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Interest Rate Risk Comes to the Fore

It has never been more expensive to fund a stream of guaranteed retirement income, nor have individuals been so in need of guarantees generated outside of large collective pensions.

It is fairly standard for the typical retirement plan participant to receive education about longevity risk and even sequence of returns risk, but the coronavirus pandemic is underscoring what can be an overlooked and very significant source of risk—interest rates.

"This pandemic and its impacts on the markets and the economy have cast into even greater relief how much risk we have foisted onto participants, on the individual," observes Josh Cohen, head of institutional defined contribution (DC) for PGIM. "In many ways, the DC plan system has had so many successes, but this is a challenge that we still are solving."

Cohen cites statistics published by his colleague Nathan Sheets, PGIM's chief economist and head of global macroeconomic research, showing just how important DC plan assets have become to middle class Americans as a source of retirement funding. Each household in the top 1% of the wealth distribution has, on average, $25 million of assets, including nearly $10 million of equities. The next 9% of the distribution holds an average of $3.5 million, supported by more than $1 million of average combined defined contribution and defined benefit (DB) plan assets. The next 40% of workers have approximately $60,000 saved on average in the form of public equity ownership, complemented by an average of $128,000 in home equity.

"For the middle class, especially, we know their DC plans are such a big part of their net wealth, in addition to their homes," Cohen observes.

As such, he says, it is more important than ever to educate individual investors about the many sources of investing risk with which professional money managers and pension funds have long known how to grapple.

"There is the basic market risk, and then there is inflation risk, and of course, longevity risk," Cohen says. "All of them are significant risks that we need to help people confront and manage. In this current situation, I think we are seeing one underappreciated risk come to the fore, and that is interest rate risk."

The movement of interest rates can negatively affect retirement plan investors in multiple ways, but the issue Cohen currently sees is tied to the pricing of annuities. Simply put, because "safe assets" such as government bonds or high quality corporate bonds are paying investors very little at this moment in time, it remains very expensive to fund a stream of guaranteed income in retirement. Put another way, if the insurance companies issuing annuities cannot assume that they will generate decent returns from their general accounts' investment in safe assets such as government bonds, they will not be able to provide an attractive premium to their customers for the sacrifice of liquidity in an annuity purchase—for which they are normally compensated.

"Whether you are talking about guaranteed or non-guaranteed income streams, this is going to remain a very challenging outlook to overcome," Cohen says. "This is even more of an issue because of the fact that we came into this pandemic with interest rates already quite low."

Cohen proposes that one way to deal with this challenge is to help individual investors implement the principles of liability-driven investing (LDI), which is an approach to investing long embraced by pensions as a means of addressing various risks, including interest rate risk and sequence of returns risk. LDI basically means making investments with the goal of securing returns that will be sufficient to meet a future funding need—rather than investing to simply maximize returns in an open-ended manner.

In a conversation last year with PLANADVISER, Aaron

Meder, CEO of Legal & General Investment Management America (LGIMA), said investment managers in the United States are slowly but surely bringing LDI principles to DC plan investors. Meder said the analog of defined benefit liability-driven investing on the DC plan side is the discussion of "in-plan guaranteed retirement income."

"So, on the pension LDI side, the objective is to have the liquid assets in hand when you need them to pay your pension liabilities," Meder said. "It's really kind of the same idea on the DC side—a successful outcome is about having sufficient money available when you need it and for as long as you need it. Pension plans are managing this goal for a whole population of people, while DC plans are serving individual account holders."

One important caveat, Meder pointed out, is that LDI strategies must be informed by a plan sponsor's goals for the DC plan. In other words, an LDI approach will look different based on whether the DC plan is designed to be the main source of retirees' income or if it is supplemental.

"Full income replacement is not the goal of every DC plan," Meder said. "Many are designed to be more supplementary in nature. The defining of goals is an important discussion to have when thinking about LDI, both for DB and DC plans."

Practically speaking, in the near term, Meder said using LDI in DC plans could mean doing a re-evaluation of the fixed-income investments offered. Just like DB plans have reconsidered holding a basic core fixed-income portfolio, which does not match their liability duration, and instead have embraced longer-duration fixed income, DC plan investors may consider doing the same, Meder said.

While such services are less a part of her current role as a wealth manager at Creative Planning, Paula Hogan gained extensive experience using annuities and creating "individual LDI strategies" during years of independent practice. Her approach was basically to help clients gradually build up layers of income insurance over time—rather than to do a big annuity purchase prior to the retirement date.

This annuitize-slowly-over-time strategy means investors are protected from sequence of returns risk and interest rate risk—i.e., they won't have to rely on the market being healthy close to their retirement date in order to make a big one-time annuity purchase at an attractive rate.

The past few months have demonstrated the prudence of this approach, Hogan says.

"Our goal was to build a floor of income over time that would meet peoples' demonstrated fixed expenses, thus freeing up the rest of their assets for discretionary purposes and additional investing throughout retirement," Hogan explains. ■