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MULTI-ASSET SOLUTIONS

THE HIDDEN COST OF EARLY ACCESS TO RETIREMENT ASSETS

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As defined contribution (DC) plans have grown and have increasingly become the primary retirement savings vehicle, asset allocators are increasingly interested in incorporating illiquid private assets in these retirement funds to offer participants access to investment portfolios and risk-adjusted returns similar to defined benefit (DB) plans. In addition, governments are encouraging plans to bolster retirement outcomes and support national economic growth by investing in illiquid private assets such as private equity and infrastructure. However, these illiquid private assets pose well-known liquidity management challenges: uncertain cash flows, commitment pacing and rebalancing.

Across the globe, multi-employer retirement plans such as Australian superannuation funds and UK Master Trusts now operate in an increasingly dynamic and evolving market and regulatory environment. Today these funds face additional and novel liquidity challenges arising from participant actions such as members switching assets to alternative low-risk funds or from government actions such as "early access programs" that unexpectedly allow participants to withdraw retirement assets without penalty during bad economic times or climate calamities. For example, the Australian government announced a program at the onset of the pandemic, which allowed adversely impacted participants to withdraw up to A$10,000 in each of the two pre-defined periods from their superannuation account balance. In the U.S., after the IRS introduced the coronavirus-related distribution (CRDs) with a limit of $100,000 from eligible retirement plans in 2020, the Consolidated Appropriations Act of 2021 allowed participants to take up to $100,000 in disaster distributions from retirement plans for calamities other than the COVID-19 without tax penalties. When participants are presented with opportunities to gain early access to their retirement assets, retirement plans are no longer solely for retirement savings anymore as they may withdraw their plan assets well before reaching retirement.

These government and participant actions bring uncertainty and complicate fund liquidity management, especially when private assets are in the mix. While well-intentioned, early access programs affect portfolio liquidity risk that may compel CIOs to adjust asset allocations today to make sure they have enough liquidity to meet these liquidity management challenges of the sudden outflows.

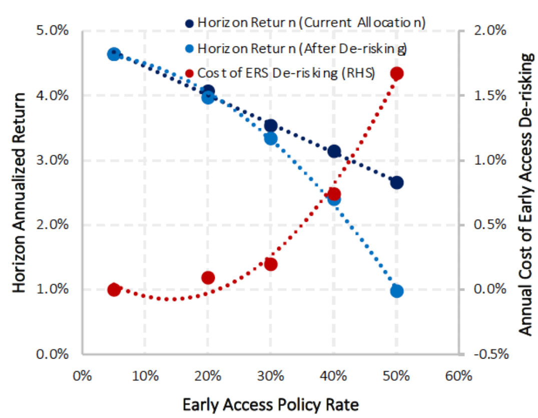
The confluence of these two trends – more illiquid assets and liberal early access programs portends heightened portfolio management challenges. A CIO of an Australian superannuation fund cannot respond to these liquidity risks by simply becoming conservative with a large allocation to cash and a small allocation to illiquid assets. This conservatism may be costly in terms of future potential fund performance, which is subject to regulators' annual performance tests.

Quantifying the "hidden" performance cost of early access to retirement funds helps CIOs and regulators make more-informed decisions

Grappling with this question, we provide a framework to help CIOs examine how to adjust their asset allocations when faced with the possibility of different levels of early access permissioning. CIOs will need to "de-risk" their plans to manage the heightened liquidity uncertainty by holding more lower-risk, lower-return assets. However, these portfolio adjustments are likely to incur a potential cost to portfolio performance. Unlike a performance or management fee, this cost is not explicit for all to see and lacks a formula to calculate.

This "hidden cost" will be continually borne by all fund participants. We offer CIOs a framework to quantify this hidden cost associated with de-risking when faced with different levels of early access permissioning. Our framework allows CIOs to evaluate how their portfolio's liquidity and performance might change under different early access scenarios. As shown below, as the liberality of early access programs increases, the potential hidden cost to all plan participants can increase at an accelerating rate, reflecting the increased portfolio conservatism required by CIOs to maintain an adequate level of liquidity.

The Hidden Cost of Early Access Programs



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By examining the potential tradeoff between the liberality of the early access programs and portfolio performance, we try to help CIOs become more confident in making portfolio allocation decisions and help regulators identify possible portfolio allocation consequences and costs of contemplated rule changes.

See M. Teng and A. Chen, '*Super Funds & Master Trusts in a World of Member Switching, Early Release Schemes & Climate Calamities,*' PMA, Forthcoming 2022.

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0307-200