DC top ten for 2021

Ten considerations for DC participants preparing for retirement

Historically, defined benefit (DB) plans were the most dominant form of retirement savings vehicles. After years of dedicated work for an employer, employees would be rewarded with a pre-agreed monthly income throughout their retirement. In that arrangement, the liability is funded entirely by an employer. As defined contribution (DC) plans have replaced DB as the primary source of retirement income, the responsibility has shifted away from well-resourced plan sponsors to individual participants. Unlike a DB plan with a specified benefit, DC plans require the individual to determine the appropriate contribution rate, so when combined with investment earnings, their retirement will be adequately funded.

While DC plans are both popular and predominant, they have not yet proven to be successful as measured by the DB yardstick of providing employees with a lifetime of sustainable income. Funding retirement for the working population is a global challenge, and a significant body of research has delved deeply into the projected retirement savings gap in the United States. Yet for all this valuable effort, little has focused on the gap that matters most to individuals: the gap between the retirement income they want and what they are on track to achieve.

"Personal Funded Ratio" is a Russell Investments-coined phrase and patented process[1] for determining an individual DC participant's personal retirement readiness based on the asset-liability funded ratio approach used by institutional investors.

$$\frac{\text{Projected Retirement Income } \textit{(based on current savings)}}{\text{Retirement Income Goal}} = \textbf{Personal Funded Ratio}$$

Beginning in the first quarter of 2020, the COVID-19 pandemic created a perfect storm in the capital markets that negatively impacted the Personal Funded Ratio of DC plan participants. Equities were down across the board, which reduced participants' savings and, as a result, their projected retirement income (the numerator). Actions taken by the Federal Reserve (Fed) to provide needed liquidity to the market created a historically low interest rate environment, which increased the present value of the retirement income goal or DC plan liability (the denominator).

This paper first considers the denominator by examining how a low interest rate environment adversely impacts a participant's retirement income. We then shift to the numerator by exploring the long-term impact on projected retirement income when funding sources are interrupted as we saw during 2020. Additionally, although equity markets have mostly recovered, we will consider strategies for building more resilient plan and participant portfolios.

[1] U.S. Patent No. 10,223,749 entitled "Retirement Planning Method."

Low interest rates

1. Retirement income goal – DC plan liability

To provide needed liquidity to economies around the world, central banks have reacted to the COVID-19 pandemic by providing fiscal stimulus at an unprecedented rate. In the United States, the Fed has set discount rates at .25%, and signaled its intent to maintain levels near zero through 2023. This period of protracted low rates will negatively affect long-term investors like pension plans and insurance companies.

While not often considered by many in the same way, the personal funded status of DC participants will also be adversely impacted. Just like DB liabilities increase as interest rates fall, a DC participant's liability, or the present value of their retirement income goal, also increases. The result is a corresponding reduction in their personal funded status.

Most investment committees have spent much of the year discussing the funded status of their pension plans. Their concern has been whether they would be required to make additional contributions or increase their allocation to return seeking assets. Compared to their well-resourced employers, the risk to DC participants is far more onerous. The financial health of many DC participants is suspect at best, which means they are likely unable to make additional contributions and are probably not willing to assume more investment risk.

2. The impact of interest rates on purchasing income in retirement

As mentioned previously, the first quarter of 2020 was a perfect storm that saw equity markets decline and interest rates reduced to historical lows. However, because the current value of an investment can be determined by discounting all future cash flows, interest rates and equity markets are often negatively correlated. As noted by Lawrence Summers, former director of the National Economic Council, "Wealth can go up because future income streams go up, or wealth can go up because the discount factor goes down."[2] For that reason, many market observers attribute much of the gains enjoyed by equity investors over the past 20 years to falling interest rates.

On the surface, the result has been positive because the projected retirement income (level of savings) for participants has increased. However, since the objective for a DC plan should be to replace income in retirement, the path is dependent on several interrelated factors. To achieve a successful outcome, participants will need to convert their DC and personal savings into an income stream in retirement, which becomes more expensive as interest rates decline. An easy way to see this is that a decline in interest rates translates in a straightforward manner into an increase in the cost of an annuity.

Exhibit 1: Cost of $1,000 of retirement income in a falling rate environment

	DEC.31, 2019	OCT. 31, 2020
10-Year Treasury Yield	1.92%	0.88%
Cost of Income ($1,000 per month)	$190,920	$215,349

Source: 10-year Treasury Yield U.S. Department of the Treasury; Cost of income Russell Investments calculation.

The result is that as stocks increase in value because interest rates decline, there is little or no real improvement in retirement income.

Interrupted funding sources

The current state of retirement readiness for DC participants is startling. In 2015, the savings gap in the United States was $28 trillion and is estimated to reach $137 trillion in 2050[3], which is an annual increase of 5%. In 2016, half of American households were considered to be at risk of being unable to maintain their standard of living in retirement[4], and 40% of workers ages 50 to 60 who are not currently poor would be poor if they were to retire at age 62[5]. Life expectancy

[2] Remarks of Lawrence Summers, Would a "Wealth Tax" Help Combat Inequality? A Debate with Saez, Summers, and Mankiw, Peterson Institute for International Economics, October 18, 2019
[3] Source: Mercer analysis and World Economic Forum, "We'll live to 100 – How can we afford it?" 2017
[4] Source: "National Retirement Risk Index Shows Modest Improvement in 2016," Munnell, Hou & Sanzenbacher, January 2018
[5] Source: "40% of older workers and their spouses will experience downward mobility in retirement," Schwatz Center for Economic Policy Analysis and Department of Economics at The New School, February 2018

today is around 79 years[6], but 50% of babies born in 2007 are predicted to be alive at age 104 according to some studies.[7]

3. Suspended employee deferrals

The COVID-19 pandemic created both a public health and economic crisis across the world, including within the United States. The response from the Fed was unprecedented, with the stimulus outsizing that provided during the Global Financial Crisis by nearly threefold. Unemployment peaked in April at 14.7%, including 24.5% for part-time and 12.9% for full-time workers[8]. Through November there were 490,622 bankruptcies, which includes 341,398 chapter 7 filings[9]. Although unemployment dropped to 6.7% in November[10] and the economy has stabilized, the impact on 401(k) savings could be significant and long-lasting.

Although the suspension of employee deferrals as a result of unemployment or financial stress may be temporary, the pandemic has the potential to have a long-lasting impact on an already inadequate retirement savings. We use a sample employee that enters the plan at age 25, with a salary of $75,000 to illustrate the impact of lost savings. For this sample employee, a one-year interruption at age 40 in their salary deferral and match will reduce their final savings at retirement by $60,263, or 2.66%.[11]

4. Suspended employer match

A priority of companies is to keep people employed, so suspending employer contributions to their DC plans has occurred and will likely be considered by additional organizations. Several smaller employers have already acted, but larger plans are considering this as well. At this point, employee retirement readiness is not top of mind for companies as they tackle far more pressing concerns.

For our sample employee, the impact on savings at retirement for a two-year suspension of the employer 401(k) match beginning at age 40, would be a reduction of $32,103 or 1.4%.[12]

5. Employee distributions to replace lost income

The Coronavirus Aid, Relief and Economic Security (CARES) Act was passed by Congress and signed into law on March 27, 2020. Among other provisions the bill waives the 10% penalty for premature distribution that would ordinarily apply for withdrawals taken prior to the age of 59 ½. The maximum allowable distribution under CARES Act is $100,000.

There is naturally increased participant activity and interest in these areas. Administrative committees and plan sponsors have made changes to their provisions, including the addition of loans if not already available, and ensuring in-service and hardship withdrawals are options.

For our sample employee, the impact on savings at retirement for a $100,000 distribution at age 40 would be a reduction of $542,743 or 23.9%.[13]

Creating more resilient plan and participant portfolios

6. Rethinking core menu design and portfolio structure

Investment committees that still view DC plans as supplemental often emphasize choice over the quality and clarity of investments. However, menu design and portfolio construction play a very important role in the success of a plan, because selecting the right

[6] Source: CDC, "Mortality in the United States, 2018" January 2020
[7] Source: Human Mortality Database, University of California, Berkley. www.mortality.org, 2018
[8] Unemployment Rates During the COVID-19 Pandemic: In Brief, Congressional Research Service, December 7, 2020
[9] Epiq Systems, Inc. AACER 2020 Nationwide Bankruptcy Filings by State and Jurisdiction, November 2020
[10] Source: Bureau of Labor Statistics, December 4, 2020
[11] Source: Russell Investments, see appendix for underlying assumptions
[12] Source: Russell Investments, see appendix for underlying assumptions
[13] Source: Russell Investments, see appendix for underlying assumptions

investment strategy can be overwhelming for most employees. For committees seeking to engage participants and help them achieve better retirement outcomes, using a multi-manager, white-label structure to consolidate and simplify the plan menu is an essential step.

Multi-manager, multi-style investing is not a new idea. It's the way institutional investors, such as DB plans, have been investing for decades. DB plans would never invest all their assets with one underlying investment manager – especially across asset classes, but not even within asset classes. Thus, multi-manager/multi-style investing helps to institutionalize a DC plan.

Russell Investments has consistently advocated that investors consider this approach to investing for a variety of reasons – one of the primary reasons is if returns from capital markets are likely to be lower going forward than they have been in the past, it is imperative that investors seek additional sources of return to improve the probability of achieving their objectives. Historically, growth and value, along with other factors and styles (e.g., momentum, deep value, quality, volatility, active, passive, quantitative and fundamental) go through cycles and are in and out of favor at different times. Managers focus on unique areas of the market, and diversifying among managers within one solution can provide a smoother ride for plan participants.

Exhibit 2

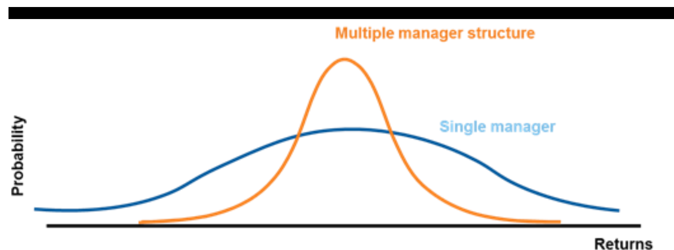

Image shown for illustrative purposes only and is not meant to represent any actual results.

In constructing a white-label portfolio, it is also important to develop a hierarchy for where active fee dollars should be spent first, and conversely, where passive management is preferred. How much active versus passive to include in any solution depends upon several factors, such as the return needs of the fund, fee budgets, and the tracking error and cost of the passive alternative. Russell Investments establishes a preference hierarchy for which asset classes we believe are most likely to generate excess returns in magnitude, persistence, and risk-adjusted terms.

7. Use of private securities

The Russell 1000® experienced significant drawdowns during both the Global Financial Crisis (GFC) of 2008-2009 and the COVID-19 pandemic, with peak to trough declines of 53% and 20.2% respectively. These were painful periods for well-resourced DB sponsors that may have been forced to make additional contributions to improve their plan's funded status. However, the impact was more significant for DC participants, particularly those at the end of their glidepath, many of whom were forced to delay retirement.

DB plan fiduciaries have long understood that creating portfolios with the appropriate balance between return seeking and hedging strategies most often leads to success. DC plans that offer white label portfolios or custom target date funds (TDFs) should consider incorporating similar strategies to help improve the efficiency of their plan's investment options. Although not suitable as a stand-alone option, Russell Investments believes a competently managed exposure in a custom TDF or white label fund to illiquid assets has the potential to generate higher returns than comparable liquid assets in many market environments.

On June 3, 2020, the Department of Labor (DOL) issued an information letter in response to requests from two managers, with respect to the inclusion of private equity investments in a designated investment alternative. In summary, the DOL concluded that, as a general matter, "…a plan fiduciary would not…violate [ERISA fiduciary rules] solely because the fiduciary offers a professionally managed asset allocation fund with a private equity component as a designated investment alternative for an ERISA covered individual account plan in the manner described in [the] letter."

Sponsors considering such an option will want to review these issues with counsel.

8. Responsible investing

Russell Investments recognizes the importance of responsible investing and environmental, social, and governance (ESG) issues for our clients. To reflect this, we have developed and codified a set of four beliefs on which our responsible investing practice is founded. These beliefs are as follows:

- ESG factors impact security prices. These factors can vary by company, industry, and region and their importance can vary through time.
- A deep understanding of how ESG factors impact security prices is value-adding to a skillful investment process.
- Embedding ESG considerations into a firm's culture and processes improves the likelihood of prolonged and successful investing.
- Active ownership of securities is an effective tool for improving investment outcomes.

In the coming years, responsible investing will become standard practice for investors. Understanding how ESG factors impact security prices and portfolio structure will be integrated into the entire industry. As we move toward this inevitable reality, Russell Investments is developing best practices for our process and clients.

9. Personalized default options

Off-the-shelf TDFs, the Qualified Default Investment Alternative (QDIA) used by most DC plans, are based on an average U.S citizen, rather than specific investor characteristics. While they have clear advantages over earlier best-in-class solutions, such as lifestyle funds, they are only attempting to simplify investment decisions, rather than providing advice on both funding and investing strategies.

On the other hand, managed accounts, which are frequently offered in a DC plan, recommend the savings level and investment allocation designed to put the participant on the path to fully fund their retirement. These solutions have also been specifically structured to function as the plan's QDIA. Just like funding and investing policies for pension plans are unique to each sponsor, in order to reach successful outcomes many DC participants would likely benefit from more comprehensive and personalized advice. Managed accounts also historically help to insulate participants from the adverse effect of sentiment-driven trading during market turmoil like we have experienced during the COVID-19 pandemic.

However, since most recordkeepers only provide access to one or two managed account providers, one of which is often proprietary, plans have almost no ability to negotiate their fees. With off-the-shelf pricing that may begin at .50%, in addition to fees paid to the core managers, it may be difficult to justify using this as the QDIA when TDFs are available at significant discounts.

With more reasonable fees, utilization of managed accounts as the plan's QDIA could increase dramatically. We believe that committees should challenge their recordkeepers to allow additional competition, and, given the fee compression experienced by the rest of the industry, they should expect a reduction as part of their triennial formal review of their provider. A hybrid approach where participants are initially defaulted into a TDF but are then automatically moved to the managed account as retirement nears could be a solution for those committees concerned about the managed account fees for a full-career employee.

10. Lifetime income solutions for those close to retirement

The primary focus for DC plan sponsors and committees has historically been on helping participants accumulate assets during their working years, with little support provided in retirement. A common analogy is taking an airplane flight only to have the pilot parachute out of the plane just before reaching the destination, leaving passengers to maneuver the landing on their own. The "landing gear" of our DC system is the solutions designed to help participants convert their accumulated retirement balances into a reliable stream of income. Without this support, the vast majority of today's retirees rely on Social Security as their primary retirement benefit, and their only source of guaranteed income.

However, a flashpoint may be on the horizon. The SECURE Act, passed in December 2019, provides a

new fiduciary safe harbor for selecting an insurance provider as a distribution option and makes mandatory inclusion of lifetime income projections on participant statements a reality. The SECURE Act appears to be a catalyst and more committees are now expressing interest in evaluating lifetime income solutions for their DC plans.

In our view, initial efforts should be focused on participants that appear to be asking for assistance during accumulation. To us, that means that committees should first focus on strategies that incorporate automatic or default distribution options in the plan's TDFs and managed accounts. In addition, Russell Investments has modeled the retirement outcomes from different product types, based on company specific demographics, to facilitate a comprehensive evaluation of lifetime income options. After many years of discussing lifetime income, we believe that we will finally begin to see more widespread implementation in 2021.

Conclusion

Today's DC participants face significant challenges in preparing for retirement, which has been exacerbated by the COVID-19 pandemic and its related market turmoil. For DC plans to succeed in preparing participants for retirement, plan sponsors and investment committees should consider changes and improvements that could make meaningful progress in helping their participants reach their personal funded status goals.

Appendix

Assumptions for sample participant

Sample Employee

Starting Age	25
Starting Salary	$75,000
Deferral Percentage	8%
Employer Match (50% of 6%)	3%
Rate of Return	7%
Annual Salary Growth	2%

Author:

Kerry Bandow, Senior Consultant

For more information

Call Russell Investments at **800-426-8506** or

visit **russellinvestments.com/institutional**

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