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RETIREMENT TIMES

NEWS AND UPDATES FOR RETIREMENT PLAN SPONSORS AND FIDUCIARIES

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Time to Reset Expectations

We are now in the eighth year of an equity bull market, making this the second-longest upswing in American history.[1] Additionally, the bond market has been in a secular bull market since 1982 as rates on the 10-year treasury fell steadily from above 14 percent to below 2 percent last year.[2] The recent strong returns we have experienced may be difficult to sustain due to equity valuations, near-record corporate profit margins, and low interest rates. This is not to say we are in a bubble or an imminent bear market looms, however now may be a good time to reset long-term investment return expectations for participants. In fact, California's state public pension system, Calpers, recently lowered their expectations for long-term investment returns from 7.5 percent to 7 percent.[3] Even those reduced projections may prove optimistic.

Equity returns are primarily a function of three factors: earnings growth, the multiple paid for earnings, and dividends. Earnings have benefitted from near-record corporate profit margins.[4] Since the Great Recession, corporate profit margins have expanded on the back of cost cutting, low labor costs and low interest rates. This margin expansion has fueled earnings growth and any reversion to the mean would create a headwind for earnings going forward.[5] Furthermore, the current price-to-earnings ratio[6] for the S&P 500 is about 18 times forward earnings. That compares to a historical 25-year average of about 16 times earnings.[7] These valuation levels are not extreme yet can provide less opportunity for future multiple expansion to drive returns. Lastly, the current dividend yield on the S&P 500 is less than 2 percent compared to a historical median yield of over 4 percent.[8] For all of the above reasons, U.S. equity returns in the high single digits may be unlikely over the coming years from this starting point.

Returns from fixed-income investments may also be challenged going forward. A significant component of fixed income returns are yields. During this secular bull market in bonds, returns have been bolstered by falling interest rates. The current yield on 10-year treasuries is about 2.5 percent. That compares to an average historical nominal yield of over 6 percent.[9] Additionally, if or when rates eventually rise, bond prices may be pressured since bond prices move inversely to interest rates. With yields near historically low levels, fixed income investments may return less than they have historically.

This is by no means a signal to exit the market and go to cash. Market timing is a fool's game because it is impossible to properly time an exit and entry back into the market. As history has repeatedly shown, investors who try to time the market may be destined for inferior returns over time. However from the current starting point, it is difficult to envision a balanced portfolio achieving high single digit returns over the next five to 10 years. A low to mid-single-digit return may be a more realistic expectation.

[1] http://money.cnn.com/2016/04/29/investing/stocks-2nd-longest-bull-market-ever/
[2]http://www.cfapubs.org/doi/pdf/10.2469/cp.v27.n2.6
[3]Calpers Cuts Investment Targets, Increasing Strain on Municipalities. The New York Times. December 21, 2016.
[4]A "Generational" Peak In Corporate Profit Margins. ZeroHedge.com. April 2, 2016.
[5]A "Generational" Peak In Corporate Profit Margins. ZeroHedge.com. April 2, 2016.
[6]The ratio for valuing a company that measures its current share price relative to its per-share earnings.
[7]2Q 2017 Guide to the Markets. J.P. Morgan.
[8]S&P 500 Dividend Yield.
[9]2017 Guide to Retirement. J.P. Morgan.

Should a Retirement Plan Implement a Fee Policy Statement?

For the client who may be concerned about fiduciary compliance, a fee policy statement may give comfort. Like all other fiduciary actions, the value of this statement is a function of how well it is written (not too loose nor too tight) and how consistently a plan sponsor actually describes/practices the process documented. So, a fee policy statement can potentially create problems in addition to mitigating them.

Having said this, assuming the plan is being managed prudently, by conducting a comprehensive live bid every three to four years (or sooner if circumstances warrant), along with an annual "second opinion" based on national normative data (as in our annual Fiduciary Plan Review), and the plan sponsor responds appropriately to the conclusions and maintains documentation, this should provide sufficient documentation to mitigate liability.

The recent attention to this issue is good in that, if interpreted properly, it will raise awareness. On the other hand, it also may create a bias for action which may not be beneficial.

A written fee policy is not required and may not be necessary. It is sufficient to state in the Investment Policy Statement (IPS) that the fiduciaries will take the necessary steps to ensure fees are reasonable. A detailed fee policy may set fiduciaries up for failure and limit their flexibility in determining how fees will be structured.

Plan fiduciaries should have a complete understanding of how much a plan is paying in total and to whom, and they should benchmark the plan periodically to ensure the fees are competitive. If the investments are sharing revenue, the fiduciaries should decide that this is appropriate and should understand who is receiving this revenue. All of this should be documented through reports and meeting minutes.

Company Stock and Fiduciary Considerations

In recent years, there has been a substantial increase in litigation involving retirement plans that have invested in the stock of their sponsoring company. The only definitive way for plan fiduciaries to avoid liability with respect to plan investments in employer stock is to avoid such investments altogether. Nevertheless, many employers, believing that employer stock is beneficial to their plans, continue to maintain it as an investment.

If company stock is available in your retirement plan, you may wish to consider hiring an independent fiduciary. Best practices dictates that the independent fiduciary should have no actual or perceived relationship with the company or its directors and should have exclusive control over the investment-related decisions for the plan, at least with respect to investment in company stock. This eliminates the concern regarding potential insider information and also helps to shift the fiduciary exposure to the independent fiduciary. That said, until this has been accomplished, your company's retirement committee likely doesn't have a choice but to monitor, and make decisions in regards to, company stock (unless the plan document expressly states that the plan must offer company stock). Absent a plan provision requiring company stock, the fiduciaries remain tasked with taking prudent action in the interests of participants in mind, which includes actions taken with respect to the company stock. For more information, contact your retirement plan advisor.

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