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Accepting market returns: Risky business for defined contribution plans?

KEY POINTS

- Low expected capital market returns call into question the adequacy of index-tracking passive investments alone to help participants become retirement-ready.
- As co-fiduciaries, we believe that plan sponsors, consultants, and managers have a shared responsibility to seek out opportunities for improving participant outcomes — including the thoughtful use of active risk.

THE CHALLENGES IN MAKING WORKERS "RETIREMENT READY" ARE WELL KNOWN. Expectations of low future capital-market returns, together with longer lifespans and single-digit employee contribution rates, mean that many defined contribution (DC) plan participants face significant retirement savings shortfalls.

Aside from having employees work longer and defer retirement, the two levers employers can pull to address this situation are to encourage participants to save more and to offer investment solutions with the potential for higher returns and better downside mitigation. Both avenues for improving retirement outcomes could be impactful and should be explored; this piece focuses on the second path.

Will market returns get your participants from here to there?

We recently examined the forecasts of eight major investment consultants for capital market returns over a five- to 10-year time frame. Averaging those forecasts resulted in a prediction of 7.0% and 2.9% annual returns from global equities and core bonds, respectively.[1]

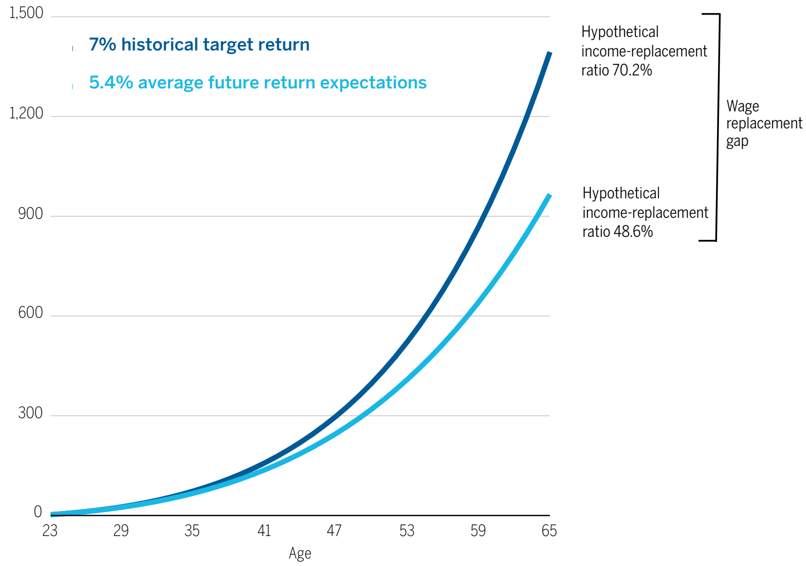
For a hypothetical 60% equity/40% bond portfolio, these numbers translate into an overall 5.4% expected annual return. Under a simple wealth-accumulation scenario (**Figure 1**, next page), using that 5.4% expected figure versus a reasonable 7.0% long-term historical average return reduces forecasted income from 70.2% of preretirement income to a scant 48.6%.

[1]Available estimates for each asset class were averaged after removing the highest and lowest estimates. | Data as of August 2016 collected by Wellington Management

Figure 1

Market returns and the impact on income replacement

Hypothetical accumulated assets (US$ thousands)

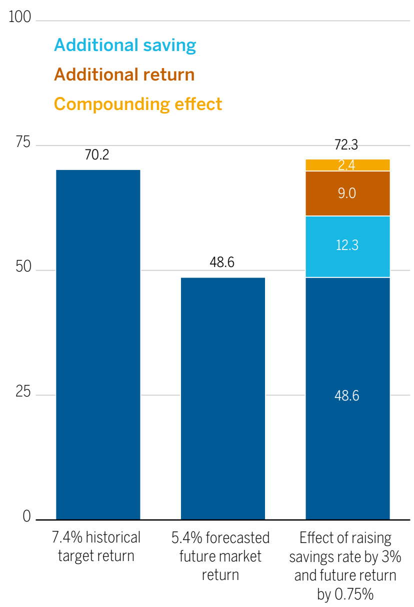


Assumes a starting salary of $26,078 at age 23. The real income growth rate is constant at 5.5% from age 23 to age 30, and linearly declines to 3.5% at age 40, 1.0% at age 50, and 0% at age 60, and stays at 0% from age 60 to age 65. Based on these growth-rate assumptions and starting income of $26,078, real income is $79,420 at age 65 in the model. Sources: US Census, Wellington Management calculations | Total annual contribution rate starts at 8.9% at age 23, and gradually increases to 9.9% at age 27, 10.8% at age 32, 11.4% at age 37, 11.9% at age 42, 12.5% at age 47, 13.9% at age 52, 14.7% at age 57, 15.3% at age 62, and 15.7% at age 65. Savings include employee deferral and employer match. Expected income-replacement ratio at age 65 is calculated based on the assumption of 4% withdrawal rate. Sources: US Census, Fidelity Investments, Wellington Management. | The returns and other assumptions provided are hypothetical and are not representative of actual accounts or investments. This material is for illustrative purposes only, is not representative of future returns, and is not to be considered investment advice. **Hypothetical results are not necessarily indicative of future results and an investment can lose value.**

Figure 2

Small changes can have a big impact on participant outcomes

Hypothetical income-replacement ratio at age 65 (%)



Please refer to disclosures for **Figure 1**.

Bridging the retirement-readiness gap

We believe that plan sponsors can take meaningful strides toward addressing the income-replacement deficit by partnering with participants in efforts to increase savings rates and seek modestly higher returns. In our hypothetical scenario, adding 0.75% to market returns through active management would raise the income-replacement ratio to 57.6%; when combined with a 3% increase in the share of income contributed, the ratio moves up to 72.3% — a meaningful improvement (**Figure 2**).

Active management: A vital tool

In recent years, the low fees of index-tracking passive investment strategies have attracted a great deal of attention from plan sponsors. Getting the most value from each fee dollar spent is certainly in participants' best interest. But to quote Warren Buffett, "Price is what you pay, value is what you get," and minimizing fees is not necessarily the same as maximizing value. In fact, sponsors' reliance on market returns to help their participants achieve retirement security could be perceived as inadequate. We believe the thoughtful use of active risk is essential to achieving successful participant outcomes in light of slim future expected market returns. In our view, the right question is not "active or passive?" Rather, it is "Where active and where passive?"

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Why are we bullish on active management?

Adding alpha may be more risk-efficient than shifting asset allocations as a way to enhance potential return

Alpha tends to be more risk-efficient than beta. For example, an investor might consider adding more exposure to equities in a quest to improve returns. Yet based on the return assumptions cited earlier in this piece, adding 1% of expected market return (beta) would require boosting the portfolio's equity allocation by about 14%. Said differently, 1% of alpha, which we would contend is not an outlandish goal, could potentially add as much return as an additional 14% in a passive equity beta allocation — a sizeable increase that could substantially heighten overall portfolio volatility and drawdown risk. We'd argue that adding 1% of active return (alpha) — a source of return independent of market direction — would increase overall portfolio risk much less than altering the stock/bond mix.

Extended valuations and mature bull markets highlight the importance of downside mitigation

Active management offers the potential to mitigate the impact of market downturns on portfolios. Mathematically, a dollar of alpha in a down market is worth more than a dollar of alpha in an up market. This idea is explored in a recent white paper[1] from our Investment Strategy and Risk team.

Mean reversion favors active

As noted by one of our strategists in another paper[2], "Many active managers have underperformed in recent years, and active management has historically demonstrated some mean-reversion characteristics. What's more, the volume of assets that has flowed into passive or other index-like approaches means there is less capital chasing active management opportunities, potentially providing more scope for active managers to add value."

Alpha is getting cheaper

Further bolstering the appeal of actively managed investment approaches is the steady decline in their average fees. As active fees have compressed, we believe that one of the arguments for passive management is eroding. Many sponsors continue to focus on the low absolute level of passive fees, rather than on the cost differential (spread) between passive and active. This spread has shrunk significantly, to the point that we believe discussions about active and passive can now focus on the fundamental merits of the two approaches, rather than fee differentials, in achieving successful participant outcomes.

Summing up

Defined contribution plans have become the primary savings vehicle for millions of US workers, and participants are facing increased headwinds. As co-fiduciaries, we believe managers, consultants, and plan sponsors have a shared responsibility to seek out opportunities to maximize value and improve participant outcomes. While there is no silver bullet, the thoughtful use of active risk is a tool for reaching these goals that should be considered — if not embraced.

About the author

Chris Goolgasian co-manages the firm's target-date strategies. As the Associate Director of Global Multi-Asset Strategies, Chris also partners with the portfolio management team on a variety of tactical, absolute-return, and risk-based strategies for the firm's clients. This includes multiple areas of the investment process across research, modeling, portfolio construction, and risk management, as well as working with clients on customized solutions.

[1] https://www.wellington.com/en/pub/downside-risk-management-still-important-update-seven-years-later

[2] https://www.wellington.com/en/pub/narrowing-return-gap-10-steps-right-direction

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