LGIMA Pension Solutions' Monitor

Market Update

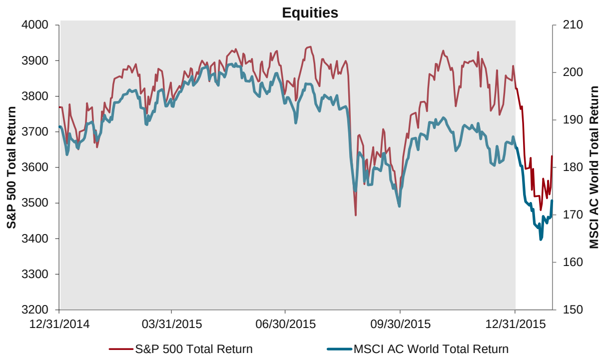
Overview

Financial markets have had a turbulent start to the year as the benign macro backdrop started to deteriorate soon into the New Year. The Yuan's continued devaluation reignited investor concerns over China as well as global growth. Chinese equities' largest daily moves triggered the newly introduced circuit breakers which were subsequently scrapped. Oil prices continued to fall to levels not seen for over a decade and risk assets sold off across the board. US credit spreads continued to widen on the back of the uninspiring macro outlook whereas US rates rallied over January.

Equities

US equities had a volatile start to the year but have subsequently stabilized in the last two weeks of January. Although realized volatility in the S&P 500 has been high year-to-date, implied volatility has surprisingly remained tame and is currently lower on the year.

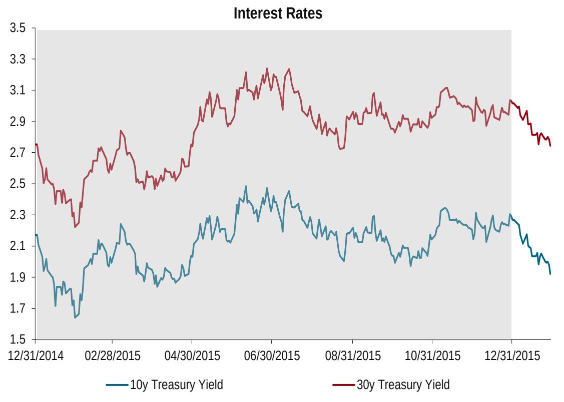
The S&P 500 TR Index decreased 5% and the MSCI AC World TR Index decreased 6% over the month of January negatively affecting pension funding ratios.



Interest rates

The yield curve steepened in January as interest rates rallied 25-40 basis points across the curve. The rally was driven by the year-long decline in oil and other commodity prices, weak data out of China, and stock markets' sharp decline across the globe. Relative to January 2015, the moves this year seem more calm and orderly when viewed through implied volatilities. The demand for interest rate options has increased across maturities but the increase in volatility is much more muted than last year. The rate moves thus far would indicate that the market is further decreasing its already low expectations for additional Fed hikes in 2016. Until this sentiment changes it may be tough to see interest rate volatility to return to elevated levels we saw in 2015. Swap spreads on the 30-year rate narrowed once again, going from -39 basis points at the end of 2015 to -47 basis points on January's month end close. The moves in spreads were highly correlated with the moves in rates this month, although that seems to be more by coincident than by any underlying fundamental factors.

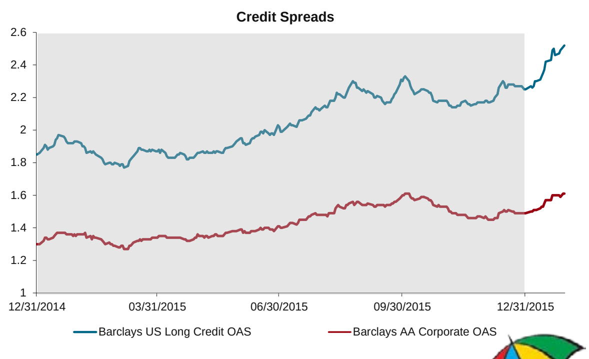
The 30-year Treasury rate decreased 35 basis points while the 10-year Treasury rate decreased 27 basis points over the month. The decrease in interest rates had a negative contribution to pension funding ratios over January.



Credit

Credit spreads widened in January on the backdrop of investor concern over China, slowing global growth, and lower commodity prices.

The option adjusted spread (OAS) for the Barclays Long Credit Index has increased 27 basis points to 252 basis points over the month where as the Barclays AA Corporate Index has increased by 12 basis points to 161 basis points over the same period. The widening in spreads has had a positive contribution to pension funding ratios over January.



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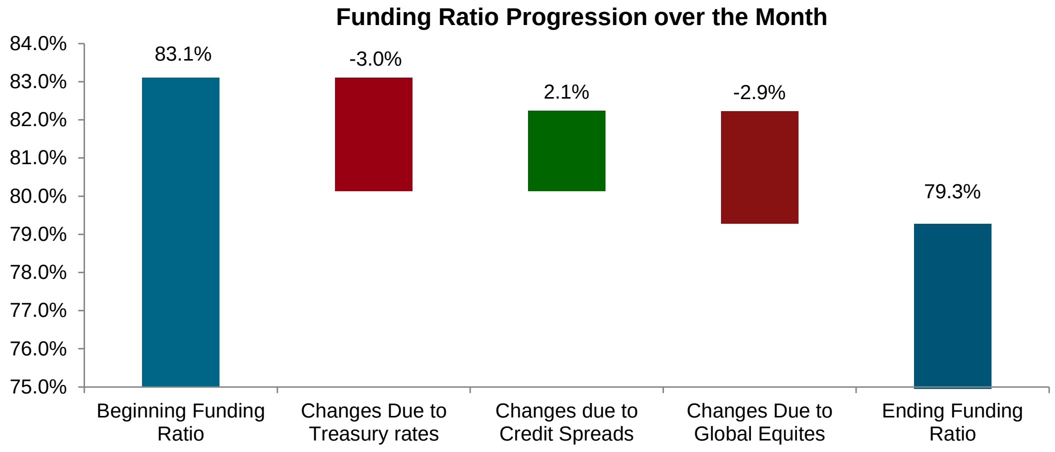
Funding status monitor

LGIMA estimates that pension funding ratios decreased over the month of January 2016. LGIMA estimates the average funding ratio fell from 83.1% to 79.3% over the month. Funding ratios decreased over the month as plan assets for a traditional "60/40" asset allocation underperformed given the significant sell-off in global equity markets. Global equity markets decreased 6.0% and the S&P 500 decreased 5.0%. Liabilities for the average plan increased modestly despite the fall in Treasury rates as credit spreads widened significantly over the month. LGIMA estimates plan discount rates decreased 10 basis points, as Treasury rates decreased 28 basis points while credit spreads widened 18 basis points[1]. Overall, liabilities for the average plan were up 1.6%, while plan assets with a traditional "60/40" asset allocation[2] decreased 3.0%, resulting in a funding ratio decrease of 3.8%.



[1] Discount rates based on a blend of the Bank of America Merrill Lynch Average US Pension Plan AAA-A and Bank of America Merrill Lynch Mature US Pension Plan AAA-A discount curves
[2] For the average plan LGIMA assumes a 60% allocation to MSCI AC World and a 40% allocation to Barclays Aggregate.

Strategy

What clients are doing

- Wider adoption of de-risking decisions resulting in continued strong flows to customized LDI solutions
- Increased implementation of liability benchmarking/completion management frameworks as fixed income allocations increase
- Greater interest in end-game solutions as ongoing costs of administering a pension plan increase (i.e. higher PBGC premiums)
- Strong demand for derivative strategies to help shape funded status outcomes which can be used to:
  - Monetize decisions already made within a glide path using swaption and synthetic equity strategies
  - Easier to gain equity exposure synthetically and gain discount rate exposure through cash bonds
  - Benefit from market pricing dislocations (i.e. skew and calendar events)