Improving pension derisking: How bridge assets can reduce funded ratio volatility

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Stock markets have continued to show resilience against significant shocks, even as interest rates globally have ratcheted higher over the last several years. For plan sponsors, this combination has been the perfect tailwind, helping drive significant improvements in funded status. Our analysis shows that bridge assets can help plans to derisk with lower volatility in their funded ratios and better protection against downside risk.

The asymmetry of surplus

The traditional derisking approach that combines (1) a liability-hedging fixed income portfolio with (2) a smaller allocation to return-seeking assets has served pension plans well, helping generate strong improvements in funded status in recent years. As of the end of July, corporate plans' funded status was at its highest level in nearly a decade.[1] As a result, the top priority for many plans now is to reduce funded ratio volatility, and with it the risk of significant declines in funded status.

This is of particular concern for plan sponsors who don't benefit from additional funding surplus after a certain point, but remain responsible for making additional contributions if market or economic downturns drive plans back into underfunded status. This imbalance is often described as the *asymmetry of surplus:* for these sponsors, the downside of a deficit outweighs the value of additional surplus. The traditional two-bucket investment strategy—which combines a liability-hedging fixed income portfolio with a smaller allocation to return-seeking assets—leaves these plans with a constrained toolkit as they look to determine a path forward. Bridge assets could provide plans with a preferable option for derisking.

Defining bridge assets

For a better way to achieve stability in funded status, plan sponsors can enhance their traditional two-bucket allocation strategy by adding a third investment category, which we call bridge assets. These are exposures that sit between the risk and return levels of growth allocations and liability hedging allocations, and include high yield bond, emerging market debt, and leveraged loan product. Bridge assets can also include yield-oriented or lower volatility return seeking assets such as global low-vol equity and infrastructure, but the focus of this paper is on fixed income bridge strategies.

Bridge assets can enhance funded ratio return while better preserving funded status in stress scenarios.

Our data shows that when packaged together, bridge assets allow less downside risk to a plan's funded status with a small reduction in the growth potential of equities. The availability of highly liquid, cost-effective indexed investment vehicles for these asset classes makes it relatively simple and efficient for plan sponsors to create a bridge assets allocation.

Why bridge assets matter now

The potential benefits of bridge assets may be especially important today. While markets have been resilient through various economic shocks, plan sponsors could face increased market volatility due to geopolitical tensions, weakening consumer sentiment, and late credit cycle dynamics. Such uncertain environments, combined with significant funded ratio improvements, suggest employing a portfolio construction solution that can better withstand shifts in market conditions and economic regimes, while shying away from attempting to time markets or implementing tactical moves. With the flexibility of new and innovative solutions available in the modern fixed income marketplace, plan sponsors can tailor their bridge assets allocations based on funded status, risk tolerance, and other objectives.

Understanding the diversification benefits of bridge assets

High yield bonds, leveraged loans, and emerging market debt incorporate elements of both return-seeking and liability hedging exposures. They offer higher yield and return potential to outperform the investment grade bonds that serve as a proxy for a plan's liabilities, but without taking on full equity risk.

When packaged together in a bridge assets allocation, the unique characteristics of each asset class provide additional diversification opportunities, lower correlations to traditional fixed income and equities, and sensitivity to different economic cycles.

For example, here is how the different components of a bridge asset allocation offer diversification that complements both growth seeking and liability hedging investment buckets:

- High yield is an important core plus strategy, with different reaction functions, industry composition, income cushion, and other characteristics versus investment grade credit.
- Emerging market debt (hard currency) can offer geographic diversification that reduces risk from US-specific macroeconomic cycles and corporate fundamentals.
- Leveraged loans provide access to floating rate securities to diversify interest rate risk.

It's very challenging to build a portfolio that's perfectly suited for all market environment and economic regimes. But by allocating a portion of plan's return-seeking and liability hedging investments into bridge assets, plan sponsors can build portfolios with the potential to better manage transitions between those conditions and reduce tracking error versus liabilities.

And, in a scenario in which an equity market correction coincides with periods of falling interest rates, bridge assets may help cushion significant declines in funded status. Figure 1 shows the key characteristics of bridge assets and their different drivers of risk and return.

Figure 1: Key characteristics of bridge assets

	US high yield	US leveraged loans	Emerging Market debt
Key risk & return drivers	• Credit risk • Interest rate risk • Sensitive to US economic cycle and corporate fundamentals	• Credit risk • Floating rate minimizes interest rate risk • Senior to high-yield debt; typically	• Hard currency sovereigns driven by US rates and country-specific factors • Local currency sovereigns driven by local rates and foreign currency
Yield	6%–8%	7%–10%	5%–7%
Volatility	7%–9%	5%–8%	7%–12%
Duration	3–4 years	< 1 year	5–7 years
Correlation to Equities	0.7–0.8	0.6–0.8	0.5–0.7
Diversification role	Complements core fixed income with high yield and lower correlation to investment grade	Low correlation to traditional fixed income; Interest rate hedge	Geographic and currency diversification; Useful in global macro strategies

Source: State Street Investment Management, as of September 1, 2026. For yield and duration, US High Yield is proxied by the Barclays U.S. High Yield Index; US leveraged loans is proxied by the Barclays US Leveraged Loan Index; EM Debt is proxied by the Barclays EM Hard Currency Aggregate Index. Modified Adjusted Duration and YTW. Data 1 year ending October 20, 2026. For correlation and volatility, sources are State Street Investment Management, JP Morgan, Bloomberg, Virtus and Morningstar, with the S&P 500 Index as proxy for equities. Data as of June 30, 2026, with 10-year data. EM Correlations are based on 3-year correlations of the Morningstar EM Bond GR Hedged versus the Morningstar US Market, as of April 20, 2026. See: https://www.morningstar.com/bonds/bonds-cash-remain-top-sources-ballast-equity-investors. Volatility for EM Debt is measured by 1-year standard deviation of the proxy index.

Modeling the impact of bridge assets

To demonstrate how bridge assets could help reduce funded ratio volatility across different regimes, we performed a modeling exercise to compare a traditional derisking strategy with one that incorporates bridge assets. Please see disclosure section for additional information on the hypothetical underlying performance related to this modeling exercise.

The analysis compared outcomes for a plan with a typical allocation of 80% liability hedging assets and 20% return-seeking assets, to a plan with a 80% allocation to liability hedging assets and a 20% allocation to bridge assets. This simulation took into account current market conditions and asset class correlations to generate 10,000 scenarios for market performance and identify a range of potential outcomes—from a best-case scenario for the plan to a worst-case scenario. See Appendix for details on the simulation.

As shown in Figure 2, a plan with a typical two-bucket derisking investment strategy performed extremely well in the best-case scenario (outcomes in the fifth percentile), growing its projected funded status from 105% to 126% over six years. Yet that excess surplus may not adequately compensate plans for the risk of poor investment performance. In the worst-case scenario (outcomes in the 95th percentile), the plan's projected funded status fell to 95% by year six.

By contrast, the outcomes for a plan that replaced equities and a portion of liability hedging assets with bridge assets fell in a tighter range. In the best environments, the plan maintained a significant portion of its upside potential and grew funded status to 117%. But the addition of bridge assets made its biggest contributions in the worst environments: Even in outcomes in the 95th percentile, the plan's funded ratio only fell by three percentage points and remained fully funded.

Figure 2: Bridge assets cushion funded status declines vs. a traditional growth seeking + liability hedging investment strategy

Growth (%)	Hedging (%)	Bridge (%)		Hypothetical funded ratio projections (Years)					
				Year 1 (%)	Year 2 (%)	Year 3 (%)	Year 4 (%)	Year 5 (%)	Year 6 (%)
20	80	0	**95th**	105	104	102	100	98	96
			50th	105	109	110	111	111	112
			5th	105	113	117	120	124	126
0	80	20	**95th**	105	106	106	105	104	102
			50th	105	108	109	110	110	110
			5th	105	112	114	115	116	117
				Hypothetical impact versus benchmark					
			95th	0	2	4	5	6	6
			50th	0	-1	-1	-1	-1	-2
			5th	0	-1	-3	-5	-8	-9

Source: State Street Investment Management, as of July 19, 2026. The results shown represent current results generated by our funding ratio model. The results do not reflect actual trading and do not reflect the impact that material economic and market factors may have had on State Street Investment Management's decision-making. The results shown were achieved by means of a mathematical formula, and are not indicative of actual future results which could differ substantially. Sample metrics shown above are hypothetical and are based on assumed returns of the underlying market indices in the growth, hedging, and bridge portfolio proportions shown above. Market indices are unmanaged and not subject to fees and expenses which would lower returns. Neither index performance nor sample portfolio performance is intended to represent the performance of any particular mutual fund, exchange-traded fund or product offered by SSGA Funds Management, Inc. SSGA Funds Management, Inc. has not managed any accounts or assets in the strategies represented by the sample portfolios above. Actual performance may differ substantially from the hypothetical performance presented. The performance data quoted represents past performance. Past performance does not guarantee future results. Inputs are scenario and correlation analyses from State Street Investment Management and Moody's Investors Service.

Solving the conundrum of excess surplus

We have written about the decisions that pension plan sponsors are charged to make when there is an excess surplus. Options are complex and come with limitations and tax consequences. In some cases, the surplus would encourage DB plan sponsors to contribute to a DC cash balance plan, rather than keep the surplus as a reserve for the future. While this is a positive for employees who then benefiting from the surplus, it could have the tertiary impact of making plan sponsors bear more of the market risk, versus a 401K plan.

Therefore, plan sponsors could benefit from thinking more broadly in terms of surplus strategy and managing their funded status for the long-term, rather than simply derisking with traditional liability-hedging fixed income assets.

Bridge assets case study: Customization at scale

Plan sponsors can add bridge assets to their investment mix at nearly any point in a derisking glidepath, then adjust exposures over time to reflect changes in funded status, benefit accruals, participant population, and other factors.

That approach helped one State Street client, a US-based technology company with a partially active plan, achieve and maintain its surplus funded status for a decade. The company consulted with us to design a derisking glidepath in 2015, when the plan was 95% funded and still held the majority of its assets in a return seeking portfolio. Together, the plan sponsor and our investment team designed a new investment portfolio with an 85% allocation to liability hedging assets and a 15% allocation to bridge assets.

After the plan's funded ratio reached 105% in 2018, the plan completed a partial annuitization of some participants and adjusted its investment mix again, shifting the portfolio to a 90% allocation to liability hedging investments and

10% to bridge assets. That portfolio helped the plan sustain its funded ratio between 109% and 118% through 2025, with no additional contributions, despite periods of high volatility in equities and interest rates, continued benefit accurals, and ongoing plan expenses.

As this example shows, the addition of bridge assets could increase funded ratio stability and improve the chances that a pension plan will complete its derisking glidepath without requiring additional contributions.

The bottom line: Modernizing portfolio construction for well-funded plans

Well-funded plans should prioritize preserving the funded status gains they've achieved. While most plan sponsors achieve little benefit by growing their funded status above a target level, they have a large incentive not to see their funded ratio fall back below 100%.

Bridge assets modernize and improve traditional DB portfolio construction. Their characteristics can better manage volatility in fixed income and equity markets and create more resilient portfolios for inevitable changes in economic regimes. Of course, asset managers must pay attention to which bridge assets are used to construct the hedging portfolio, and when. For example, one must acknowledge that the duration of bridge assets, such as high yield and emerging market debt, is less stable and can behave very differently from that of U.S. investment grade bonds, particularly during market dislocations and periods of credit stress

This approach to pension management can help plans pursue other critical goals: Bridge assets can help underfunded plans smooth the path to full funding, as in the client case study above. And once plans are fully funded, bridge assets can help offset fees, the impact of the uninvestability of the discount curve as well as the impact of service cost if active participants still accrue benefits.

To learn more about how a bridge assets allocation may be beneficial to your DB plan, please contact the State Street Investment Management Fixed Income, Currencies, and Commodities (FICC) team.

Appendix

The pension projections reflects trends based on scenario analyses from Moody's Investors Service. This engine's projections are based on the latest trends in correlations between asset classes. Sources are Moody's and State Street Investment Management.

Endnote

1 Wadia, Zorast. "Pension funding index June 2026." Milliman, as of August 2026.

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The simulated performance shown was created by the State Street Investment Management Defined Benefit Strategy team. The methodology used to calculate performance was combining assumed correlations and yields from State Street Investment Management and Moody's Investors Service. The results shown do not represent the results of any singular pension fund, but were achieved by combining the actual performance data of various asset classes to create a new hypothetical performance stream. The simulated performance was compiled after the end of the period depicted and reflects blended investment results rather than the live performance of any particular strategy or product.

The simulated performance data is reported on a gross of fees basis, but net of administrative costs. Additional fees, such as the advisory fee, would reduce the return. For example, if an annualized gross return of 10% was achieved over a 5-year period and a management fee of 1% per year was charged and deducted annually, then the resulting return would be reduced from 61% to 54%. The performance includes the reinvestment of dividends and other corporate earnings and is calculated in US dollars. The simulated performance shown is not necessarily indicative of future performance, which could differ substantially.

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