%
AA	60.8%	6.8%	0.0%	0.7%	4.8%	4.7%
A	20.6%	45.2%	0.1%	1.4%	5.1%	5.0%
BBB	2.8%	47.0%	1.0%	3.6%	5.7%	5.3%

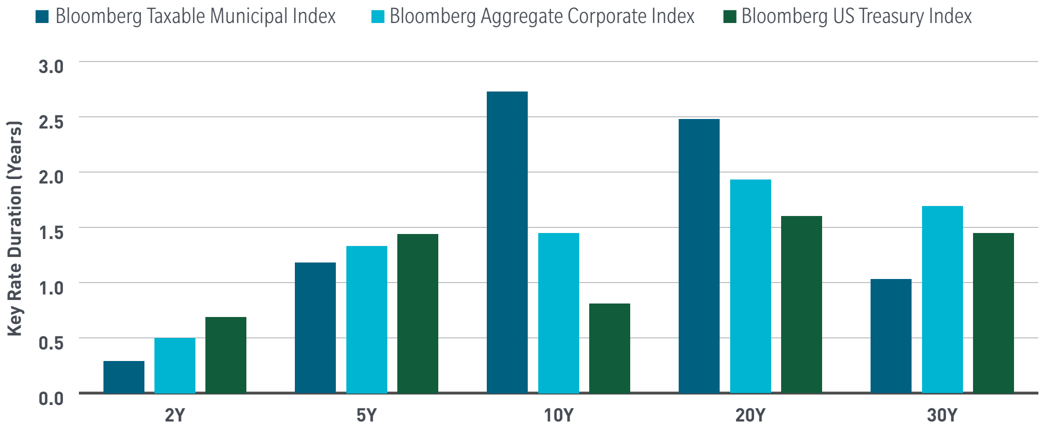
Source: Bloomberg, Moody's Investor Services. Weight and yields as of 31 January 2024. Municipal default rates from Moody's Public Finance Report "US Municipal Bond Defaults and Recoveries." Annual data from 31 December 1970 through 31 December 2022. US Corporate default rates from Moody's Default and Ratings database. Annual data from 31 December 1970 through 31 December 2022. Note: numbers may not sum due to rounding.

Taxable Munis May Hold the Key to Better Liability Matching

As funded status improves, plan sponsors and insurers typically seek to not only match the total duration of assets with the liability they are trying to immunize, but also key rate durations to protect against movements in different parts of the yield curve. However, corporate bonds historically lack deep representation in the 10- to 20-year segments of the yield curve, which often means derivatives are needed to attain desired key rate duration profiles.

As we see in Exhibit 4, taxable municipals have notably higher key rate duration than corporates or treasuries at the 10- and 20-year portions of the curve which could help fill key rate gaps that sponsors may encounter when utilizing those assets. This could potentially allow for more liability to be covered with physical bonds, which could enable sponsors to reduce derivative exposure and associated liquidity and counterparty risks while also lessening the governance oversight that comes with derivatives.

Exhibit 4: Key Rate Duration Comparison



Source: Bloomberg as of February 15, 2024.

Plans May Benefit from Increased and Broadened Exposure to Taxable Municipals

While the features noted above make a strong case for taxable municipals, the opportunity becomes even more compelling when the vastness of the asset class is considered. The municipal bond market, whether taxable or tax-exempt, is fragmented with significant numbers of issuance not included in indices. There are approximately 84,000 issues in the taxable municipal universe, with over 73,000 of those issues not included in an index due to size limits imposed by the index provider. These non-index eligible issues typically receive less research coverage and lower interest by investors, which often results in inefficiency and a yield premium driven by somewhat heightened illiquidity risk.

Increasing exposure to A- and BBB-rated taxable municipals may also allow pension sponsors to use the lower default rate relative to corporates to their advantage. Plans that impose a lower quality limit on corporates might consider raising that limit on taxable municipals given their favorable default rate characteristics. The result may be enhanced yields without sacrificing credit risk.

It is also worth noting the yields represented in Exhibit 3 are based on the taxable municipal index, and we believe it may be reasonable to expect somewhat higher yields when broadening beyond the index. This yield premium would likely come with some incremental sacrifice to liquidity; however, long-term investors such as pension plans and insurers may find this to be a welcome tradeoff.

Now May Be the Time to Consider Introducing or Increasing a Taxable Municipal Allocation

With yields at multi-year highs and a market that has grown from increased supply,[2] now may be a good time for plan sponsors and insurers to consider an allocation to taxable municipals within an LDI portfolio. We believe taxable municipals have many advantages compared to corporates, including higher quality, lower historical default rates, higher yields and broader representation in the long portion of the yield curve.

We believe an active approach that takes advantage of the broad universe of issues will benefit investors. An active manager has several alpha levers at their disposal, including accessing illiquidity premia, which we believe is a risk that can be well tolerated by the long holding periods associated with pension plans and insurers.

Endnotes

[1] Source: FTSE Pension Discount Curve data as of 30 November 2023. Discount rate for "Intermediate" plan increased from 2.74% on 12/31/2022 to 5.28% on 11/30/2023, while duration decreased from 16.83 years to 13.41 years over the same period. Discount rate for "Short" plan increased from 2.63% to 5.26%, and duration decreased from 13.42 to 10.96 over the same period.

[2] The size of the Bloomberg Municipal Index Taxable Bonds increased from $313B as of 12/2018 to $411B as of 12/2023. The total size of the taxable municipal market is $663B as of 12/2023.

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