PUBLIC PENSION STRATEGY

A TIMELY REVIEW

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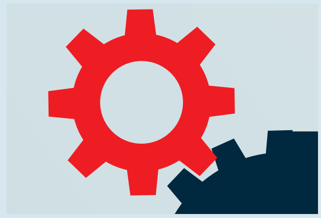

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A SHIFT IN STRATEGIC ALLOCATIONS

With interest rates starting to fall, public pensions should consider locking in yields now and get the most out of their fixed-income allocations.

The ground underneath financial markets has shifted: After raising interest rates, starting in 2022 and keeping them elevated for two-and-a-half years, the Federal Reserve began to cut rates in September this year.

This change in the direction of rates has positive implications for public pension plans. Because falling rates help stimulate the economy and reduce borrowing costs, they improve the prospects for equities and fixed income alike — which can make it easier for plans to achieve their targeted rates of return and meet their payment obligations.

Now is a good time for sponsors of public plans to review their strategic asset allocation, if they haven't already done so. They should think about how to best position their portfolios as the rate environment transitions from higher to lower.

FIXED INCOME HOLDS THE KEY

Kevin Kneafsey, senior investment strategist for the multi-asset team at Allspring Global Investments, believes that public plans will increase their fixed-income allocations.

"When the Fed responded to the great financial crisis by cutting the fed funds rate to zero," he said, "they forced investors to take more risk to achieve their target returns. Plans did so and helped fuel the huge push into growth assets. It's reasonable to think that at significantly higher rates, plans can shift to taking less risk to achieve their target return."

"We expect to see many types of risks — such as asset-liability mismatch, growth, liquidity and total plan risks — come down as plans shift back to lower-risk asset allocations to meet their return targets," Kneafsey continued. "There should be a big move from growth assets into fixed income, which has already begun. Eventually, we expect a shift back out of illiquid assets into liquid, public market assets."

Elizabeth Burton, managing director and client investment strategist for the client solutions group at Goldman Sachs Asset Management, also sees greater interest in fixed income. Rather than calling for increasing allocations, through an investment policy change process, she would consider additional diversification within the existing allocations of public pension plans.

"We're advocating that clients may want to flex within their target allocation ranges," she said. "Stock-bond correlations have been changing over the last few years, which surprised some public pension allocators. They're looking for more diversifiers now because they don't necessarily want to make a call on whether the correlations are going to remain stable or move around. We agree with the idea of 'diversifying your diversifiers.'"

Compared with before the COVID-19 pandemic and the last few years, Burton added, "we believe there are more opportunities for breadth and more places to look for yield." In emerging market sovereign debt, for example, she sees potential for attractive total return through ratings upgrades, or in corporates through favorable macroeconomic developments from central bank moves, maturing markets and exposure to megatrends.

YIELD-CURVE POSITIONING

How should public pensions navigate the yield curve to benefit from falling interest rates? Jeff Mueller, co-head of fixed income and high yield at Morgan Stanley Investment Management, believes for many, reallocating from shorter maturities to longer ones will be the right move.

"We think the easing cycle will have a bigger impact on the curve's front end," he said. "When the Fed cuts and continues to cut, the front end will move the most. The middle and the long end probably won't react as sharply to changes in sentiment and monetary policy."

Mueller suggests that pension plans consider reallocating at least part of their short-maturity holdings, where they're currently earning attractive yields. They can lock in current longer-term yields in core fixed-income and certain credit sectors that could better meet their long-term return targets. They may also consider adding to intermediate-duration fixed income by reducing their equity allocations or positions in private markets.

Looking ahead, Mueller's base case is that fixed-income sectors with some duration aren't likely to revert to what he calls the "financial repression era," when yields were very low. He believes changes in the yield curve will be easier to handle this time because the curve should steepen, rather than absorb a massive repricing lower at every maturity point.

commercial MBS, he said, office properties have taken the biggest hit, while nonoffice commercial spaces have unfairly been tarred with the same brush. He views multifamily residential properties and single-family rentals as trading at appealing spreads.

Investors can find good value in residential MBS, Mueller added. "Given the amount of home price appreciation that we've seen in the U.S., if you do your homework and pick the correct vintages, you're investing in homeowners with a significant equity cushion and long-term mortgages locked in at relatively low rates," he said.

In addition, collateralized loan obligations provide an appealing combination of complexity premia along with higher yields from their underlying loans — and the high yield also offers potentially enough to help pension plans exceed their required rates of return, Mueller said.

IT'S TIME FOR ACTIVE

The current fixed-income environment is compelling for active strategies, said Morgan Stanley Investment Management's Mueller.

"For public pension plans and any type of defined benefit plan, the present offers a great opportunity for active management," he said. "Fixed-income yields are quite wide compared to the last 15 years, and credit spreads are relatively tight. Yield is what brings you to the

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FINDING POTENTIAL

The first step in a strategic allocation review is to decide whether broad allocations should change. The next is to fill in the blanks for how to implement them.

Michael Moran, pension strategist at Goldman Sachs Asset Management, sees opportunities in several fixed-income sectors, especially securitizations and high yield. He identified a number of macro factors — an economic soft landing, solid corporate fundamentals and strong earnings growth — as particularly supportive.

Morgan Stanley Investment Management's Mueller said credit allocations could have a bit more risk in the mix. For him, the key driver is the availability of high yields that haven't been around for years. While this applies to Treasuries as well as credit, he is especially enthusiastic about certain asset-backed sectors and high yield.

"We think U.S. agency mortgage-backed securities look quite attractive," he said. "Historically, the Fed and commercial banks have been large buyers, but banks have been much less active following the mini banking crisis in early 2023. This has prompted a technical shift in which MBS spreads have moved materially wider, and we think that presents an opportunity."

Mueller also sees potential gains in commercial and nonagency residential MBS, which have suffered. Within

asset class, but you need active management for alpha when you get there. The value of active management for DB plans shines through in this kind of environment."

"If you're investing in credit sectors, you need active management as the cornerstone of how you manage them. It's not a one-size-fits-all approach," Mueller continued. "Yields are fairly high in the more 'plus' parts of the market; in high yield, for example, it's around 7.5% for the benchmark. The ability to drive returns there is amazing if you approach it with an active lens."

Mueller noted that the Federal Reserve has succeeded in raising rates from near zero and it appears comfortable with slightly higher inflation. But this also means that volatility risk is significantly higher. While passive strategies tend to underperform in volatile markets, volatility offers the opportunity to add alpha from active management.

In the less efficient areas of fixed income — which, collectively, comprise most of the market — an active approach is especially important, Mueller added. "In most market environments, a substantial portion of your return comes from the yield you're earning. With a passive approach, you're going to have credit losses that erode principal," he said. "An active approach can manage that downside risk and could potentially drive higher returns than the benchmark."

ALTERNATIVES:

A SELECTIVE APPROACH

Institutions have gobbled up alternative investments for years. Is it time to reduce exposure?

Public pensions and their asset managers generally are bullish about the prospects for alternative investments. After all, allocations to the asset class have steadily risen over the past decade (see visual), and there are few indications that this upward trend will stop.

Moran at Goldman Sachs Asset Management said that alternatives offer a number of compelling characteristics. These may include potentially attractive return expectations, diversification benefits and an opportunity set that includes a broader array of industries. While there clearly is dispersion among plans in terms of the size and makeup of their allocations, and some plans are currently overallocated to private markets, he believes that alternatives will continue to be an important part of public DB portfolios.

In recent years, public plans have broadened their exposure within alternatives. "Infrastructure and private credit have been around for a while, but they've only recently turned up in some portfolios where private equity has had the biggest share of alternative allocations for a long time. We're seeing more secondaries, co-investments and even general partner stakes," Moran said.

Real estate — a mainstay of alternatives allocations for decades — has taken a beating for several years in response to the pandemic and then the sharp rise in interest rates. It's fair to ask whether plans should reduce their exposure or even exit entirely.

Moran responded with an unequivocal no. In his view, there could be a place for real estate in any DB plan. He also pointed to a shift in the portfolio positioning of real estate and related debt.

"We've seen investors who are hesitant about real estate equity start to look at real estate credit," he said. "In our view, there are still a number of credit opportunities that have yet to come through the pipeline in the form of loans that will reset over the next couple of years or come due. We're also seeing some allocators move real estate credit from their real estate portfolio to their private credit books."

WATCH THE DOWNSIDE

However, not everyone is optimistic about alternative investments. Allspring Global Investments' Kneafsey sees potential downside, specifically in private markets.

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>
> —Kevin Kneafsey, Allspring Global Investments

"In our view, the boom in private markets will continue until it blows up," he said. "It'll continue because they've been packaged so well. The industry has taken what otherwise would be traditional publicly traded assets, such as equity and debt, and packaged them into privately held assets that in normal market environments offer benefits to investors. Privates have higher expected returns than their public market counterparts, and lower realized volatility and zero correlation with their public market counterparts due to nonmarket pricing. They have virtually no drawdowns because most GPs fail to write down assets."

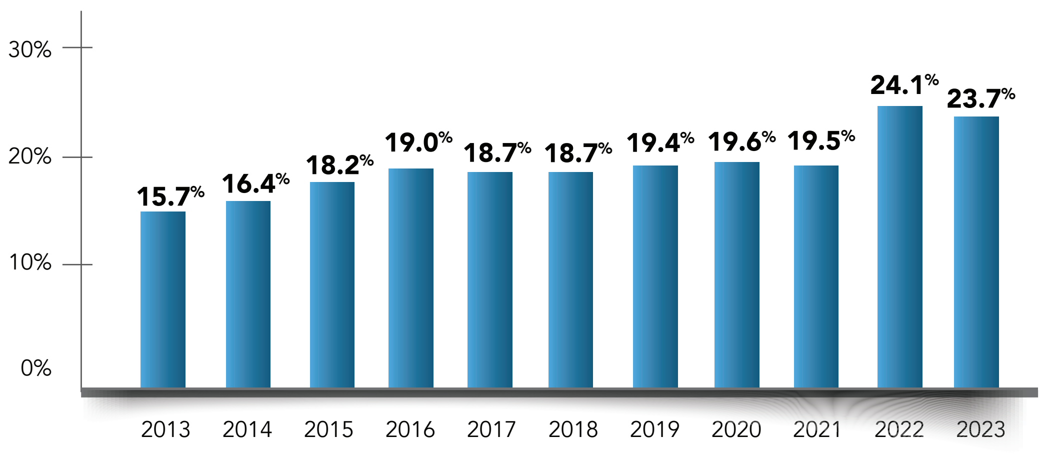
However, Kneafsey said he expects two factors to hurt private markets: leverage and liquidity. Leverage — the linchpin of private market investing — now costs much more than it did previously, making it much harder to generate significant returns above the cost of financing.

The amount of leverage employed also has increased. "Incentives are important. The GPs have a 'heads I win, tails you lose' situation," said Kneafsey. GPs themselves generally don't borrow; they have their funds and portfolio companies borrow, "which gives GPs the incentive to use more leverage than a typical investor that bears both the upside and downside consequences of that leverage. The consequences of leverage's higher cost and excessive quantity will lead to disappointing private market returns, especially in times of market stress," he said.

As for liquidity, it's usually not an issue except when prices start to fall, which can trigger a sell-off. "When you get a significant drop in market prices, the effect of so much money being in illiquid assets will be profound," Kneafsey said. "It affects liquid assets because they're the first things that get sold. Pension funds typically run cash flows of negative 2% to 3%, so they're

Steady Increase in Alternative Assets at Public Pension Plans

Alternative assets % allocation in U.S. public defined benefit plans 2013-2023*



** U.S. public defined benefit plans with more than $25 billion in assets. Data as of Sept. 30 for each year. Alternative assets data include private equity, real estate, private credit/debt and other alternatives. Source: Pensions & Investments Research Center.*

going to have to sell liquid assets to meet their obligations. But those with the most in illiquid assets may be forced sellers in an illiquid market and will have to make massive price concessions."

The bottom line for Kneafsey is that leverage can lead to disappointment and liquidity can lead to insolvency. "Once investors are hit by one or both of these, they'll be once bitten, twice shy, and less likely to put so much money into private market assets," he said.

MIXED VIEWS ON PRIVATE CREDIT

While institutional investors are well aware of the explosion of private credit in the past few years (see visual) and many continue to allocate to it, others have chosen to avoid the sector.

Goldman Sachs Asset Management's Burton is constructive on private credit and sees it as being in a process of evolution. "Public plans' interest in private credit has shifted from what I call private credit 1.0 to private credit 2.0," she said. "There's still some interest in pure middle-market direct lending, especially from plans getting their feet wet. But those that have already invested in it feel comfortable and are broadening their exposures, and now plans are showing greater interest in other parts of the private credit universe, like specialty finance, real estate credit, secondaries and asset-based finance."

"It's also an acknowledgement of the structural change in the capital markets, where origination by nonbanks is increasing," Burton added. "Plan sponsors are making sure they're capturing all the benefits of what's out there in the lending market, whether on the public or the private side."

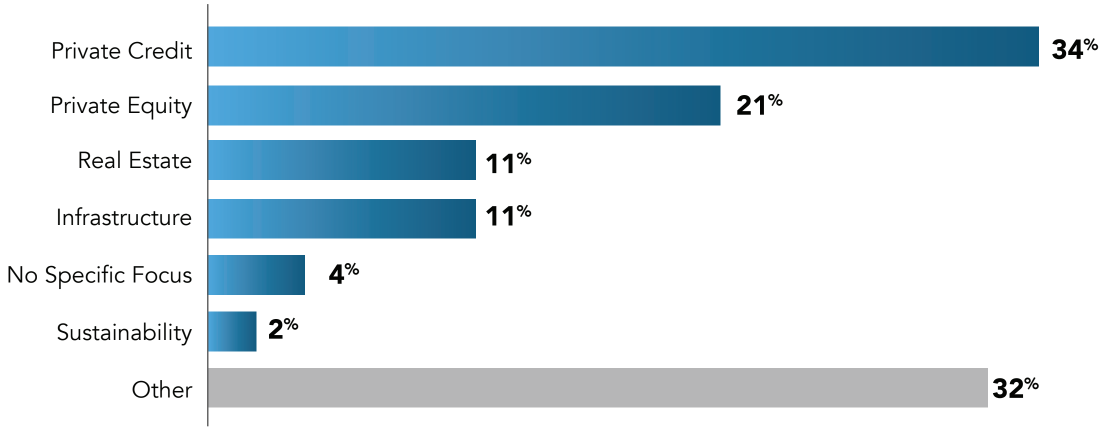
"Sentiment among our clients about private credit is barbelled," Allspring's Kneafsey said. "On one end, many love it, and on the other, there are some that scratch their heads and expect it not to end well. The skeptics have a valid point, in our opinion."

Kneafsey noted several factors suggesting that private credit will disappoint. The first is too much money chasing too few deals. This could lead to poor decision-making, such as inadequate deal vetting and acceptance of deals with relatively low investor protections. Next is the fact that most private credit is floating rate, which could prove too expensive for borrowers to service at these now-higher rates. "If you owned floating-rate debt and interest rates went up 500 basis points in a little more than a year, wouldn't you expect a big jump in defaults over time?" he asked.

Kneafsey also emphasized that some plan sponsors have faith that their managers can avoid private credit's potential dangers. "With too much money chasing too few deals and a 500-basis-point hike in rates, plans expect there to be pain," he said. "But many plan sponsors seem convinced that their private credit managers won't be the ones chasing deals and somehow dodge the defaults on that floating-rate debt. Time will tell."

Institutions Most Focused on Investing in Private Credit

"Where are you most focused on deploying capital over the next 12 months?"*



** Responses don't sum to 100% due to some respondents indicating multiple strategies.*
Source: 2024 Private Markets Diagnostic Survey, Goldman Sachs Asset Management, Oct. 2, 2024.
https://am.gs.com/en-ae/advisors/insights/report-survey/private-markets-survey

GOING HOLISTIC

Public DB plans are trimming their manager rosters to build deeper relationships and adopt a more flexible approach to market opportunities.

Many public pension plans are choosing to reduce the number of managers they hire and deepen their relationships with those they retain. Goldman Sachs Asset Management's Burton explained how plans are thinking about this holistic approach and what they're looking for.

"Public plans are asking themselves important questions," she said. "How many managers do we actually have in our portfolio? How many line items? Would we be better off with less? How can we reduce the complexity of managing the plan? And if we go with fewer managers, how can we get more value from them?"

It's only natural that plans would feel most comfortable with existing managers who've worked with the plans for a long time, added Burton. "You may have been invested with a manager for decades or more, so you've built trust through a number of market cycles, and the manager's understanding of your portfolio is much wider than that of a shorter-tenured manager," she said.

Burton listed several key potential benefits that plans want when they pare down their manager rosters. These notably include lower fees from the consolidation of assets; better client service; the manager's ability to work more closely with a plan's staff and provide training, as needed; and more access to investment professionals and their views on markets.

BIGGER IS BETTER

Perhaps the biggest benefit of manager consolidation, according to Morgan Stanley Investment Management's Mueller, is the opportunity to partner with large managers and reap the advantages of their size and scale.

Public plans, he said, are looking for managers with top-shelf investment capabilities across the spectrum of asset classes, a deep understanding of what the plan's institution is trying to achieve and a high degree of trustworthiness. The managers also should make investment teams easily accessible, be able to pivot as market conditions change and, above all, generate strong performance.

Given these requirements, what does an ideal manager look like? For Mueller, it starts with size. "You must have more capabilities, which means you need to be bigger and well resourced," he said. "And that gives a natural advantage to managers, like MSIM, that have achieved a certain level of scale and breadth and put significant emphasis on performance and client service. In fixed income, that translates into having an investment platform that spans the asset class, does it really well and can offer private solutions."

The current trend toward manager consolidations began post-financial crisis, when plans wanted to give their managers more flexible mandates to take advantage of massive dislocations. The pandemic caused more dislocations that reinforced plans' desire to give their managers more flexibility, and it has only accelerated since then. "Those conversations continue, and the theme of wanting to do more with less is increasing," Mueller said.

TACTICAL FLEXIBILITY

Public pension plans are also showing increasing interest in flexible fixed-income mandates. By definition, these mandates give managers the freedom to move around within the broad fixed-income universe as market conditions shift.

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>
> —Jeff Mueller, Morgan Stanley Investment Management

As Goldman Sachs Asset Management's Moran explained, "When rates were very low, many of our public pension clients had to reduce their fixed-income exposure because they had to look elsewhere for incremental yield. In some cases, these plans now have to rebuild that exposure back to where it previously was, which could involve an increase to the allocation."

"It's much faster and more efficient to use one manager who can be flexible in terms of strategies in different environments instead of multiple managers," he said. "The chosen manager should offer economies of scale and capabilities across fixed-income sectors. And given the multitude of investing risks that we have today — like geopolitical risks, a potential growth slowdown, tight spreads and high Treasury issuance — having a manager with the flexibility to make changes within the parameters of the mandate makes it easier for clients to implement their market view at any time."

UNDERSTAND 'FINANCIAL GRAVITY'

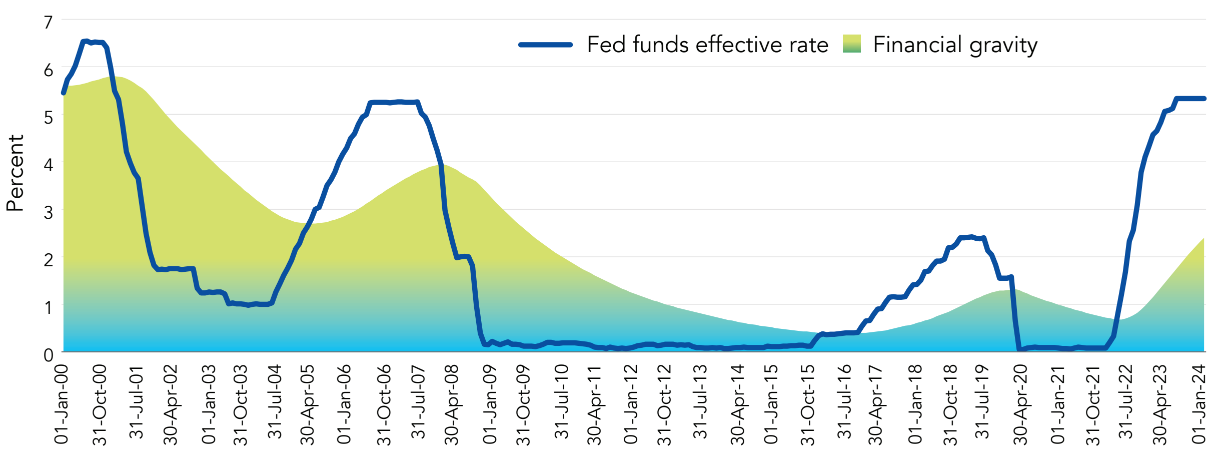
Another key consideration for public pension plans as they position their portfolios in this next rate cycle is to understand and address a phenomenon known as "financial gravity," said Allspring Global Investments' Kneafsey.

He posits that the weight of interest rates on the economy is a function of their level and the length of time they stay there (see visual).[1] Financial gravity exerts little downward pressure on financial assets when rates are low for an extended period, as they were for most of the time between the great financial crisis and 2022. But the weight grows more significant when rates are higher for longer, as the burden on floating-rate borrowers grows and more fixed-rate borrowers issue new debt or refinance at much higher rates.

If Kneafsey is right, then markets may be poised for significant weakness. What can institutional investors do to cushion the blow?

"Plans with big holdings of illiquid assets should consider selling some of those positions in the secondary market," he said. "The first sellers will get the best prices and can increase their liquidity, so they'd be better able to withstand a market shock. Those with ample liquidity should protect liquid assets so they stand ready to buy public or private assets at distressed prices in a liquidity event."

Financial Gravity Lags Changes in Interest Rates



Sources: Allspring Global Investments and Bloomberg Finance. Period shown is Jan. 31, 2000, through March 31, 2024.

[1] Financial gravity is probably best characterized by some combination of nominal and real rates times time. For simplicity and clarity, we limit this discussion to nominal rates. Interestingly, as of March 31, 2024, the financial gravity effect of real rates is slowly recovering from being strongly negative, which helps explain the muted economic response to the dramatic shift in nominal rates.