

Insights

Pension funds and tax reform: how to deal with a double-edged sword

Executive summary

The new tax reform bill could have an enormous impact on pension fund credit portfolios – one we believe has yet to receive the attention it deserves. While market participants have been focused on the benefits of tax reform for major risk assets, very few have taken into account the potential effects to their hedging portfolios, which continue to grow in importance as more of these plans move closer to their end goals.

Specifically, we see three potential consequences of the tax bill:

- **Lower supply of long-duration credit:** A reduction in corporate taxes could decrease issuance of corporate credit, and in particular long-duration credit, a key component to pension fund liability management.
- **Supply/demand imbalance:** Heightened demand for long-duration credit from defined benefit plans and nontraditional investors could exacerbate the supply/demand mismatch that already exists.
- **Wider scope of assets needed in liability hedging:** As a result, we believe pension plans should consider expanding the opportunity set for hedging portfolios to include asset classes outside of long-duration corporate credit. This could include securitized credit, private credit or tax-exempt municipal bonds.

Here, we discuss key considerations arising from the new tax code, provide a more detailed overview on the current state of the U.S. credit market and ultimately address how pension funds can minimize possible adverse scenarios by expanding investment guidelines within their hedging portfolio.

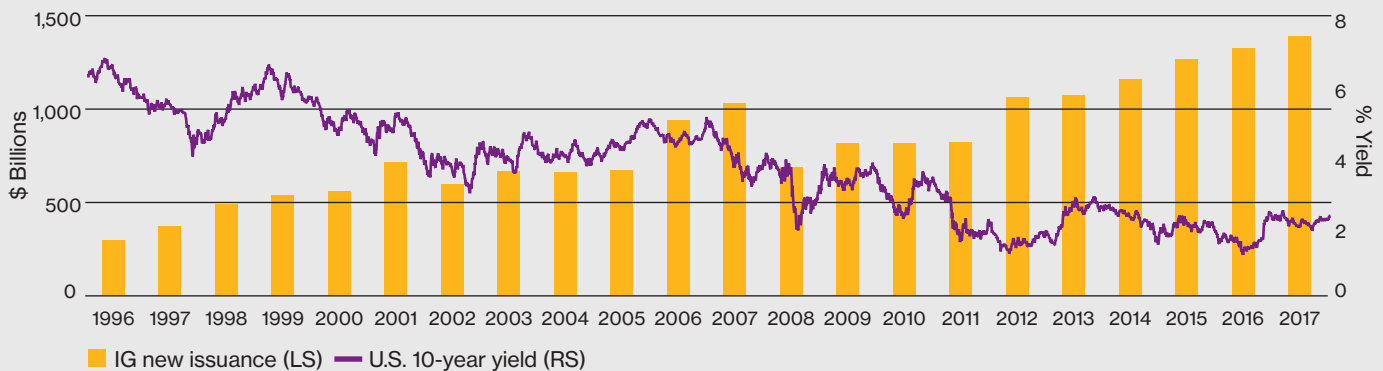
Why will credit supply drop?

Credit markets have witnessed an evolution of tax bill proposals, culminating with the Tax Cuts and Jobs Act in late 2017.¹ While the new bill involves a wide array of changes to the way corporations are taxed domestically, a few are more pertinent to the credit markets as of this writing. In particular, the adjustments made to the corporate tax rate, repatriation of offshore cash and interest rate deductibility all are likely to have immediate effects on the credit markets.

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¹For more information, please see the full tax bill [here](#).

Figure 1. **Investment grade issuance at an all-time high amid low rates**



Source: SIMFA, Bloomberg

The headline reduction of the corporate tax rate from a 35% maximum to a flat 21% has garnered much of the attention, and rightfully so. A lower tax rate affects the way companies manage their balance sheets as the relative attractiveness of financial engineering becomes less compelling and the value of issuing debt is reduced. In addition, companies may no longer be incentivized to borrow over longer time horizons due to rising rates. *Figure 1* shows that issuance has tended to be inversely related to interest rates. Therefore, the combination of rising rates and a lower corporate tax could deter companies from issuing debt. While these dynamics may not take effect immediately, over the long term there is reason to believe that companies could deleverage as a result.

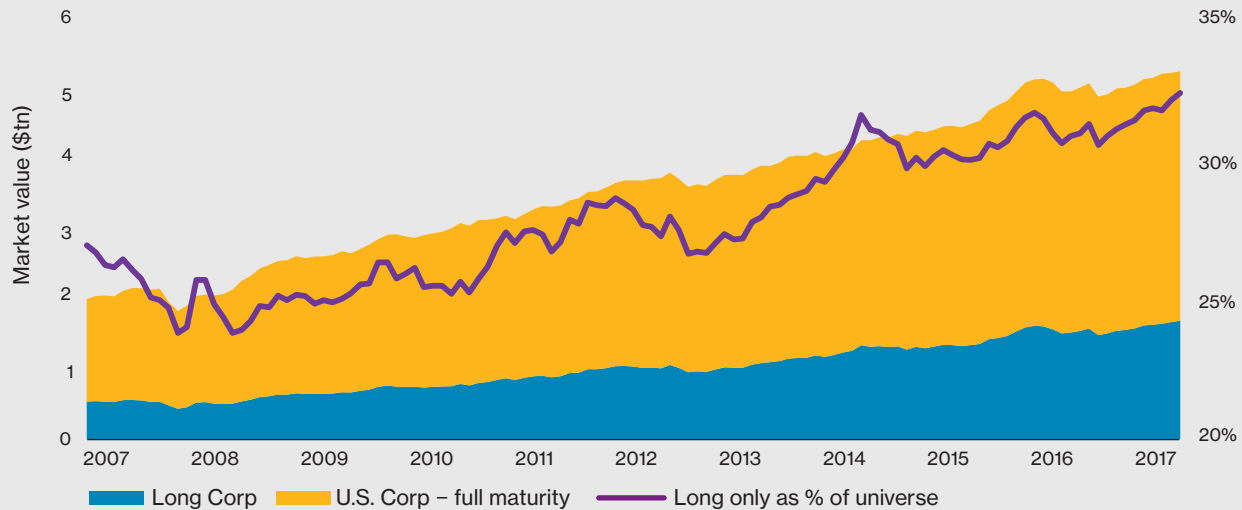
Similarly, repatriation offers companies the opportunity to bring cash traditionally held overseas back to the U.S. after paying a one-time tax rate. Companies that have assets tied up in other countries have typically been concentrated in select sectors, such as Technology and Pharmaceuticals, investing in short-term instruments, such as money market funds. Because they were unable to deploy the cash in the U.S., many turned to the foreign debt markets. It's reasonable to anticipate that some portion of the funds eligible for repatriation will be brought back and made available to these companies. In doing so, the need for U.S. debt issuance is reduced.

The reduction in allowance for interest rate deductibility could affect many lower-rated, **high-yield** companies. While not a part of the hedging portfolio, the high-yield market will help shape the new reality within credit as companies adjust their issuance patterns. As such, it should be taken into consideration by investors as they review their portfolios holistically.

A closer look: High-yield buyers might like tax reform

High-yield debt issuance has hit record levels in recent years as firms have used the low interest rate environment to finance their operations cheaply. A key attraction of issuing this debt has been the ability to deduct interest expenses from taxes; however, the tax reform bill reduces the allowance, or amount these firms can deduct, which could, in turn, reduce high-yield debt issuance.

Figure 2: Long corporate credit has been a key in the growth of U.S. credit



Source: Barclays Live

Corporate credit market review

The U.S. corporate credit market has witnessed tremendous growth following the global financial crisis of 2008, as companies have utilized historically low interest rates to issue long-term debt more cheaply. As a result, long-dated corporate credit (securities with greater than 10 years to maturity at the time of data collection) has become a larger portion of the market as a whole, representing more than 30%, and has nearly tripled in size to more than \$5 trillion as of December 31, 2017 (see Figure 2).

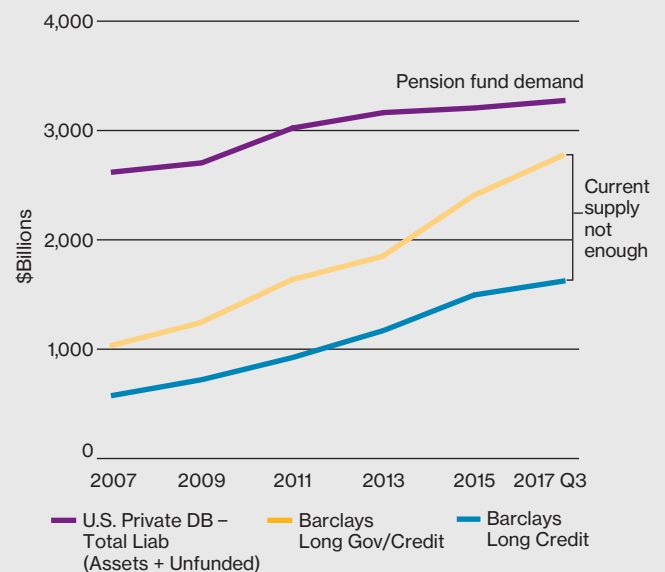
While issuance is at an all-time high, spreads are near all-time tight, driven by investors' search for yield. The U.S. primary issuance market has been one of the largest benefactors of this trend as U.S. yields have still looked attractive relative to their global developed market peers. Despite being constrained in the amount of capital they are able to invest in the U.S., nontraditional investors have contributed in a meaningful way to a significant supply/demand imbalance in U.S. credit as new issues have been heavily oversubscribed.

Long-duration credit

There is sufficient reason to believe that the shift in dynamics associated with the aforementioned aspects of the new tax law could lead to lower issuance over the medium to long term. On the surface, much of what has been discussed points to a scenario that is favorable for long-duration credit markets as demand should continue to outpace supply, a positive for bondholders.

However, we believe investors must also consider the risk that capital will become more difficult to deploy due to scarcity, leaving pension funds in a troubling situation. Figure 3 illustrates this point, showing the total U.S. defined benefit liabilities relative to the overall size of the Barclays Long Credit and Long Government/Credit indices. Despite the staggering growth of credit markets discussed earlier, it's evident that supply in the market is already a concern – without incorporating other market participants that traffic in long-dated bonds. Though it is not our base case, a tail risk is that a significant amount of defined benefit assets could flow into the asset class during a time when supply weakens.

Figure 3: Potential liability demand vs. supply on the long end of the curve



Source: ICI, Barclays Live

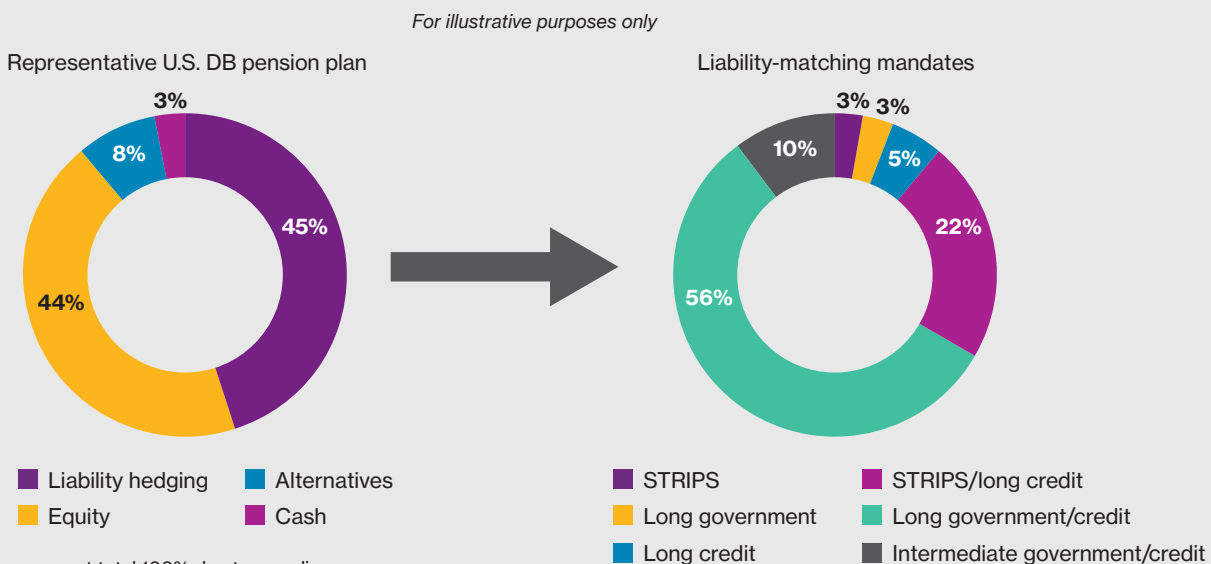
Portfolio implementation for pension funds

The pie charts in *Figure 4* illustrate what we've found to be the typical asset allocation mix for defined benefit plans (left) and the frequency of specific strategies that are employed within their hedging portfolios (right). Despite the considerable size of the hedging portfolio, the instruments used are seemingly one dimensional.

As we have explored various opportunities outside of traditional hedging assets, we have identified multiple asset classes other than long corporate credit that may be added to the hedging portfolio to help provide a diversifying source of long-term credit premia, without major administrative burden. Some of these include:

- **Securitized credit:** A staple of core bond mandates across the U.S., securitized credit — securities made up of underlying loans that have been packaged together to create a single instrument — has only recently been considered in the context of defined benefit hedging portfolios. There are many reasons for the historical exclusion of securitized credit from hedging portfolios, such as the structure of corporate DB liability discount curves, a generally shorter duration than corporates, and uncertainty of cash flows should the bond's duration increase as yields increase (i.e., negative convexity). We've found that despite these challenges, certain securities have robust markets to transact in, show high correlations with corporate credit and have more predictable cash flows, allowing them to achieve the desired duration for liability-matching mandates.
- **Private credit:** A key concern for the inclusion of private credit within a hedging portfolio has been liquidity, as these securities typically do not trade and are often originated directly between lenders and borrowers. However, private credit markets are extremely large and offer an illiquidity premium to public markets. Additionally, certain types of private credit, such as corporate private placements, are highly correlated to public credit markets due to the overlap of issuers that tap into both markets. This makes their hedging characteristics similar to public corporate bonds and, we believe, worthy of consideration.
- **Tax-exempt municipal bonds:** Pension plans have heavily allocated to taxable municipal bonds (fixed income securities issued by a local government that do not qualify for tax exemption due to the nature of the project the bonds are financing) since their significant growth during the "Build America Bond" program established post-financial crisis. However, an often-overlooked sector by pension plans is tax-exempt municipal bonds. Although they have historically yielded less than corporate bonds for the same unit of duration, the municipal market has changed considerably from a primarily insured market pre-financial crisis to a more traditional credit market where market participants evaluate the fundamentals of the underlying issuer. As such, in recent years, tax-exempt municipals, particularly on the long end, have presented some attractive buying opportunities for managers to allocate to, and diversify away from, corporate bonds. Given the passage of corporate tax reform, we believe there is the potential for this to continue as insurance companies, a key market participant, have less incentive to buy as much municipal debt, since the benefit of tax-exempt income is not as strong in a lower overall tax environment.

Figure 4: Typical DB asset allocation mix and frequency of strategies used in hedging portfolios



Conclusion

We believe that tax reform will be transformational for credit markets, and defined benefit pension plan sponsors need to ensure that they are prepared to confront the challenges that could arise. We have outlined a scenario in which corporate credit supply, particularly on the long end of the curve, could become strained during a time when these same assets could see rising demand. In this scenario, many plans may have unintended risks embedded in their hedging portfolios as a result of under-diversification that could lead to issues down the road. The part of their portfolio that is supposed to be sleepy could turn out to be anything but, and the consequences could be material.

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Still, we recognize that each plan sponsor faces unique challenges. For many clients that are near or at fully funded status, there may not be a need to adjust their hedging portfolio. However, we believe there is an opportunity for clients faced with meaningful funding gaps to enhance their current hedging assets by introducing a broader opportunity set. We encourage investors to review their hedging portfolio carefully to ensure sufficient diversification of assets.



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