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Retirement Report

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

Fixed Income Investing in a Rising Rate Environment

Intermediate and long term interest rates are on the rise. On January 1, 2013 a 10-year Treasury bond yielded 1.84%. As of August 22nd, yields on those same bonds climbed to 2.86%. U.S. stocks also enjoyed strong gains during this time period while their fixed income counterparts have not fared as well. It is not uncommon for fixed income investments to produce negative performance in a rising interest rate environment, but their recent negative returns beg the question, "Should I be invested in fixed income?" Despite short term performance issues, the answer is typically yes for investors seeking the benefits of diversification.

First, fixed income is a great diversifier within a portfolio. While interest rates have risen in the short term, this trend may not continue. By maintaining exposure to fixed income, a portfolio will be insulated if the market changes direction. Second, a good active manager will navigate the storm of rising interest rates to lessen their negative impact on a portfolio. Portfolios with shorter duration and lower credit quality tend to be less impacted by rising rates and a good portfolio manager may be able to produce positive return despite a negative market. Third, while negative return is unwelcome, in the fixed income market it tends to be less severe than negative return in the equity market. Examining fixed income and equity markets since 1950, the worst one-year return for fixed income was -8%, while the equity markets suffered a worst one-year return of -37%[1]. In conclusion, while short term results have been negative in the fixed income market, fixed income still occupies an important role in a long term, diversified investment portfolio.

~ *Dan Mullarkey, Director of Investment Research*

[1] Data from J.P. Morgan's 4Q | 2013 *Guide to the Markets*.

Happy Birthday, *Target Date Fund!*

Dear *Target Date Fund*,

Congratulations on your special day marking a full two decades! While it was 65 years ago I, myself turned 20, I remember it well. As my gift to you, allow me to share some wisdom I've picked up along the way. Turning 20 is not only significant because it marks the end of your rowdy teenage years, but because it is the beginning of adulthood, which will bring new responsibilities and challenges.

It seems like just yesterday when you came into this world. Much like myself, there were so many expectations on you when you were born. I loathed when they compared you, like me, to the S&P 500 or the Barclays Capital Aggregate Bond Index. It made no sense and was so unfair! Your teenage years brought different challenges – you were such a risk-taker! I remember your first date with Guaranteed Income. Yes, I know that didn't turn out well, but despair not as there will be others.

Most definitely, the QDIA designation was a highlight for you. I remember my eyes tearing up when you received your

-over-

QDIA designation. While that was a crowning achievement, it was just the beginning. While I have many lessons to share, I want to impart on your 20th birthday just one – be true to yourself.

You can't be all things to all people. People will try to change you; they will even try convincing you that you are something you're not. As you grow older, you will understand, like when I realized my specific calling. Don't get me wrong, I loved my 60% stocks and 40% bonds composition (people calling me "60/40" for short). I believed I could be and do anything. The truth was, I couldn't be all things to all people. As my generation got older, we all eventually came to grips with that reality. Today, we are much wiser and happier for it.

Take for example my friend "30/70", who was 30% stocks and 70% bonds. More conservative than I, but better suited for situations calling for less risk. 30/70 also provided more stability than the rest of us could give, even if his return opportunities were not as good. Of course, there was also my friend 80/20, who was just the opposite (more stocks than bonds). Ever the daredevil, he was better for situations where a higher return was desired without as much concern for risk. Each of us was better suited for some things versus others. Focus on what makes you special. It will be the key to your popularity.

It is time now to raise our glass to 20 years old, a time when the world is your oyster! I wish you success over the next 20! As you venture out to conquer this world, remember who you are and what makes you unique. You will go farther in life not only knowing your strengths, but your weaknesses as well. With the QDIA designation, I have no doubt your generation will go farther than mine, if used wisely. I know my friends (nicknamed) conservative, moderate and aggressive would all say the same. Their nicknames are a true testament to their strengths and challenges. So finally, happy birthday Target Date! I hope my gift of wisdom eases the expectation, nay burden, that you need to be everything to everyone. Truth be told, I'm not too worried about you. It's in your nature to readjust over time.

Very Truly Yours,

Balanced Fund

P.S. The target date is the approximate date when investors plan to start withdrawing their money. Note that the principal value of the fund(s) is not guaranteed at any time. As the target retirement date approaches (and often continuing after the target date), the fund's asset allocation shifts to include a higher proportion of more conservative investments, like bonds and cash instruments, which generally are less volatile and carry less investment risk than stocks.

Safety in Stable Value

Stable value products provide retirement plan participants with protections that are generally not available as part of most other investment choices within retirement plans. These products typically combine an investment in fixed income securities with a guarantee that participants will receive their entire principal and accumulated earnings when they redeem their investments; the source of earnings is a crediting rate promised to participants. In contrast, comparable retirement investment options, such as fixed income mutual funds or money market funds, do not provide such guarantees.

Stable value products attracted relatively little attention until the financial crisis in 2008, even though stable value assets exceeded $500 billion at that time.[1] However, during the financial crisis, participants seeking safety directed record flows to stable value products. Retirement plan sponsor and participant interest in stable value products has remained high after the financial crisis, in large part because stable value products offer relatively attractive yields.[2] Regulators and policymakers have also become more focused on stable value products as they seek to strengthen the financial and retirement systems in the U.S.

• **Retirement savers need access to a "low volatility" retirement investment option.** The three key attributes of a "low volatility" retirement investment option are principal protection, predictable returns, and a reasonable likelihood of delivering returns that outpace inflation.[3] Stable value products effectively fulfill these requirements by relying on the creditworthiness of an insurer or other financial institution to provide principal protection and predictable returns.

"Low volatility" retirement investment options help participants protect their retirement assets at critical times, such as right before retiring; investment losses experienced in the years right before retirement are more harmful to participants

than investment losses experienced several years before retirement. "Low volatility" retirement investment options also benefit participants who have a need to provide diversification compared to their riskier investments.

• **The need for "low volatility" retirement investment options has increased because individuals have become more conservative investors after the financial crisis.** This trend is amplified by the aging of the American workforce, as older workers tend to invest more conservatively than younger workers.

• **Stable value products are carefully designed to ensure that product providers can deliver on their guarantees.** Stable value providers rely on their ability to adjust crediting rates over a period of years to fulfill the guarantees offered to participants. As a result, stable value products are almost exclusively offered via retirement plans, whose participants generally have an intermediate-term or long-term investment horizon. In addition, many stable value products include contractual limitations on large-scale withdrawals that are driven by plan sponsor actions. These limitations are designed to protect plan participants, plan sponsors, and insurers from the impact of bulk withdrawals by helping to ensure that providers can fulfill any guarantees over a long-term time horizon.[4] These and other aspects of stable value products have contributed to the long and successful record of stable value providers in fulfilling their guarantees to participants.

[1] Stable Value Investment Association website.
[2] During the period 1989 to 2009, stable value funds produced an average annual return of more than 200 basis points above the average annual return for money market funds.
Source: Dr. David Babbel and Dr. Miguel A. Herce, "Stable Value Funds: Performance to Date," The Wharton School, January 2011. Additional summarization provided by Dr. Babbel and Dr. Herce, February 2011.
[3] In this paper, a "low volatility" investment option is one that contains certain safeguards and protections (described in this document) that are not present in other investments. No inference should be drawn that a "low volatility" investment option is free of risk.
[4] Plan sponsors should understand the product design and contractual terms as part of making an informed decision to include stable value as a fund option for participants.

This article was originally published by Prudential in their white paper: *Stable Value Products - An Increasingly Important Component of the U.S. Retirement Market.* Minor edits were made for compliance purposes.

Do You Need An Independent ERISA Audit?

If your plan has 100 or more participants (as of January 1st – for calendar year plans), you must complete an audit and submit the results with your Form 5500. In this situation, the DOL defines a plan participant as any person with an account balance in the plan, as well as any employee who is eligible for the plan as of the first of the plan year, even if they are not actively making elective deferrals. An exception does apply, if your plan has between 80 and 120 participants and filed as a small plan for the previous year. However, in all cases where a plan has more than 120 participants on the first of the plan year an audit is required. Please contact Lee Pierce at lee@piercefinancial.org if you need or more information or would like a referral to a CPA firm specializing in employee benefits audits.

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