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RETIREMENT SAVINGS IN THE COVID-19 ERA: THE GOOD, THE BAD, AND THE UGLY

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The extreme market volatility unleashed by the COVID-19 pandemic has taken a heavy toll on retirement accounts, defined contribution (DC) plan* accounts included. Account balances are down, due mostly to the drop in equity prices from their record highs in February. Continued volatility, which I think we can expect, could further undermine plan participants' retirement security, as could the tendency of participants to tap their retirement accounts during periods of high unemployment.

With the retirement savings environment likely to remain difficult for the foreseeable future, I thought it would be helpful to look at the challenges confronting plan participants and sponsors, as well as the positives (yes there are some) that might help contain the damage from any future drop in market values. I will organize these factors under a framework suggested by my colleague, Ashley Dimayorca, at PGIM Investments: **The Good, the Bad and the Ugly**. (Cue Clint Eastwood squinting—always squinting—smoking a cigar.)

THE GOOD

- **Portfolio Diversification**: Most DC plan participants are invested in target date funds (TDFs), so they benefit from a well-diversified portfolio with a generally appropriate level of equity exposure. Beyond the diversification to equity and fixed income, target date funds typically invest in anywhere from five to 20 (or more) asset classes. Robust diversification historically has helped mitigate the impact of falling equity prices on investment accounts during volatile markets. It should also leave participants better positioned to recoup their losses as the US economy heals and markets stabilize.
- **"Sticky" TDF Assets**: No doubt, plan participants are making account changes, particularly moving from riskier investments, such as stocks, to more conservative asset classes, such as bonds and cash. But because TDF assets in DC plans tend to be stickier than other assets due to TDFs' status as a Qualified Default Investment Alternative and their high level of diversification, we typically see less self-directed reallocation in DC plans than we do outside the DC space.
- **RMD Holiday**: The US CARES Act (Coronavirus, Aid, Relief and Economic Security Act) waives the 2019 and 2020 required minimum distribution rule. This is important because it means retirees will not be forced to cash out portions of their accounts when asset prices are depressed.

*All mentions of defined contribution (DC) plans and DC plan participants refer to qualified US retirement plans and account holders in US defined contribution plans, respectively. Target date funds (TDFs) are predominantly a US investment vehicle and are not readily available outside of the United States.

THE BAD

- **Interrupted Contributions**: The staggering increase in unemployment means that not only are millions more Americans no longer collecting a paycheck, they also are not contributing to their DC plans or receiving their company match.

- **Increased Trading**: Only 2.5% of DC plan participants made a trade during the 30-day period beginning February 24, 2020 as markets began to sell off, according to Empower Retirement. Still, trading was higher than it was during the same time period in each of the ten previous calendar years. According to Alight Solutions, March saw record-high trading by DC participants. Even the investments most immune to outflows in DC plans, TDFs, which rarely see net outflows in a month, experienced an all-time high of more than $8 billion of outflows from mutual funds alone in March.

- **Overly Engaged Participants**: There was a noticeable increase in DC participant engagements in the US between February 20th and March 23rd (when the S&P 500 fell 34%), compared to the same time period in 2019 (based on Prudential Financial, Inc. DC record-kept participant transactions). More specifically, we saw:

  - A significant increase in call volumes, web visits and mobile app usage during this crisis as participants looked for information and support.

  - A 200% increase in the number of investment changes from February 24 to May 8 versus the same period in 2019

  - A large rise in savings rate decreases for the period of February 24 to May 5, 2020 versus the same period in 2019, as well as versus the January 1 to February 24, 2020 period.

  Overall many participants reacted to pandemic-driven market volatility. Often when these actions occur, people exit riskier asset classes, such as stocks, too late, then inevitably sit on the sidelines too long and miss the recovery. At the end of the day, they all too often are worse off than they would have been had they stayed the course.

THE UGLY

- **Increased Correlations**: While diversified asset allocation provided some protection from collapsing equity prices, increased correlations during the first quarter of 2020 led to underperformance in nearly all commonly used DC asset classes. Put simply, there weren't many places to hide during the stock market sell-off. While diversification may appear to have failed during March's painful market drawdown, periods of increased correlation are rare and generally do not last long. As the old saying goes, diversification is still the one free lunch in investing.

- **Older Participants Fleeing TDFs**: We know that one of the major benefits of TDFs is the peace of mind they offer plan participants, who presumably can rest easier knowing trained professionals determined their asset allocation and risk exposure. Well, if recent outflows from certain TDF vintages are any indication, that confidence in TDF managers may have been shaken. TDFs typically held by participants 55 and older have experienced unprecedent outflows. According to Morningstar Direct, these vintages, which averaged a net inflow of more than $342 million per month during 2019, saw a whopping $11.4 billion in net outflows in March. What accounts for this reversal? Excessive investment risk assumed by many of the major target date fund players is likely a major factor, (but I'll save that topic for a future conversation).

- **Unintended Consequences of CARES**: Some well-intended provisions of the CARES Act designed to help people cope with the financial fallout from the pandemic may profoundly impact retirement readiness for the worse. By allowing participants to withdraw up to $100,000 from their accounts penalty- and tax-free, the CARES Act eliminates two powerful disincentives to tapping DC accounts pre-retirement, potentially undermining participants retirement security. It scares me to think of how many people will take money from their accounts and never pay it back, putting them behind (or further behind) the financial readiness 8-ball.

Clearly, the retirement savings environment has been inhospitable for both plan participants and sponsors and likely will be until the COVID-19 pandemic abates. That could take months, which means market volatility likely will continue to pressure account balances, as will the propensity of participants to lock in losses during economic crises, whether through reallocations or by using their retirement savings to meet living expenses. For the foreseeable future, then, participants and sponsors should prepare themselves for the bad and the ugly and take the good where they can find it.

AUTHOR

Jeremy Stempien
Principal, Portfolio Manager and Strategist

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