

PIERCE FINANCIAL

# Retirement Report

NEWS AND UPDATES FOR PLAN SPONSORS AND  
FIDUCIARIES OF DEFINED CONTRIBUTION PLANS

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## Fixed Income: A Sinking Ship or Much Ado About Nothing

Time is a powerful modifier of perception and purpose. No need to look any further than the frequent rumbles surrounding fixed income in the current rising interest rate environment. That isn't to say the frequently touted "bond bubble" and rising interest rate topics are unimportant or overstated, it's merely a reaction to the volume and misappropriation of focus often exhibited in these ongoing conversations. Monitoring the trajectory of rising interest rates is a good idea, however letting it affect the way you invest in fixed income may not prove additive in the long term.

Generally speaking, fixed income, aka bonds, react in direct opposition to interest rate movement. That is to say, when interest rates go up, the price of bonds go down. That much is easy enough to understand considering the structure of these investment vehicles: a bond is a loan and, if held to maturity, allows the investor to know the return on investment (interest paid on the loan or "coupon") at the time of purchase. However, the purpose and value of fixed income, relative to one's overall portfolio, can be easily forgotten considering the market environment over the past 30 years. Interest rates over this period exhibited a relatively steady decline while the Bloomberg Barclays's U.S. Aggregate Bond Index<sup>1</sup>, the most common benchmark by which fixed income is compared, returned an annualized average of 6.31 percent<sup>2</sup>. This near equity-like level of return on investment has led to an environment that has fostered a viewpoint of looking at bonds in a similar fashion as equity, when in fact their primary function in the context of a well-diversified portfolio is entirely different.

Let's take a step back and revisit two fundamentals of portfolio construction: 1) the role of equity (stocks) in a portfolio is wealth accumulation, 2) the role of fixed income (bonds) is wealth preservation. As we continue into the early stages of a rising interest rate environment, expectations have to be retrained and refocused. From a macro long-term outlook, fixed income should reduce volatility while providing income. Equity is generally more volatile and provides the source from which one hopes to generate greater return. Proper balance between the two is determined by a number of metrics and is personal in nature, but none more so than proximity to retirement and risk tolerance.

Now we can return to the aforementioned end of the bond bull market and interest rates on the rise. Does this in any way change the purpose and function of fixed income? I would argue the answer is a resounding no. Fixed income provides a hedge against the higher risk/volatility of equities. The functional relationship of bonds to equity remains unchanged. Thus, the viability and benefit for consideration and inclusion within a well-diversified portfolio also remains unchanged.

It merits mentioning that not all fixed income instruments bare equal sensitivity to interest rate movement. Longer duration or time until maturity is certainly one of the primary factors to consider, however it also isn't the end-all de facto. Bond categories with low correlation to U.S. government debt have historically fared better than those with high correlation. High yield and bank loans may be particularly resilient options for income seeking investors in times of rising rates<sup>3</sup>.

Attempting to time the markets as a strategy is about as viable a solution as relying on Punxsutawney Phil for reliable weather forecasts (Phil has worse accuracy than a coin flip (39 percent<sup>4</sup>) in case you were curious). Consider the following historical data as it relates to what happens just after the initial negative effect rising interest rates have on bond prices in the short term: out of the 19 periods of rate increases dating back to 1979, the Bloomberg Barclays U.S. Aggregate Bond Index actually saw improved returns 17 times in the year that

followed (returns between less than 1 percent and 35 percent, and an average return of more than 10 percent)<sup>5</sup>.

The complexities that affect market fluctuations and interest rates, can and should be analyzed when making prudent investment decisions. However, keeping a macro view firmly in place when it comes to investment characteristics will help maintain expectations and provide context for fiduciary and participant decisions alike.

So before the media chatter of “the sky is falling” spooks you into getting out of fixed income, consider the possibility this “scary movie” might just end up rated G.

<sup>1</sup>The Bloomberg Barclays U.S. Aggregate Bond Index is composed of securities from the Barclays Government/Credit Bond Index, Mortgage-Backed Securities Index, Asset-Backed Securities Index, and Commercial Mortgage-Backed Securities Index.

<sup>2</sup>Morningstar Direct as of 3/31/2017

<sup>3</sup>Morningstar, Ned Davis Research, 12/16. Period of rising rates were defined by a 20% change in the 10-year U.S. Treasury yield.

<sup>4</sup>According to the Stormfax® Almanac: <http://www.stormfax.com/ghogday.htm>

<sup>5</sup>Morningstar, Ned Davis Research, 12/16. Period of rising rates were defined by a 20% change in the 10-year U.S. Treasury yield.

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## When Participants Retire, Should Their QDIA Retire as Well?

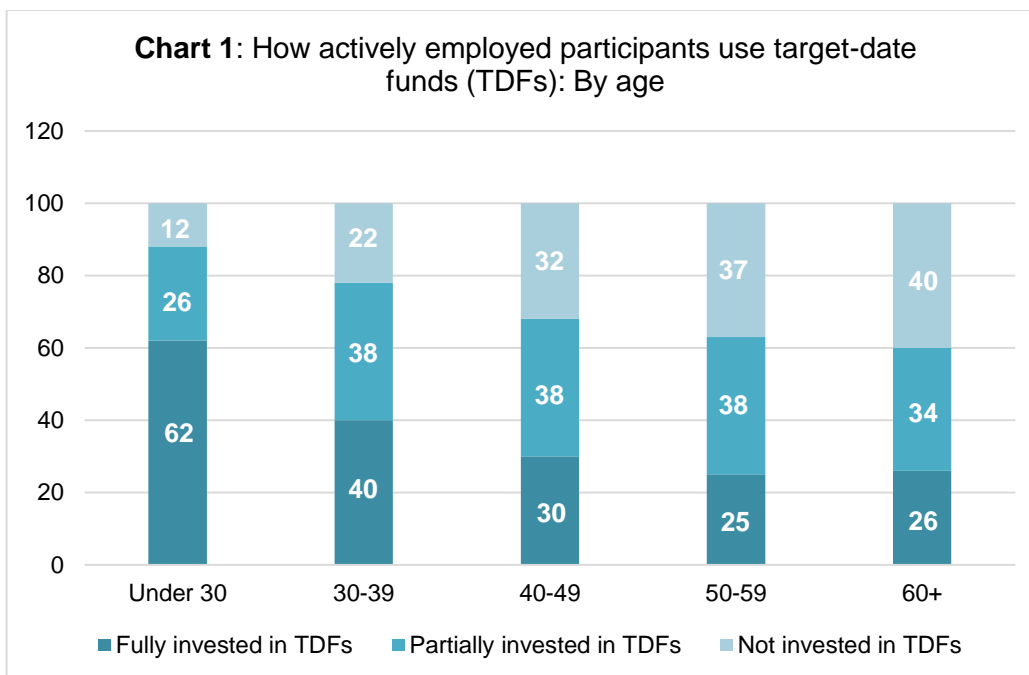
Many retirement plan sponsors are increasingly recognizing the benefits of allowing retired employees to leave assets in the defined contribution (DC) plan. This arrangement can be a win-win for both plan sponsors and participants. Fat retiree balances may improve plan economics, allowing plan sponsors to negotiate lower fees. And participants can take advantage of funds that are overseen by fiduciaries, often available at lower costs.

Those passively enrolled generally have their contributions invested by default in the plan’s qualified default investment alternative (QDIA). In light of this, plan sponsors and their advisors may ask: The plan’s QDIA may be appropriate for younger workers, but is it the best choice for retired participants? For that matter, what about near-retirees and other participants who may have different risk profiles?

There are a number of individual investment types to consider to help support the needs of participants, both near retirement and already retired. For example, plan sponsors may want to consider adding risk-managed, multi-asset allocation funds designed to deliver both growth and income as a starting point. It could be supplemented with a fixed income fund to support the more immediate financial needs of retirees and for more risk-averse investors. Retirees with higher risk profiles — those who don’t need to tap their assets immediately — may want more access to equities, perhaps in specialized areas like small-cap and emerging market funds, to help infuse more diversity into the growth portion of their portfolios that won’t be tapped until later in retirement.

While target-date funds are designed to be all-in investments, their one-size-fits-all approach may simply not work for different circumstances. An Aon Hewitt study<sup>1</sup>, which found that slightly less than half (49.7 percent) of investors were using target-date funds “correctly” as their sole retirement investment, suggests some retirement investors may have valid reasons for partial target date use.

For example, the study noted, two 50-year-old participants may have different financial circumstances. One might have a defined benefit (DB) plan, a child who has completed college, and a house that’s paid off. The other might not be eligible for a DB plan, has children just starting college, and has significant mortgage payments. These two participants may need different retirement portfolios, but a target-date fund would treat them in identical fashion. With that in mind, it may not be surprising that as participants age there’s a decrease in the percentage of those using target date funds for their full portfolio, as shown in Chart 1.



### Asking the right questions

Advisors can help plan sponsors stay ahead of the trends by analyzing their pre-retiree and retiree populations now to answer these questions:

- When will most retirees across the population likely need to tap their plan assets?
- Do the current QDIAs meet those needs?
- Should new retiree-focused investments be designated?
- Does the fund lineup need to be expanded to meet the diverse needs of retirees?
- What is the plan's approach to educating near-retirees on this issue, and possibly tying it to other financial wellness efforts?

Educational resources and managed account services targeted to pre-retirees and retirees can help these participants implement strategies that make sense for their own situations and their retirement years.

<sup>1</sup>Aon Hewitt, *Target-Date Funds: Who is Using Them and How Are They Being Used?* November 2016.

**Mutual funds are sold by prospectus only. Before investing, investors should carefully consider the investment objectives, risks, charges and expenses of a mutual fund. The fund prospectus provides this and other important information. Please contact your representative or the Company to obtain a prospectus. Please read the prospectus carefully before investing or sending money.**

This is an excerpt of Macquarie Investment Management's article, "When participants retire, should their QDIA retire as well?"

### New Definition of Fiduciary

As you are aware, in 2016 the Department of Labor (DOL) finalized regulations updating, and expanding, the definition of "fiduciary" in regards to the provision of investment advice. Originally these regulations were set to become applicable in April of this year. The current administration wanted to delay the applicable date to allow the DOL to fully examine the impact of the new rules. As a result the DOL pushed back the applicable date to June 9<sup>th</sup>. Then, days after the confirmation of Secretary Acosta he confirmed that June 9<sup>th</sup> would be the date the new rules would become applicable. That date has arrived and we have a new operative definition of fiduciary for the financial services industry.

As you are likely aware, as a fiduciary under the rule, advisors must receive level compensation in connection with covered recommendations unless their engagement falls under an exemption. The DOL continues to make the Best Interest Contract (BIC) exemption available to allow fiduciaries to receive commissions and other forms of non-level compensation.

Importantly, the DOL has limited the requirements of the exemption to adoption and implementation of Impartial Conduct Standards, as defined in the rule.

As more information becomes available Pierce Financial will continue to keep you informed.

If you have any questions please do not hesitate to contact Lee Pierce at 901-271-3720, or [lee@piercefincial.org](mailto:lee@piercefincial.org).

## Benchmarks Are Not Created Equal

Because benchmarks are an important part of investment due diligence, a plan fiduciary should carefully consider their selection. Two of the most common are FTSE Russell<sup>1</sup> and Standard & Poor's<sup>2</sup>. The RPAG Scorecard<sup>3</sup> utilizes Russell and here's why:

- Russell ranks each company in the investable universe according to its total market capitalization. The market cap is the primary tool to determine where a company belongs in the Russell Index. S&P uses a committee to make these decisions.
- Russell indices adjust each company's capitalization ranking to eliminate closely held shares that aren't likely to be traded. Using this float adjustment methodology, Russell creates benchmarks that aims to accurately reflect the market.
- Russell updates their indices' holdings on a regular basis. Russell reconstitutes its indices annually, which assist in a truer representation of the market.
- Russell indices objectively allow the market to determine the index composition according to clear and published rules. The market determines which companies are included, not the subjective vote of a selection committee.

<sup>1</sup>Russell U.S. Indexes are the leading U.S. equity benchmarks for institutional investors. This broad range of U.S. indexes allow investors to track current and historical market performance by specific size, investment style and other market characteristics.

<sup>2</sup>Standard & Poor's (S&P) is the world's leading index provider and the foremost source of independent credit ratings. Standard & Poor's has been providing financial market intelligence to decision makers for more than 150 years. S&P Global divisions include S&P Global Ratings, S&P Global Market Intelligence, S&P Dow Jones Indices and S&P Global Platts.

<sup>3</sup>The RPAG Scorecard System is a ranking of funds in approximately 30 asset classes to identify skillful managers utilizing quantitative and qualitative factors. Scores range from 1 to 10.

## Communication Corner: 4 Tips for Increasing Your Retirement Dollars

This month's employee memo offers four tips for participants to increase their retirement savings.

Call or email Lee Pierce you have questions or need assistance, 901-271-3720, or [lee@piercefincial.org](mailto:lee@piercefincial.org)

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