

BACK ON TARGET

Three post-crisis changes you're likely to see in the DC landscape.

BY COLIN RIPS MAN

2008 was a catastrophic year for investors around the world. The U.S. real estate market collapse led to a crisis in the financial sector, which resulted in the instability of some of the most historic and stable global financial institutions. This crisis also triggered a freezing of the credit market and the onset of a global recession. For investors, there was nowhere to hide. As global equity markets fell in unison, traditional regional diversification offered little benefit. The Canadian equity market lost 33%, the S&P 500 lost 37% and the MSCI EAFE Index lost 40% in 2008. At the same time, corporate bond spreads jumped to historic levels, negatively impacting many fixed income portfolios. Periods of extreme market underperformance can identify problems or act as a stress test for financial systems and investment structures.

For defined contribution (DC) plans, 2008 highlighted the extent of the risk assumed by members under their plans. For many DC plan sponsors, it reinforced the rationale for opting for a DC plan in the first place. For defined benefit (DB) plan sponsors, it provided additional impetus to consider a shift to a DC structure. As 2009 rolls along and we gain perspective, what has the impact of the financial crisis been in DC funds? Specifically how have target date funds (TDFs) that aim to “automate” asset mix and risk tolerance adjustments over time done?

Today's target date funds consist of a series of balanced funds that use a dynamic asset mix path (or glide path), designed to provide members with an optimum asset mix throughout their career. The proportion of the fund invested in equities declines over time as the target retirement date approaches. Today, TDFs attract the largest allocations of new assets in DC programs and are increasingly designated the default investment choice for members who fail to provide investment direction under the plan. Recently, TDFs have come under scrutiny in the

U.S., as a result of their performance in 2008. Of particular concern to U.S. regulators was the broad range of returns across funds with similar target retirement dates. This issue was most acute in near-dated TDFs (designed for current or imminent retirees) where the performance differential was almost 40%, largely due to the significant differences in equity weightings.

This performance differential is of particular concern to U.S. regulators, since TDFs have been designated as Qualified Default Investment Alternatives (QDIAs) under the Employee Retirement Income Security Act of 1974 (ERISA), and are granted “safe harbour” legislative protection. Since near-dated funds are held by investors that are at or near retirement, balances tend to be highest for investors in this category, while the margin for error (the ability to make up poor performance) is small. These issues were not as pronounced in Canada, where TDFs have not been granted preferred legislative status. Moreover, the TDFs offered in the Canadian institutional market tend to have a much narrower range of equity weightings. Although extreme actions are possible, such as legislating minimum and maximum equity weightings for specific-dated funds, the likely outcome of the U.S. legislative inquiries is clearer standards on disclosure, communication and naming of TDFs. In the aftermath of the 2008 market correction, we will likely see some enhancements or changes to TDF funds and DC lineups in general, including:

1. BETTER INFLATION LINKAGES

Recent experience in Canada is of low inflation. That said, any level of inflation will significantly erode a retiree's purchasing power over time. For example, a retiree who purchased an annuity at retirement, replacing 60% of his pre-retirement income, would experience an erosion in real income of 38%, or a cumulative income shortfall of \$322,178 over a 25-year period of low inflation (at

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2% per year). Today, in the wake of the recent and massive government stimulus packages worldwide, there are concerns that we are headed for a period of higher inflation. Canada last experienced a period of high inflation between 1985 and 1991 (ignoring the hyperinflation period between 1972 and 1984), when the average annual inflation was 4.7%. If we were to experience a five-year period of high inflation, with annual inflation levels at 5%, the cumulative shortfall for the retiree would increase 62% to \$522,161. As concerns over long-term inflationary pressures increase, TDF managers will explore ways to enhance their funds' links with movements in the inflation rate. This objective can be achieved by incorporating allocations to asset classes that offer strong inflation linkages, such as real return bonds (RRBs) and real estate.

2. MINIMUM GUARANTEES

Guaranteed minimum withdrawal benefits (GMWB) have received a lot of attention over the last few years from investors approaching retirement age. GMWB products are market-based investment products that provide a guaranteed minimum income stream, which can increase over time with positive market performance. GMWB products may incorporate other unique guarantee options or features, such as a principal guarantee or minimum death benefits. Generally, GMWB products have incorporated a fee premium (above the basic fund MER) in the range of 1% to 1.25%, depending on the specific guarantee options selected and the equity weighting utilized. This type of structure would be an ideal option to embed within a TDF to accommodate risk-averse members looking to maintain equity market exposure into retirement.

Prior to the market correction, many felt that the pricing of the guarantee features eroded much of the value of the guarantee, due to the persistent drain on the expected investment return. There was thought to be little chance of a balanced portfolio with a 1% fee advantage underperforming the product guarantee over a 20-year period. Even looking at the 20-year period

from 1929 (beginning with the Great Depression) a 50% stock and 50% bonds portfolio return would have matched the minimum guarantee. The benefits of the GMWB were thought to be largely behavioural in nature because they encourage risk-averse members to maintain a more aggressive asset mix and to maintain their equity weightings in the face of a steep market correction.

The 2008 market correction has acted to further stimulate investor demand for market-based product that would guarantee a minimum value. At the same time, it highlighted the potential financial impact of such guarantees to the issuers in extreme market conditions. As a result, we can expect to see an increase in the pricing of guarantee-based products in the future as well as restrictions on asset mix and product functionality. It will be important to re-evaluate the cost/benefit analysis for market guarantee features after this repricing occurs.

3. ENHANCED DECUMULATION OPTIONS

As more employees retire, relying primarily on their DC plans to support their retirement income needs, we can expect TDFs to utilize longer glide paths that model the asset mix to support the income needs in the decumulation period. The next generation of TDFs will likely combine the traditional accumulation-focused vehicles with optional payout vehicles such as annuities (full, partial and deferred), systematic withdrawal products (that enable the investor to withdraw a fixed percentage of the remaining asset balance each year), and longevity annuities, which will enable members to customize their desired income stream in retirement.

Target date funds will continue to be a staple in DC investment structures, since they assist unsophisticated DC members to impose and maintain a reasonable asset mix structure. However, we can expect to see significant evolution and enhancements to these products, to increase the degree to which they can be tailored to address evolving DC plan member needs. ■