Group Retirement Services

Brace for impact: Adjusting for inflation in Capital Accumulation Plans

Capital Accumulation Plans appear well positioned to weather inflationary markets

The uptick in the cost of living across Canada is a result of multiple factors.

Supply chain issues for example – not all of them associated with the COVID-19 pandemic – continue to plague the global economy and drive prices higher. A recent report by the World Economic Forum outlined five sources of ongoing pressure: labour unrest, energy shortages, geopolitics, extreme weather and, adding insult to injury, inflation.

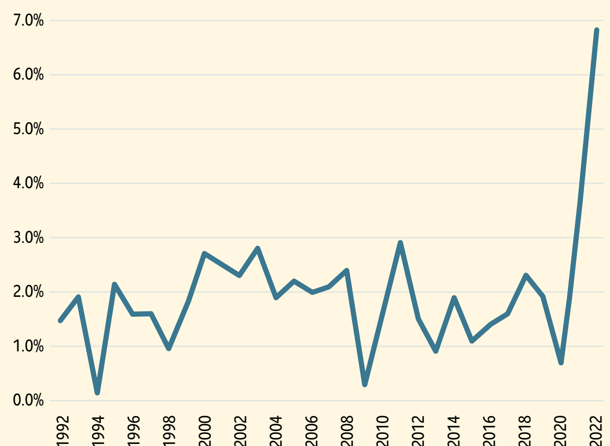
To date however, this has not had a material impact on capital accumulation plans (CAPs) and their members. (We are referring to CAP as an umbrella term, which includes defined contribution pension plans, group RRSPs, etc.) A review of Sun Life Group Retirement Services (GRS) client data shows plan member contribution rates holding firm and relatively little change in transaction activity. CAPs appear well positioned to weather inflationary markets.

Immediately following the first lockdowns, Canadians experienced a brief period of pandemic-driven deflation (bad news for an economy because people stop spending when they believe prices will continue to fall). On an annualized basis, our inflation rate fell to -0.2% in April 2020. A second negative result was reported the next month – the May 2020 number was -0.4%.[1]

That short-lived dip came after an extended period of stability. Annual increases in the Consumer Price Index (CPI) had remained in the low single digits, dating back to 1991. The CPI is a virtual basket of about 700 goods and services tracked by the Bank of Canada to approximate the cost of living.[2]

But after recording a 0.7% annual rate of inflation in 2020, the cost of living began to rise sharply. It was 3.4% in 2021. And by the end of 2022, the annual rate of inflation had reached 6.8%.[3]

Canada's Annual Inflation Rate



Source: Statistics Canada

These numbers were driven significantly by food and energy costs, but what went up and what didn't made little difference to Canadians. When paycheques stop stretching as far as they need to, it can be difficult to prioritize anything beyond short-term financial priorities

[1] *Source: Statistics Canada*

[2] *Source: Statistics Canada*

[3] *Source: Statistics Canada*

Everyone's interest

To manage this rise in the cost of living, the Bank of Canada announced its first in a series of overnight rate hikes in March 2022, from 0.25% to 0.5% – a level that by historical standards is remarkably low. Canada's central bank has increased that key rate seven more times since. By January 2023, it was 4.5%.[4]

The effect of these hikes on inflation has been as intended. After the annual rate hit 8.1% in June 2022, it fell on a month-to-month basis in five of the next six months. (It held steady at 6.9% in September and October.)[5] But while these rate increases are having their desired impact on the cost of living, they are tough on Canadians carrying debt.

If interest rates remain at their current levels long term, members – particularly those with high levels of home mortgage and other debt – will suffer financially. Their vulnerability will be even greater if inflation also remains high. Working plan members will find it more difficult to save for the future, which could put their retirement plans at risk. Retired plan members may need to adjust their draw-down to meet increased expense levels, and in some cases cover the higher costs associated with debt. Some could outlive their savings.

All of this makes it more challenging for CAP sponsors to manage their workforce and their plans.

Regardless of what happens to the inflation rate, if interest rates remain elevated, the same housing expense challenges remain and members will find it tough to save for retirement. A sustained period of higher rates could also prolong the negative impact on capital markets.

[4] *Source: Bank of Canada*
[5] *Source: Bank of Canada*

Plans for the future

For now, the current round of inflation has reflected positively on CAP sponsors and their plans. So much so that if high inflation does persist, some of the conventional wisdom associated with asset accumulation and decumulation may evolve.

This member impact story has five parts:

1. On balance, many members' exposure to equities within their CAP has benefited from inflation.

Much is made of the fact that equities perform poorly as interest rates rise. This is true, but it's not that simple. Broadly speaking, stocks often do well during inflationary periods. Sometimes well enough to offset the hit taken by rate hikes.

Higher prices drive higher earnings because wage growth tends not to keep up with inflation in times like this. Certainly, these public companies face higher raw-material costs, but there is often enough of a delta between revenue and salary increases that their shareholders benefit.

Bonds on the other hand, have done less well. To the extent that plan members maintain fixed income exposure within their portfolio, active management is worth their consideration.

Are plan members making portfolio changes as a result of higher inflation and interest rates?

Sun Life GRS Client data show a decrease in interfund transfers in 2022 relative to 2021, both in dollar terms and in the number of transfers. Both are down even more sharply relative to 2020, a year in which the pandemic had its initial capital market impact.

We saw a year-over-year increase in the number and dollar value of asset transfers designed to reduce risk in 2022. But both totals were well below our 2020 reporting.

In fact, there were more member transactions designed to increase risk (e.g., buy more equities) last year than there were transactions to reduce risk (e.g. sell equities in favour of more conservative asset classes).

2. Target date funds serve plan members well through their exposure to growth assets (e.g. equities) and real assets (e.g. real estate, infrastructure) that can act as a natural hedge against inflation.

The inclusion of real assets can help improve relative performance of target date funds in an inflationary period because people continue to need a place to live and work, and they continue to use infrastructure. Some of these assets perform well when inflation climbs because their revenues rise along with the cost of living.

Target date funds are designed to manage inflation risk for plan members, taking into account how close they are to retirement.

3. Should interest rates remain elevated, payout annuities will deliver greater value as part of a decumulation strategy.

It's unlikely that we'll see a return to the low-for-long interest rate environment that has dominated the global economy for some three decades. The historically low rates implemented after the credit crisis are behind us, at least until the next significant market event.

As rates rise, the return on investment delivered by payout annuities improves. So this valuable tool for retiring CAP members may once again become part of financial advisor-recommended decumulation strategies.

Annuities indexed for inflation include a relatively expensive protection to price rises, but we can expect to hear them discussed more often as rates remain elevated.

Individual annuity sales rose approximately 85% in 2022, relative to the previous year. But 2021 was something of an outlier.[6] Relative to average annual annuity sales between 2018 and 2020, last year's total represented a more moderate 13% increase.[7]

4. CAPs can provide greater inflation risk protection, compared to a defined benefit (DB) pension plan not indexed for inflation.

DB plans are a valuable source of retirement income for Canadians lucky enough to have one. But few offer members a payout linked to increases in the cost of living. As a result, the The purchasing power of the retirement income paid out over the course of the retiree's life often diminishes as inflation rises.

CAPs, on the other hand, offer protection to members against inflation risk by offering access to investment options that perform well as the cost of living rises.

[6] *Sun Life transactional data and internal analysis, February 2023*
[7] *Sun Life transactional data and internal analysis, February 2023*

5. Draw-down strategies may change for members with multiple sources of retirement income.

Because inflation is having a greater impact on Canadians' household finances, we may see a change in drawdown strategies for members heading into retirement or those already drawing income in retirement. Traditionally, members with both income from a DB plan and assets in a CAP would consider postponing drawing income from their DB plan (if they can) at least until their pension is fully unreduced. But timing is everything.

Periods of negative market returns paired with high inflation near, or early in the decumulation phase can have a significant impact on the length of time a member is able to draw an income from their investments in retirement. Sequence of returns risk can be managed by ensuring plan members have a flexible and diversified financial plan that helps them understand how to draw income from all their sources of retirement income while managing their cash flow needs.

How can we help?

Our plan member data makes clear that this period of relatively high inflation is far from a crisis. Those old enough to remember double-digit inflation rates in the 1970s and 1980s recognize the value of placing what we're experiencing now in a historical context.

From a financial wellness perspective however, this is clearly a source of stress for plan members. There are a number of things plan sponsors and their providers can do to help.

- **Conduct a review of in-plan investment options**. Speak with your Sun Life GRS representative about how the investment options available to your members account for inflation risk. Ask for reporting on your plan member contribution rates, segmented by age and income level. Pay careful attention to members close to retirement age.
- **Communicate and educate. Make sure your plan members understand how their plan manages inflation risk and the equity risk premium**. Make clear that decisions to change the amount they save for retirement in the plan can have an outsized impact on their long-term financial future. Encourage members to continue investing and to take maximum advantage of the plan so that they're not leaving money on the table. Remind them that CAPs have professorially selected fund lineups and are cost-effective savings vehicles, relative to the retail market. And explain, for example, that as a member's salary rises, employer contributions to the member's CAP rises with it.

- **Pay careful attention to members nearing retirement**. Recommend that they take advantage of retirement planning tools and seek professional financial advice. Inflation and higher interest rates can impact the decumulation process in multiple ways – good and bad.
- **Help members build and manage their emergency fund.** Provide a Group Tax Free Savings Account (TFSA) or promote the one you have. Many Canadians managed to save money during the pandemic. Help them ensure they're putting those dollars to work in a tax-efficient manner. The flexibility of TFSAs is especially valuable in uncertain times. Members can save for whatever they choose and withdraw the money without a tax hit. Guaranteed Interest Accounts – which are TFSA eligible – pay interest while protecting the member's deposits, no matter how stock and bond markets perform. They can be made available with short-term, long-term and flexible maturity dates.

We can take encouragement from the fact that the Bank of Canada's interest rate hikes have lowered the inflation rate. If the 8.1% annual rate reported in June 2022[8] is in fact the highest number we see during this round of elevated inflation, the effects on most Canadians will be manageable.

But we cannot take this for granted. A range of economic and political events could trigger another rise in the rate at which the cost of living increases. As long as interest rates remain elevated, potentially many plan members will find it more difficult to save for retirement.

[8] *Source: Statistics Canada*

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