Group Retirement Services

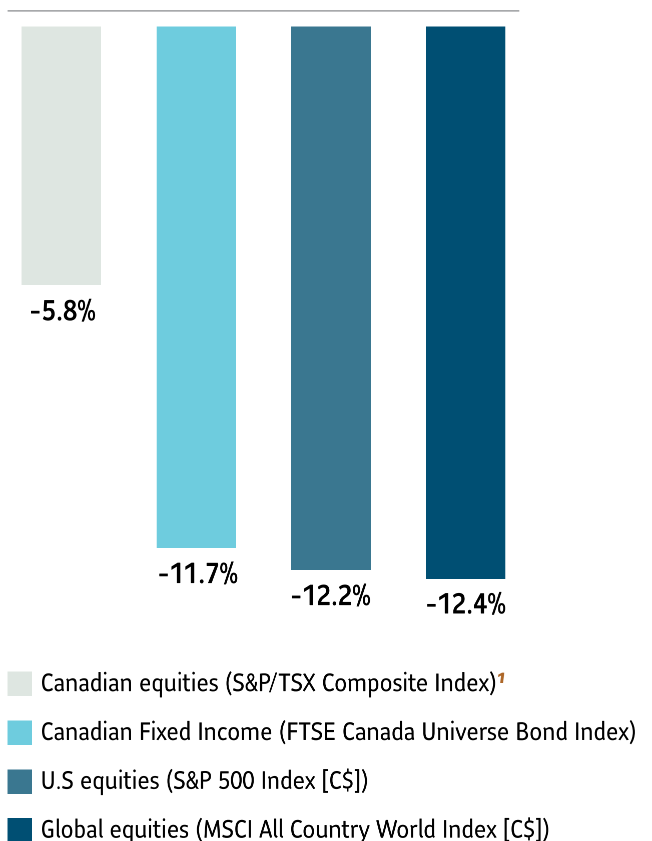
The impact of high inflation and volatile returns on group retirement plans

We usually think of inflation in a consumer context, as that's what grabs the headlines. Higher prices for gas, groceries, restaurant meals and more. Coupled with market volatility, it can effect saving for the future too. What are the effects on your group retirement plans, and what can you do?

While inflation's impact on group retirement plans is less direct than consumer cost impacts, it's just as profound. You know the story. As inflation began its meteoric rise, central banks raised interest rates to curb it. They did this quickly and aggressively. With a difficult economy and a recession looming, profits and profit forecasts declined. Equity markets followed suit in 2022, and stock prices across many sectors have fallen significantly.

Bond markets fared even worse. With interest rates rising quickly, bonds declined as a result. It marked the first time in decades that stock and bond markets both declined in the same year.

Stock and bond performance in 2022



This combination of high inflation and poor performance across asset classes has affected both plan members and plan sponsors.

[1] Index data source: Various providers, including MSCI, FTSE, S&P. The index providers make no express or implied warranties or representations and shall have no liability whatsoever with respect to any data contained herein. The index data may not be further redistributed or used as a basis for other indices or any securities of financial products. This report is not approved, reviewed, or produced by the index providers. Sun Life makes no representations or warranties about the completeness, reliability, and accuracy of the index source data. Any action you take upon reliance of the index source data is strictly at your own risk.

Plan member impacts

With no place to hide, we've seen little change in plan members' asset allocation. Most plan members are staying the course, and that's a good thing.

But we do expect to see two other impacts that are more troubling:

- **A lower rate of discretionary contributions.** Unless salaries have kept pace with inflation, plan members have less buying power than a year ago. They need to spend more to maintain their living standards. And that leaves less for future savings. There's also less incentive to save in a declining market. The thinking goes: "A dollar invested today could equal 90 cents tomorrow, so why bother?"

  For plans where a portion of contributions are discretionary, some plan members may reduce their contribution rate. They also may eliminate lump sum contributions, such as those at bonus or RRSP-refund time.

  While this has little short-term impact on plan sponsors, it could impact retirement readiness down the road. And that could effect your longer-term employee succession planning.

- **Delayed retirement**. For plan members considering retirement, a lower account balance could lead to some delaying their departure. The impact on employee succession planning in this case is more immediate. Plan members who were close to retirement are now staying in their jobs longer than expected.

These can both be challenging issues. However, they provide an excellent opportunity to proactively engage with plan members about their planned savings.

Engage with plan members about their options

Your outreach can acknowledge the difficult environment. But it's a good idea to remind plan members of the benefits of strategies like dollar cost averaging. This strategy involves buying equal dollar amounts of a given investment on a regular basis.[2] It can be especially beneficial during down markets, as plan members can purchase more units at lower prices.

You also have an opportunity to remind plan members about your plan's **Help Me Do It** options.

Sun Life's **Help Me Do It** options include target date funds. These funds offer broad diversification and ensure plan members have the appropriate asset mix as they age.

Target date funds can also improve plan members' investment performance. Sun Life has compared personal rates of return for plan members using only target date funds versus those using a la carte options. On average, target date only investors have outperformed do it yourself investors, on average, by about 1% per year, net of fees. We've done this analysis over five-year rolling periods since 2014.[3]

Plan sponsor impacts

World economies have changed quickly—and the effects will be long-lasting. The recent one-two punch of high inflation and rising rates reinforces the need for regular investment reviews.

Whether or not market conditions are the catalyst, regular reviews are a key part of good plan governance. We expect inflation, interest rates and market volatility to remain above recent norms for some time. With this "new normal" in place, there are three key areas we're encouraging plan sponsors to examine:

- Your fund managers' approaches to fixed income options—both a la carte and within target date funds
- Your target date fund managers' approach to glidepath design (including equity landing point)
- Diversification opportunities that may provide some inflation protection, such as real assets - like real estate and infrastructure - a la carte and/or within target date funds.

1. Fixed income options—the benefits of active management, including Core Plus

Plan members traditionally consider fixed income investments a "risk-mitigating" element in their portfolios. So, the recent decline in fixed income funds may have you fielding some plan member questions about their investments. And that can create greater urgency for including fixed income as part of your plan review.

One area worth examining is the passive versus active fund distinction. On Sun Life's platform, the majority of plans (83%) offer at least one passive fixed income option. And one-third of plans only offer a passive fixed income option.

[2] *Dollar-cost averaging can minimize the effects of an investment's volatility by investing the same amount of money in regular instalments over a number of months or years. Provided the investment gains value over the long term, dollar cost averaging lets uses an investment's volatility to an investors' advantage.*

[3] *2021 Designed for Savings Report, Sun Life Group Retirement Services, https://www.sunlife.ca/workplace/en/group-retirement-services/insights/data-and-case-studies/designed-for-savings/*

The rationale for a passive approach has historically made sense. Why pay an active manager higher fee when past analysis suggested most active managers don't add value over the benchmark? And fixed income returns have been buoyed by the tailwind of a decreasing rate environment. In such an environment, a passive approach was all you needed.

But active fixed income funds have generally outperformed passive funds over the past five years. We compared outcomes for active versus passive options on our core investment platform. We found that, on average, active managers outperformed their benchmark, with superior risk metrics, such as standard deviation and down-market capture.

Passive funds have typically performed below the median of the Canada Universe Bonds peer group. And they are often ranked in the bottom quartile. This is a clear indication that active managers have outperformed the index across changing rate environments.

In this higher rate environment, active managers may continue to add value, over and above their higher fees. Actively managed bond funds tend to be underweight federal government bonds and overweight corporate and/or provincial bonds. They are looking to gain a yield advantage from security selection, while staying relatively close to benchmark duration.

With rates resetting to much higher levels, there will be even more opportunities for active managers to add value. There's more room to maneuver in a 4% yield environment than a 1% one.

Another element worth examining is whether additional diversification within an active fund can add value. Counterintuitively, adding 'riskier' sectors to a bond portfolio may reduce overall risk by introducing new elements of diversification. For example, the Canadian corporate bond market is very thin and concentrated in financials and utilities. By adding U.S. corporate bonds, as an example, a fund can improve sector diversification, given the larger breadth of issuers. In addition, options like Core Plus funds can enhance diversification. These funds may make allocations to high yield, emerging markets debt, private fixed income and other off-benchmark securities. These are used to diversify the portfolio and potentially add new sources of excess return.

For these reasons, plan sponsors should consider whether an active bond fund, including Core Plus, can offer superior risk/return characteristics going forward. They should also consider whether any superior performance is enough to justify any fee differential that may exist vs a purely passive bond fund.

2. Review target date suites

Most plans on the Sun Life platform offer target date funds. In fact, target date funds are often the default investment option. These funds are designed to be a "set it and forget it" option for plan members. However, it's prudent for plan sponsors to periodically review their target date offering to ensure it continues to meet plan member needs. We recommend a default investment fund review at least every five years.

Target date suites can differ greatly from a fixed income perspective. So, they are worth including in any investment review. Target date fixed income allocations differ in two primary ways:

Glidepath

One target date suite might include 60% fixed income exposure as retirement approaches, while another includes 80%. That's a significant difference. It's worth confirming whether the suite you've chosen—and its associated glidepath—remain the best fit for your members.

Exposure to different categories of fixed income

There are significant differences in the exposure to various categories of fixed income within target date suites. Some target date suites take a 100% passive approach to fixed income. Others take an active approach that may include broader diversification. This can include 'plus' exposures as well as alternative categories such as private fixed income, commercial mortgages, and infrastructure. A review can help you determine whether these different diversification elements can better serve your plan objectives.

Regardless of the manager, all target date glidepaths carry a meaningful allocation to fixed income. That makes it a primary driver of plan member investment outcomes, especially for those approaching retirement. That's why your choice of target date suite warrants a regular review.

3. Inclusion of real assets

Real assets can provide protection against inflation. Investments in real estate, infrastructure and commodities tend to benefit from:

- Higher prices on assets
- Higher rents, and
- Higher demand for goods and services such as electricity.

These assets also benefit from lower volatility due to high and stable cash flows. However, liquidity requirements can make these exposures harder to access for plans that require daily valuation. And there are generally fewer options available than for traditional asset classes. Manager selection, due diligence, and ongoing reviews and governance are especially important for alternative asset classes. With these in place, real assets can be a welcome addition to Capital Accumulation Plans (CAP) line-ups in order to offer members further diversification opportunities.

In the age of inflation—a timely investment line-up review can help

Your pension committee has an important governance role – and regular plan reviews are a key part of it. With the recent changes in inflation and rates, this is an excellent time to review the investment framework for your plan. Consider extending any review to the fixed income components of your investment lineup. This includes both stand-alone funds and target date suites.

Our Group Retirement Services Investment Solutions Executives, partnering with your consultants, can help with ongoing investment governance reviews. It's also worth getting input directly from your portfolio managers. This helps ensure your manager's approach continues to align with your plan's objectives and expectations.