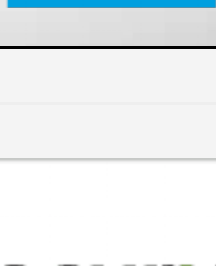


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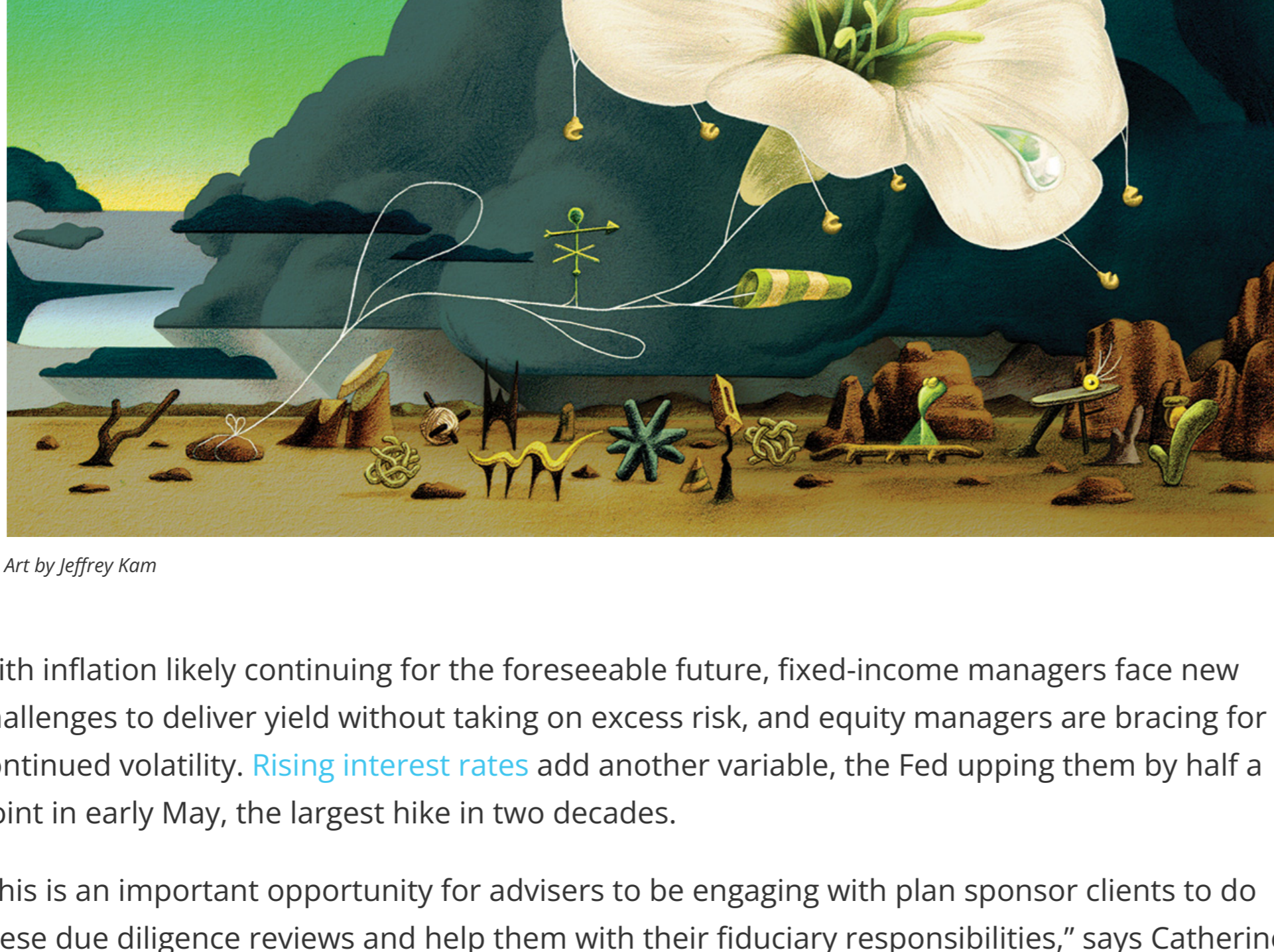


FEATURE Published in PLANADVISER May/June 2022

Design and Stability

Evaluating the investment menu in inflationary times.

By Beth Braverman



Art by Jeffrey Kam

With inflation likely continuing for the foreseeable future, fixed-income managers face new challenges to deliver yield without taking on excess risk, and equity managers are bracing for continued volatility. [Rising interest rates](#) add another variable, the Fed upping them by half a point in early May, the largest hike in two decades.

“This is an important opportunity for advisers to be engaging with plan sponsor clients to do these due diligence reviews and help them with their fiduciary responsibilities,” says Catherine Collinson, CEO and president of the Transamerica Institute and president of the Transamerica Center for Retirement Studies. “In some cases, changes may be needed; in others, the plan’s investments might be fine as they are.”

To facilitate these conversations, experts note, plan advisers might come to committee meetings prepared with a formal agenda and materials that include economic forecasts from their firm, as well as basic analytics and benchmarks associated with the funds in the plan, Collinson says.

Annual inflation rates were 3% or lower from 2008 through 2021, and annual stock returns were in the double digits for most of that time as well.

“We’ve been talking about market volatility, but inflation is new for both advisers and clients,” says Allie Rivera, vice president, OneDigital Retirement Services in Atlanta. “Many of us are experiencing inflation unlike we’ve ever seen in our career.”

‘More Scrutiny Needed’

When the market is strong, advisers have few issues to address. “It’s very easy to walk into a committee meeting and talk about how the market is up 30% again this year,” Rivera says. But investment needs more scrutiny in a challenging economic climate. Arguably, it should have been there in the first place, she says, but if you could squeak by without it before, you no longer can, considering this environment.

Holly Verdeyen, U.S. defined contribution leader at Mercer in Chicago, says the process of plan menu evaluation typically can take place over three quarterly meetings: The first focuses on education, with the adviser sharing his outlook for inflation and what it could mean for plan participants. In the second, he discusses different fund and manager options, including those already in the plan, and votes on any potential changes; in the third, the committee implements the changes.

If a target-date fund is the qualified default investment alternative, it deserves additional attention, Rivera says. Plan advisers should be helping their clients look under the hood of their target-date funds to make sure they are [designed for resilience](#) in the current fiscal climate.

“Most target-date funds do have some asset allocation to inflation-sensitive options—i.e., assets for which the price generally increases during an inflationary period,” Verdeyen says. “If the plan sponsor has 60% of its population in a target-date fund, and it has a healthy allocation to an inflation-sensitive option, it may or may not need to add an inflation-responsive option to the core menu.”

Understanding the plan’s demographics and overall allocation is the first step to making that decision, she says.

Steve Beck, vice president, portfolio engineering at Fidelity Investments in Boston, agrees it is important for plan committees to scrutinize the investments in their target-date fund. “The glide path should be suitable to a QDIA, and it should include a broad range of asset classes, built to perform well regardless of market conditions,” he says.

Near-Retirees and Retirees

“While all participants will feel the impact of inflation, it’s the near-retirees and retirees who are the most vulnerable and are the most inflation-sensitive group,” Verdeyen says. “They have nonexistent or little opportunity for wage growth and a short time horizon before they start spending.”

In some cases, advisers might want to talk to plan sponsors about steering older workers toward multi-asset portfolios or suggest one with a higher allocation to Treasury inflation-protected securities or real estate, Verdeyen says.

“Plan sponsors just want to think about how the current investment options affect their specific participant population,” she says.

Most 401(k) menus tend to focus more heavily on equity funds than fixed income, with equity dominating by a margin of three to one, according to Janus Henderson Investors.

Given today’s inflationary environment and the unique challenges it poses for fixed income, it might be worth taking a closer look at the fixed-income portion of the plan menu, Rivera suggests.

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That said, the recent interest rate increases were widely expected, and most fixed-income fund managers had baked them into their strategy, says David Eichorn, CEO and head of investment strategies at NISA Investment Advisors LLC, in St. Louis. “While there have been price losses in bond funds, they’re actually generating meaningful income for the first time in a while,” Eichorn says. “So, they’re attractive, and, as interest rates go up, that drives institutional flows into fixed income for the higher yield, so we’re seeing them as a more attractive asset class.”

Building Blocks Remain the Same

While rising interest rates, higher inflation and stock market volatility pose new challenges for asset managers, the key components of a successful plan menu have not changed, Beck says. For him and his team, those building blocks include: broad market coverage; high diversification potential, including negatively correlated options; sufficient choice; and a straightforward design that is easy to use.

In this market, though, he says, advisers must also work with plan sponsors to conduct thorough due diligence on the asset managers they select within that framework.

“Manager due diligence is even more critical in these times because the dispersions of returns may be higher in certain asset classes,” Beck says. “There’s an opportunity to pick winners and avoid losers. So there’s an opportunity for plan sponsors to not only get the asset allocation and the offering right, but also to select the right manager.”

Setting Expectations

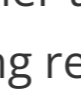
Even if no changes are necessary, advisers might take this as an opportunity to level-set expectations with plan sponsors, Collinson says.

“You want to make sure that plan sponsors have a basic understanding of inflation and what the potential implications of inflation are, so they are sufficiently knowledgeable and can be asking good questions and making informed decisions about the plan,” she says.

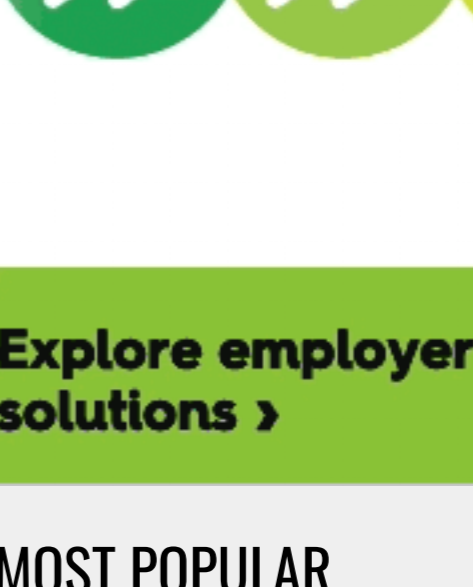
Then, advisers can take a closer look at the lineup with their sponsor client to make sure it understands the potential performance of the investments that might be susceptible to inflation—and can communicate that to plan participants, if necessary.

Despite current market conditions, plan sponsors that work with Alight Solutions largely have not been making big changes to their investment lineup, says Winfield Evans, the recordkeeper’s vice president of investment solutions and strategy in New York City. “Roughly 10% or less of our clients have used a dedicated fund that offers investment protection,” Evans says. “And we have not seen an upsurge in plan sponsor interest. What investors really need in their plan is an all-weather portfolio.”

Tagged: Fixed income, inflation, investment menu



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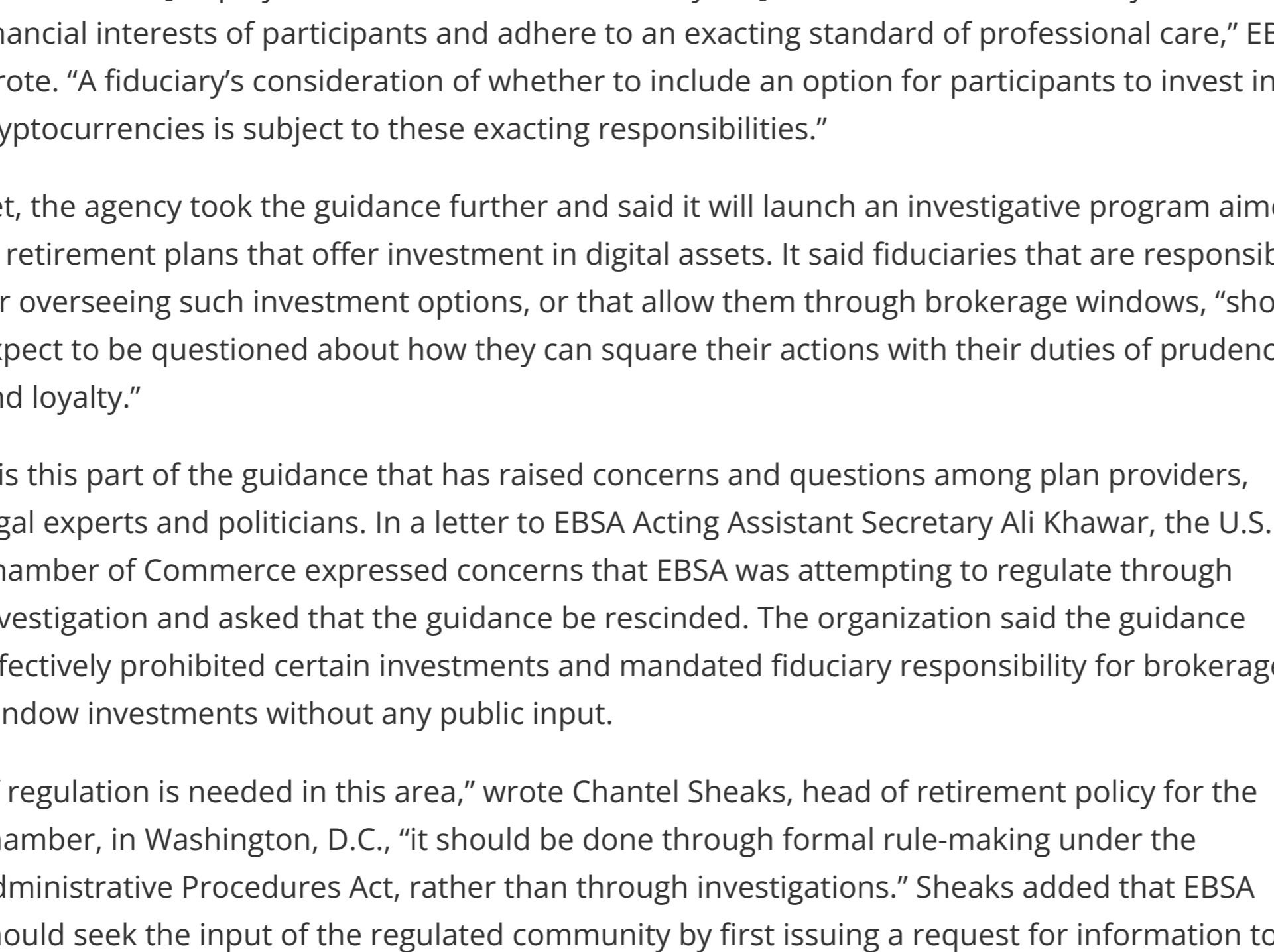
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Art by Mar Hernandez

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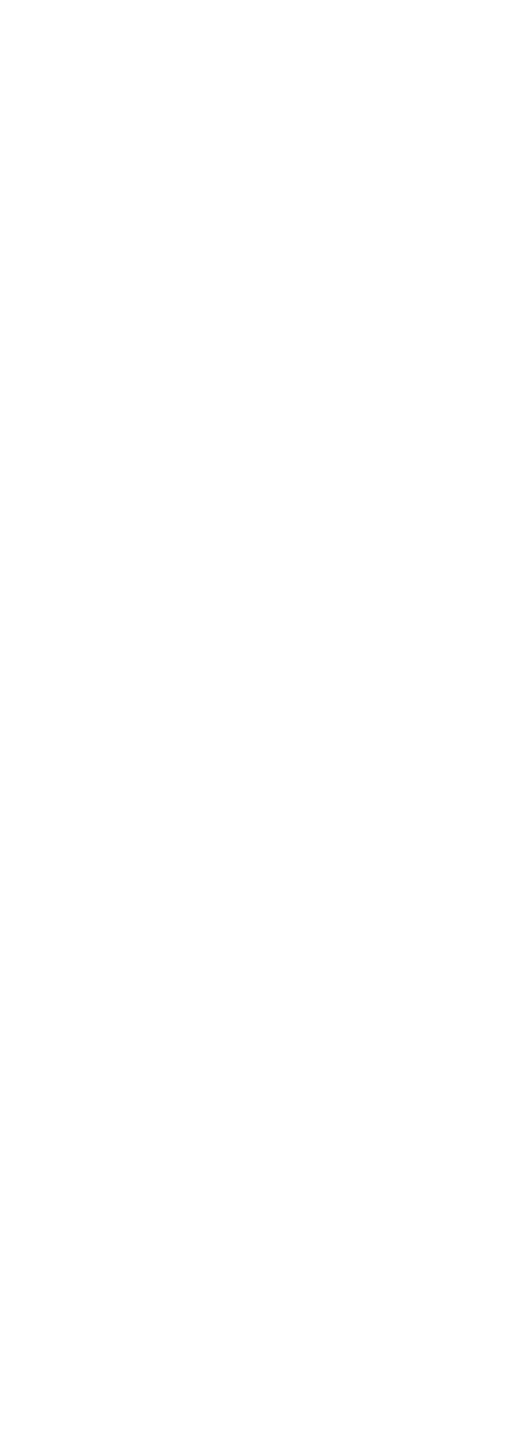
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