Boosting Savings and Raising Returns

Retirement plan participants face challenges from a low-expected-return environment made worse by too-low saving rates. Plan sponsors are responding with new investing strategies and plan design innovations.

By Howard Moore

Lousy returns. For retirement plan participants, they are the 300-pound gorilla in the room — the one that, somehow, is easy to miss.

“The most important issue facing retirement security is the low-expected-return environment, which is far too often overlooked,” says Antti Ilmanen, principal and head of the portfolio solutions group at AQR. When defined-contribution-plan participants calculate the saving level they need to hit to assure themselves a comfortable retirement, it highlights the need for them to save more. But these calculations assume investors will achieve the same returns they have experienced over the past 30 or 40 years.

“We think that’s incredibly optimistic,” Ilmanen says. Factoring in an expected return just a couple of percentage points lower on an investor’s future portfolio approximately doubles the required saving rate over the course of that individual’s career. “This generation of savers is going to have a more difficult time achieving the needed savings to afford a comfortable retirement,” concludes Ilmanen.

Coupled with the other risks that plan participants face, including longevity, inflation and taxes (see “Five key risks,” page 5), low expected returns are prompting more U.S. plan sponsors to take a multipronged, holistic approach to financial wellness, with some companies even making services available to help individuals budget, manage debt and navigate different life stages. “When an employee has a child, for example, more employers offer help to prioritize savings between education, health and retirement,” says Rob Austin, director of retirement research at Aon Hewitt.

The aim is to make employees more aware of their finances in general and their short- and long-term financial needs in particular. “Over the past ten years, more people have come to rely solely on their 401(k) plans and many have not changed their savings behavior very much,” Austin says. Many believe they cannot afford to save. “The conversation is shifting to financial wellness in general in order to solve the problem of low participation, not just the symptom.”

DC plans have largely replaced traditional defined benefit pension plans in the U.S., placing the weight of responsibility to save for retirement on employees. “That’s okay in the accumulation phase, but the problem comes when you start to...

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Introduction

Over a 40-year working life, defined contribution (DC) plan savers try to maximize two basic investment outcomes: wealth accumulation and wealth preservation. However, these objectives present a basic tradeoff: for many retirement savers, the investments designed to promote wealth preservation (e.g., cash, bonds). Defensive equities seek to provide a “best of both worlds”: delivering the equity risk premium to achieve wealth accumulation, but by investing in less-risky equity securities to promote wealth preservation.

The Defensive Premium

One of the oldest findings in finance is that lower-risk stocks deliver returns that are “too high” compared to what traditional models predict. As shown in Figure 1, over the long term, lower-risk U.S. stocks (left side) have delivered approximately the same average return as higher-risk stocks (right side). Defensive equity strategies seek to capture this premium by investing across a range of low-risk stocks, with the objective of achieving market-like returns but with less volatility.

What Drives the Defensive Premium?

Various theories seek to explain why defensive stocks perform as well as they do. One of the oldest and most tested is “leverage aversion,” which considers what happens to stock prices when a meaningful subset of investors are unable or unwilling to use leverage.

In general, equity investors with aggressive return targets have two options: 1) invest in higher-risk stocks in hopes of being rewarded with commensurately higher returns, or 2) use leverage to magnify the return on lower-risk stocks. However, in a leverage-averse world, investors do not have a choice between options 1 and 2. Instead, they are forced to take option 1: invest in higher-risk stocks. The resulting high demand for higher-risk stocks means their prices get bid up and their expected returns go down. The opposite holds for lower-risk, or defensive, stocks: Because there is less demand for them, their prices are bid lower and thus may be expected to perform better than they otherwise would.

What Makes a Stock “Defensive”? 

There are many ways to evaluate whether a security is defensive. These fall into two categories: fundamental and quantitative. From a fundamental perspective, companies with low risk may have relatively high margins, sustainable earnings and low credit risk. From a quantitative standpoint, companies with low risk may be those with low beta, or sensitivity to the market, or low volatility. We believe both categories are useful for identifying defensive companies and that the combination is likely to produce a more robust portfolio of truly defensive stocks.

Defensive and Defined Contribution

Defensive equities may be among the best suited to meet the twin objectives of wealth accumulation and wealth preservation. Figure 2 charts the rolling three-year average returns of two portfolios: a hypothetical U.S. large-cap defensive equity strategy and the Russell 1000. In good times the returns are comparable,
which supports the idea that defensive equities may achieve returns on par with passive equities and thus provide a similar engine for growth.

The difference, though, can be seen in the shaded areas in Figure 2 — periods when lower volatility led to smaller drawdowns, demonstrating that defensive equities may be better at achieving wealth preservation in down markets.5

This characteristic is clearly valuable near retirement, when investors have less time to ride through a market drawdown. But it may also aid younger savers, who may be less likely to throw in the towel after a severe — and potentially prolonged — bear market, maintaining the allocations they need to accumulate enough savings for retirement.

AQR is a global investment management firm that employs a systematic, research-driven approach to manage alternative and traditional strategies. As of June 30, 2016, we managed approximately $159 billion for institutional investors and investment professionals.

Figure 2: Equity-Like Returns With Potentially Smaller Drawdowns
U.S. Equities, January 1986–April 2016

Source: AQR, FTSE Russell. The backtest incorporates fundamental and quantitative measures of defensiveness. Fundamental measures include profitability (high margins, high asset turnover), low earnings and cash flow variability, high cash flows versus accruals and low credit risk; quantitative measures include over/underweighting low/high beta stocks. The portfolio seeks to maintain balanced risk exposures to underlying industries and is constrained from large exposures to value, growth and momentum styles. The universe is approximately the 1,900 largest stocks in the U.S. and is rebalanced quarterly. The portfolio typically has over 150 positions. We use the Barra USE3L risk model over the backtest period and deduct from returns AQR’s proprietary transaction cost estimates. Returns are shown in USD. These are not the returns to an actual, AQR-managed portfolio and are for illustrative purposes only. Hypothetical performance results have certain inherent limitations, some of which are disclosed at the end of this article. Past performance is not a guarantee of future performance.

1 For more, see Frazzini, Friedman and Kim (2012), “Understanding Defensive Equity.”

2 Early studies include Black (1972).

3 Defensive Equity, Low Beta, Minimum Variance, Low Volatility — these names all describe investment strategies that generally seek to overweight safe securities and underweight risky securities (relative to capitalization-weighted benchmarks).

4 Evidence for the defensive premium is pervasive. Beyond

5 Consistent with the earlier evidence, safe, profitable and stable companies have historically earned higher risk-adjusted returns than risky, unprofitable and unstable firms, as shown in Piotroski (2002), Novy-Marc (2012), Asness, Frazzini and Pedersen (2012).

6 Over the full period shown in Figure 2, the average volatility and total return of the Russell 1000 are 15% and 11%, respectively. For the Hypothetical Defensive Strategy the average volatility and total return are 12% and 12%, respectively.

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Bibliography


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FIVE KEY RISKS

Retirees and people planning for retirement face five key risks, says AXA Distributors’ Graham Day. Topping the list is longevity risk. With more people living more years, the distribution phase — when they will be taking money out of their savings instead of accumulating it — looms large. A close second is inflation and the need to factor in the shifting purchasing power of the dollar in ten, 15 or 20 years. “People have to account not only for the rising cost of living for the 30 or 35 years they will be in retirement, but for the exponentially rising critical costs, like health care and prescription drugs,” says Day. Many financial planners do not allow for a sufficient rise in inflation when creating a retirement income plan.

The third key risk is volatility, which markets appear to be exhibiting with greater frequency. “Volatility often turns people who are normally investors into savers,” says Day. “They react emotionally and begin to deviate from their investment program at the wrong time.” This underscores the need to craft a sound investment plan and stick to it.

Interest rate risk also looms large. “We’re in a historically low-interest-rate environment, with the ten-year Treasury hovering around 1.5 percent, which is unprecedented,” Day notes. Over the past 50 years, the ten-year Treasury has averaged 5 percent more than 90 percent of the time. “It’s great if you’re refinancing a home, but it’s unfortunate if you’re looking for a strong fixed rate of return.” When rates do start to rise, savers and other investors with much of their holdings in fixed income will see the value of these investments drop. “That’s a major concern, especially as those who are further into retirement reallocate from equities to fixed income,” Day says.

The last of the five key risks is taxes, which have been historically low for some years but increased for capital gains and qualified dividends in 2013. “It’s a major issue for high-income earners and those who have trust assets as well as those who have investments outside of IRA and other tax-deferred retirement accounts,” Day says. Active mutual funds are no longer able to write off losses from 2008–09 and 2010. “There have been significant accumulated gains and thus distributions, and if they’re owned outside of an IRA or other retirement plan, they are taxed on the way up, the way down and the way out,” he warns. — H.M.
Risk parity is another promising strategy, especially within target date funds (TDFs). The classic TDF starts with 90 percent equities and follows a glide path to 50 percent at retirement. “Even though a 50 percent equity allocation sounds diversified, equities still represent 90 percent of total portfolio risk, which is a pretty dangerous portfolio for someone at retirement,” says Ilmanen. Applying the principles of risk diversification and holding a more explicitly risk-balanced portfolio through life could be a better option.

A further concern in a low-expected-return environment is the fact that, as the workforce ages, more plan participants are approaching retirement. “Now investors are looking for ways to protect their portfolios,” says Day. Many are doing so with life insurance and annuities. Whether fixed or variable, annuities provide a level of assurance of a lifetime of income even if the market takes a slide, the individual happens to retire at the wrong time or a prolonged period of low interest rates dents their fixed-income holdings. Annuities “are almost like a personal defined benefit plan,” Day says. They have evolved as investors’ needs have evolved, with fixed, variable, hybrid, pure indexed and other types available to meet a variety of risk and return preferences.

**Participation and design**

If plan participants are to explore less conventional approaches in response to a low-expected-return landscape, including alternative investments and target date funds, staying the course when markets get scary becomes all the more important. In the ten years since it was sanctioned under the Pension Protection Act, automatic enrollment has become close to a standard DC plan feature and plan sponsors have made further innovations to encourage employees to join the plan and stick with it.

“Auto-enrollment programs began at about 3 percent of gross income, and many employees enrolled at that level and stayed there, which isn’t high enough to ensure a comfortable retirement,” says Austin. Today employers are setting default rates higher and adding auto-escalation. “Last year we saw for the first time that the majority of plans auto-enroll employees at a rate that’s at or above the threshold at which they provide matching contributions,” Austin notes.

TDFs are becoming the norm as the default option under auto-enrollment. “Forty cents of each new dollar contributed to a 401(k) plan goes into a target date fund, and they are rapidly becoming the largest asset class for many plans,” says Austin. Because TDFs are large and growing, he foresees a lot of evolution and innovation: active versus passive, custom designed or off the shelf.

By no means are all plan participants using TDFs as intended, however. While they were designed to be an all-in investment, only 55 percent of plan participants with TDFs use them as their principal retirement investment vehicle, according to Aon Hewitt research. “We find that plan participants may allocate 50 percent of their assets to a target date fund, 25 percent in a large-cap equity fund and the remaining 25 percent into company stock, for example, which has far more risk,” Austin says.

To help them make the best use of TDFs, or of any of their investment options, plan sponsors must understand participants’ investment preferences and their motivations and concerns as they make investment elections. “We're finding out if people simply don't understand target date funds or if they are looking for something more aggressive,” Austin says.

These issues aside, alternative investments, TDFs, annuities and plan features like auto-enrollment help make DC plans a more viable vehicle for participants to achieve retirement security in a low-expected-return environment.

“DC plans have historically tended to underperform DB plans, due to their holding less diversified portfolios and other inefficiencies,” says Ilmanen. Many investors and plan sponsors still believe the only way to improve returns is by taking more risk through equities, but there is growing recognition that DC plans can enhance performance by adopting some of the less conventional solutions.

“I'm optimistic that there can be a change in approach,” Ilmanen says — a shift the pension industry should prepare itself for as investor concerns mount about persistent low returns. “In the short term a solution may be to tweak equity-oriented portfolios with style tilts and better risk balancing via risk parity, but long term I expect more openness for even more innovative solutions.”