

US Rates Watch

Private pension fund rebalancing update

Rough estimate for direction of rebalancing needs

We use the framework introduced in the [Pension fund rebalancing and UST demand](#) report, to estimate expected December quarter-end rebalancing flows. The rebalancing needs of a portfolio that contains two assets (with allocation weights w_1 and $1-w_1$) and N assets under management is a function of the relative total return performance of the two asset classes (r_1-r_2):

$$\text{Rebalance} = N * w_1 * (1-w_1) * (r_1-r_2)$$

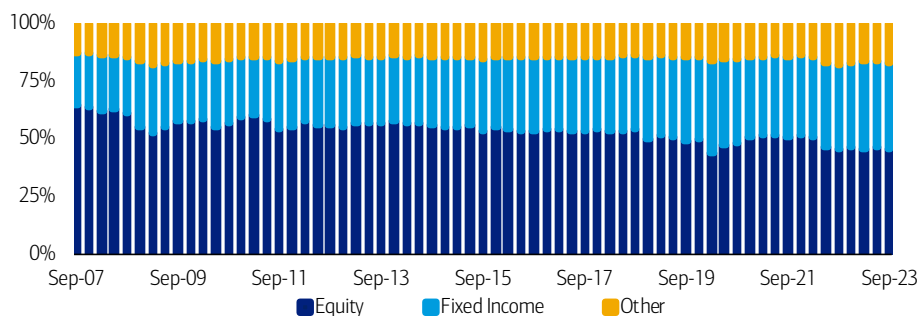
S&P total return month to date c.4.0%, and 10y+ UST index c.8.0% total return over the same period. The expectation is for a rebalancing out of Fixed income and into equities. For the quarter, however, strong S&P and 10y+ UST performance (c.11.1% and c.11.9%, respectively) and the relative underperformance of other asset classes (Corporates and Agency & GSE-backed securities) drives net outflows from both Equities and USTs.

Our expectations for rebalancing flows

Assuming only c.1/3 of the Oct. and Nov. rebalance was performed at the respective month ends, we see c.-\$14.5bn flows out of equities and c.-\$7.5bn out of USTs (standard deviation of monthly rebalance over the last 3y is c.\$22bn for equities and 8.5bn for USTs). For other FI assets the flows break down as: c.\$13bn into Corporates, c.\$8.5bn into Agency & GSE-backed securities, and c.\$0.5bn into Mortgages.

Exhibit 1: Allocation breakdown for private pension funds obtained from the FRB Z.1 release

Equity allocations c.46-47% over the last 5 quarters, UST allocations >10% since 1Q23



Source: BofA Global Research, FRB Z.1 Release

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Passive rebalancing vs structural demand

Beyond passive rebalancing, we continue to expect some structural demand for duration from pension funds (see [Pension de-risking opportunity may narrow with lower rates](#) and Exhibit 2) particularly as funded ratios stay > 100%. In de-risking, allocation profiles converge over time to target significantly higher fixed income contents and lower equity exposures. This structural demand is likely to persist medium/longer term.

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Rates Research
United States

Bruno Braizinha, CFA
Rates Strategist
BofAS
bruno.braizinha@bofa.com

Anna (Caiyi) Zhang
Rates Strategist
BofAS
cai.yi.zhang@bofa.com

c.: circa

FI: fixed income

GSE: Government-Sponsored Enterprise

UST: US Treasury

N: Assets Under Management

r: Return

w = Allocation Weight

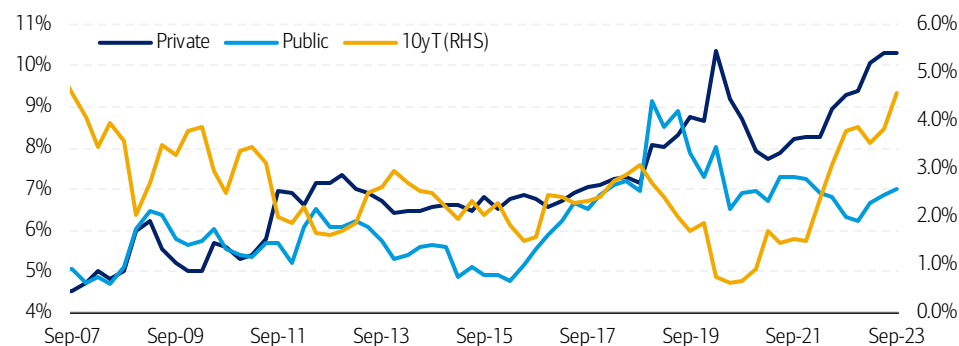
10y = 10-year

c. = circa

FI = fixed income

Exhibit 2: Allocations to USTs as a % of total allocated assets (total – miscellaneous assets) for both public (state and local) and private defined benefit pension funds vs 10yT yields.

Higher UST allocations over 1Q23 in a risk-off context (10yT rallied c.30bp) and again in 2Q and 3Q23 as rates sold off c.30bp and 70bp respectively (last leg of selloff in 3Q saw a smaller allocation increase). This seems to suggest a more structural bias to increase allocations (and de-risk in the case of private pension funds) in a late cycle dynamic rather than a more tactical stance.



Source: BofA Global Research, FRB Z.1 Release

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Methodology

The data sources we use in our framework are pension fund allocation weights obtained from the Federal Reserve Board (FRB) Z.1 release and total return performance for each of the asset classes. Critical to this process is the choice of the appropriate benchmarks that define the performance of each asset class.

The FRB Z.1 release segregates private pension fund assets into (1) checkable deposits and currency; (2) time and savings deposits; (3) money market fund shares; (4) security repurchase agreements; (5) open market paper (also known as commercial paper); (6) Treasury securities; (7) agency and GSE-backed securities; (8) corporate and foreign bonds; (9) loans (mortgages); (10) corporate securities; (11) mutual fund shares; (12) unallocated insurance contracts; (13) assets of private pension plans held at life insurance (LI) companies; (14) contributions receivable; and (14) claims of pension fund on sponsor (unfunded defined benefit pension entitlements).

In our approach, we aggregate these into equities (10+11), fixed income securities (6+7+8+9), and other assets. Together, the first two generally amount to 70-80% of total assets (5-10% in Treasuries). For each of these assets (6 to 11 above), we assign a benchmark to calculate their expected performance – for example, the S&P total return for the equity portion of the allocation (10+11) and the total return on the ICE BofA 10+ Year US Treasury Index for the Treasury portion (6).

In this framework, we assume that the allocation weights are kept constant from the last information available and calculate the monthly and quarterly rebalancing needs based on the performance of assets and the assumption of convergence back to target allocation. Because there are clear trends in allocation weights over time, we correct the rebalancing weighs by the average allocation drift seen over the last two quarters.

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