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De-Risking Your Portfolio

October 2023

The recent surge in bond yields offers pension plans an opportunity to de-risk a portion of liabilities. The recent rapid climb among bond yields has nearly eliminated the potential reward in owning stocks over bonds, also known as the equity risk premium. In early October, the expected S&P 500 earnings yield over the next 12 months was just 0.74% above the 10-year Treasury bond yield – the lowest premium in over 20 years (WSJ 10/10/23).

When the stock market earnings yield is similar to the bond market yield, there is virtually no risk premium in owning stocks over bonds. For example, if the long-term return expectation in owning stocks is 8.0% and the yield to maturity of a high-quality bond portfolio is 6.0%, the return to risk trade-off favors bonds.

Yield to maturity is an accurate predictor of what a bond portfolio will produce over time and in the current environment it will be 90% income. And that is precisely what a pension plan looks for. Defined benefit plans were originally designed to carefully match liability payments to current period income, along with low volatility.

During the past several decades, pension fund asset allocators were forced to seek bond alternatives, as bond yields gradually declined to near zero in 2020. The alternatives introduced greater levels of risk to pensions plans. This included leveraged products, illiquidity, and lagging or estimated pricing of assets.

Using high quality bonds, it is possible today for a manager to build a long-term fixed-income portfolio model that nearly matches a portion of the long-term liability assumptions constructed by the actuary. If a pension fund sponsor wanted to de-risk a portion of the pension fund, this is possible today. How did this happen? The Federal Reserve and inflation together with market action raised the 10-year treasury bond to a 22 year high. And recently, the yield curve has begun offering longer-dated issues a higher yield. The 10-year U.S. Treasury may move higher, but that only makes the de-risking option even more attractive.

More public pensions plans are studying the topic and de-risking may be even more attractive for closed plans. Stocks are a great way to create long-term growth, but along with the ride comes volatility and uncertainty. In some cases, the draw-down recovery takes a decade. In contrast, a long-term and stable 6.0% yield to maturity derived from a dedicated bond portfolio might solve all or a portion of the volatility and liability problems for plan sponsors. De-risking will most likely still have a cost, but those costs have decreased significantly over the past few quarters, as interest rates have risen at a record pace.

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