LGIMA Pension Solutions' Monitor

Market Update

Overview

Global and US equities underperformed in the month of October, largely due to mixed earnings results and further economic data suggesting a US rate hike in December. Global yields rose on the back of inflationary pressures in addition to a signaling from Central Banks of a less accommodative monetary policy. Additionally, credit spreads tightened amidst the return of a technical bid from predominately domestic buyers.

Equities

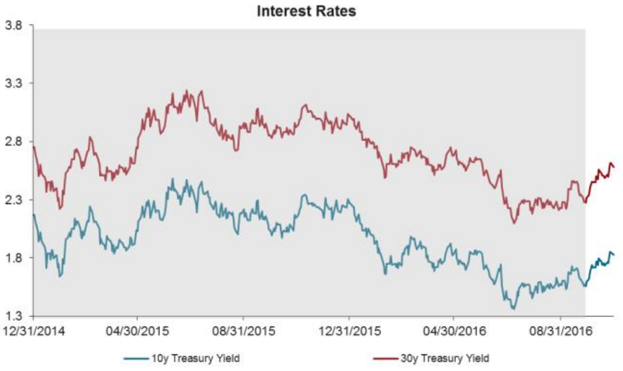
Both global and US equity markets declined in October. Globally, losses were fueled by a turn in sentiment regarding central banks' willingness to continue easing monetary policy. In addition to data suggesting a rate hike in December, US stocks suffered as a result of uncertainty surrounding the presidential race and heavy losses in both the real estate and telecommunication sectors.

The S&P 500 TR index fell1.8% and the MSCI AC World TR index fell 1.7% in October, negatively impacting pension funding ratios.

Interest Rates

The US yield curve sold off and steepened in October, with 5-year Treasuries selling off 15 basis points and the 30-year rate moving 27 basis points higher, returning to pre-Brexit level for the first time since the vote in June. This move was largely in sympathy with a global rates selloff – long end yields moved 35 basis points higher in Europe and 40 basis points higher in the UK. With the ECB not yet announcing plans to extend their QE program—and many starting to forecast a tapering of their buying program—and the BOJ moving from negative rates to targeting 10-year rates, there seems to be a move away from central banks keeping short end rates perpetually low.

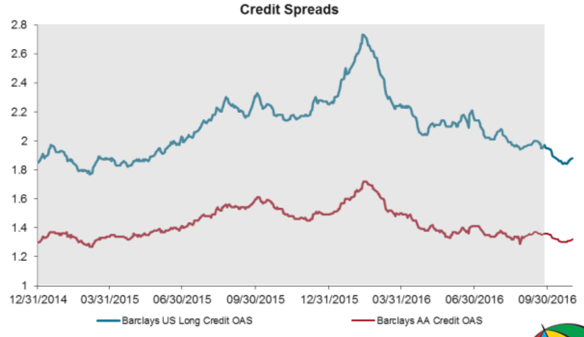
A global yield grab had led many foreign investors to purchase US Treasuries and credit bonds over the past 12+ months, but that trade has been done in such high volume that the FX hedging costs have significantly reduced the extra yield pickup. As global demand fades and the Fed seems more determined to raise their target rate, yields could continue to rise from these levels.



Credit

Credit spreads began to tighten again in October driven by a continued technical bid and a lack of major macroeconomic catalysts over the month. It appears the latest wave of buying is from domestic institutional investors—largely those seeking to cover underweights into year-end with an eye toward preserving performance.

The option adjusted spread (OAS) for Bloomberg Barclays Long Credit tightened 7 basis points to 188 basis points, while the Bloomberg Barclays Long AA Credit Index tightened 4 basis points to 132 basis points over the month. The overall tightening in spreads (within the discount rate) had a negative contribution to pension funding ratios over October.



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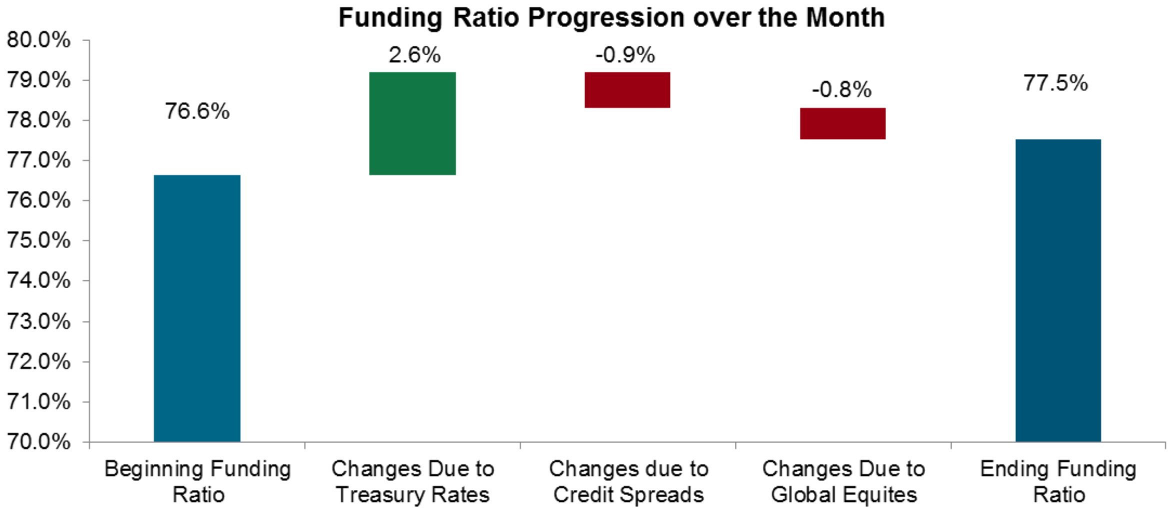
Funding Status Monitor

LGIMA estimates that pension funding ratios increased approximately 0.9% over October. Global equity markets decreased by 1.7% and the S&P 500 decreased 1.9%. LGIMA estimates plan discount rates rose 20 basis points, as Treasury rates rose 24 basis points and credit spreads tightened 4 basis points[1]. Overall, liabilities for the average plan were down 2.4%, while plan assets with a traditional "60/40" asset allocation[2] decreased by 1.3%.



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.

What Clients Are Doing

- Continued interest and flows into customized liability hedging strategies (liability benchmarking and completion management) driven by:
  - Volatile interest rate environment
  - Little improvement in funding ratios despite the extended rally in equities
  - Cost of being underfunded is going up due to increased PBGC premiums
  - Greater interest in end-game solutions
- Increased use of derivative strategies to shape funded status outcomes
  - Monetize decisions already made within a glidepath utilizing swaption and equity option strategies
  - Dynamic protection strategies
  - Benefit from market pricing dislocations (i.e. skew and calendar events)
  - Synthetic equity strategies
- Increased interest in synthetic risk premia (alternative beta) strategies for both hedge fund replication and/or factor completion
  - Institutional investors increasingly looking to alternative allocations for diversification rather than "alpha"
  - Synthetic risk premia strategies offer similar exposures with greater transparency, lower fees, and increased liquidity