DEFINED CONTRIBUTION

APRIL | 2020

USI CONSULTING GROUP

MARKET VOLATILITY AND TARGET DATE FUNDS

As unprecedented market volatility continues in the global financial markets, more retirement plan participants than ever before are concerned about the magnitude of recent losses in their retirement savings. As we emphasize keeping a long-term perspective with retirement investment decisions, there is a significant group of participants who are potentially more susceptible to overlooking long-term investment goals for short-term refuge: target date investors. In retirement plans, target date investors are rapidly growing in number and saved assets. And due to the characteristics and ease of target date investments, many of these investors may have difficulties in making prudent investment decisions during these challenging times.

Over the last 15 years, target date investments have become overwhelmingly accepted within defined contribution plans. Combining the ease of a "set it and forget it" investment approach with the advent and increased use of automatic enrollment, it's hardly surprising that target date fund popularity and assets have grown exponentially. Assets invested into target date strategies exceeded $2 trillion at the end of 2019[1]. According to an employer survey conducted online by The Harris Poll, 91% of plan sponsors offer a target date fund in their defined contribution plans, and 83% say that target date funds are the default investment option in their defined contribution plans[2]. Coinciding with this growth in target date funds, many millennials have also entered the workforce and started saving and investing for retirement for the first time in their lives, undoubtedly relying on target date funds as the cornerstone of their retirement strategies.

The features that have fueled this increased growth in target date funds come at a potentially significant cost. Of course, investing in target date funds poses risks. But due to the ease of their adoption, there is an apparent and potentially dangerous lack of knowledge about, or even an awareness of, the risks associated with these investments. Despite the increasing prevalence of these offerings, many workers and retirees do not understand the basics of target date funds. According to the employer survey conducted online by The Harris Poll, only 40% of responders knew that money invested in a target date fund can decrease in value. Only 51% of responders knew that a target date fund is a mix of stocks, bonds and other types of investments, while only 50% knew that target date funds become more conservative the closer one gets to retirement[2]. This lack of understanding will not only affect those who are at or nearing retirement but will also affect millennials who are decades away from their retirement goals.

Target date funds address various risks including: market risk and longevity risk. Market risk is the risk of a material loss in value due to market movements. Target date funds have demonstrated their market risks as a result of the COVID-19 meltdown, which created significant losses in the market beginning in February 2020. Despite a focus on diversification in target date funds, investors expected to retire soon (and were therefore invested in 2020 funds) lost more than 17% on average. Individuals expected to retire in 40 years (and were therefore invested in 2060 funds) lost 31% on average[1].

Older workers and retirees who experienced the ups and downs of the markets can rely on their experiences in past bear markets to maintain their long-term perspective. However, millennials may have never experienced anything approaching the magnitude of these losses. February 2020 was the end of the longest bull market in U.S. stock market history (which began in March 2009). A millennial who joined the work force and started saving for retirement through the appropriate target date fund within the last decade had experienced consistent gains in their target date fund, up until February 2020. Combining the potential significant losses with a lack of experience, millennials may be concerned about remaining invested.

---

[1]Leo Acheson, CFA, "How Target-Date Funds Fared Amidst the Coronavirus Sell-Off," Morningstar, 2020, https://www.morningstar.com/articles/975425/how-target-date-funds-fared-amidst-the-coronavirus-sell-off

[2]Metropolitan Life Insurance Company, "Evolving Retirement Model Study," Metropolitan Life Insurance Company, 2020, https://www.metlife.com/content/dam/metlifecom/us/homepage/evolving-retirement-model-study/pdf/MetLife_ERM_Study.pdf

Recent short-term losses have led to concerns from participants across age ranges, which in some cases, translated into actions. Across recordkeepers, there was an increase in call volume and website traffic showing that participants were concerned during this period. While only 0.046% of 401(k) plan balances were traded daily during February, the highest rate since August of 2011, the vast majority of participants remained invested. Target date funds accounted for the second- highest outflows for all of February 2020[3]. It's likely that there is a link between these outflows from target date funds and basic misunderstandings about target date funds.

Short-term losses as a result of market risks most directly affect retirees and workers nearing retirement who will need to draw down on their savings in the near term, but losses can also have the effect of scaring younger investors away from investing. Therefore, despite these losses, investment advisors are united in their message to their long-term investment clients to "stay the course".

However, many retirement plan sponsors and participants are not just questioning the message. They are also questioning the method. Specifically, they are asking why do target date funds invest with significant market risk? According to the employer survey conducted online by The Harris Poll, nearly six in ten employers believe target date funds should include an allocation to a capital preservation option such as stable value to protect a portion of participants' savings, with more than two in five workers either cautious (35%) or completely avoid taking any risk with their investments (9%)[2].

Based on the outflows from target date fund assets, many investors have taken it upon themselves to reduce market risk. Most inflows went to bond funds (47%), stable value funds (41%) and money market funds (11%)[3]. However, these transactions will significantly increase longevity risk, the second significant risk driver for target date managers. Longevity risk is the risk of not saving enough or outliving your savings for retirement. Investing into equities and other instruments that have historically outpaced inflation can reduce longevity risk, but in this recent stock market sell-off, the potential for long-term gains comes with near-term pains.

For the millennial generation, understanding the balance of market risk with longevity risk is crucial in "staying the course" with target date funds. Millennials exiting their respective target date investments to investment safe havens, such as money market funds and stable value funds, may reduce market risk over the short-term. Unfortunately, these transactions to safer investments increase longevity risk such that millennials could experience significant shortfalls in their long-term retirement savings and potentially fail to reach their retirement goals.

As Plan Consultants and Fiduciaries, it is our goal to help retirement plan participants realize better outcomes. Avoiding emotional decisions during volatile periods can improve participants' chances of reaching their long-term retirement goals. Education meetings for participants on a regular basis can encourage informed decision-making by reinforcing the importance of a long-term approach to investing. By understanding the balance of market risk and longevity risk in target date funds, investors of all ages can better understand the financial rewards of "staying the course" through these market selloffs.

If you have any questions or would like more information, please contact your USI Consulting Group representative. We're here to help.

---

[3]Robert Steyer, "COVID-19 uncertainty disturbs DC participants," Pensions & Investments, Crain Communications, Inc., 2020, https://www.pionline.com/defined-contribution/covid-19-uncertainty-disturbs-dc-participants reaching their long-term retirement goals. Education meetings for participants on a regular basis can encourage prudent decision making by reinforcing the importance of a long-term approach to investing. By understanding the balance of market risk and longevity risk in target date funds, investors of all ages can better understand the financial rewards of "staying the course" through these market selloffs.