

Retirement Times

NEWS AND UPDATES FOR RETIREMENT PLAN SPONSORS AND FIDUCIARIES

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To Bond or Not to Bond?

Over the last few years, there has been a fair bit of concern in the market over the general impact of rising interest rates. “You shouldn’t be holding bonds because rates will rise soon” goes the logic. But what does this really mean for investors? If interest rates rise, what will ultimately be the impact on investors’ portfolios?

To understand this, we first need to understand how all of the moving pieces fit together. At a high level, if interest rates increase, this generally has a negative impact on bond prices, and to get a sense for how large this impact could be, we can look to a bond’s duration¹ or interest rate sensitivity². Using the broad Bloomberg Barclays U.S. Aggregate Bond Index to approximate an investor’s diversified bond portfolio, we see that the index has a duration of about 5.3. This means that if interest rates at ALL maturities move higher by 1 percent, the PRICE of the bonds will fall by an average of 5.3 percent.



There are a couple of key distinctions in that statement. The first is that all interest rates need to move together, not just some. The Federal Reserve can move short-term rates, but they have little direct control over 30-year rates, which contribute more heavily to price changes in bonds. The second note is that the price of the bonds will decline for a change in interest rates, but investors also still receive coupon payments³ or yield⁴. Currently (as of 12/8/16), the yield on the index is about 1.9 percent, which can help to offset losses from bond price movements. Taking these two sources of return together, if all interest rates move higher by 1 percent over the next year, bond investors could see a total loss of 3.4 percent.

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To put this into historical context, the largest total return loss on the Bloomberg Barclays U.S. Aggregate Bond Index, going back to 1976 was 2.92 percent and the index has only been negative on a total return basis in three of those 40 years.⁵

If a relatively significant move higher in interest rates can be expected to result in a loss (no matter how small) for fixed

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Fees, Funds and Fiduciaries – Cheaper is Not Always Better

The scrutiny of fees within retirement plans has reached a fever pitch and shows no signs of abating. The endless stream of lawsuits accusing plan fiduciaries and service providers of charging excessive fees, of all types, has fostered a heightened sense of anxiety amongst plan sponsors and advisors. Understanding plan expenses in relation to services provided and paying only reasonable costs is of the utmost importance; however, examining fees in isolation is problematic. This is particularly true when applied to investments.



Selecting the lowest cost option or a passive fund due to fear of litigation does not fulfill fiduciary obligations nor does it excuse liability and, potentially, may not be in the best interest of plan participants. According to a recent Cerulli report and survey titled “Facing Fiduciary Fears: Choosing passive does not equal fiduciary hall pass,”¹ the primary motivating factor for plan sponsors to select a passive fund over an active fund was to alleviate concerns related to lawsuits as opposed to having a developed argument against the investment merit of active management. This approach toward investment selection could be interpreted as putting the plan sponsor’s interest ahead of those of the

plan participants and their beneficiaries, violating a fiduciary’s responsibility under ERISA.

According to an often overlooked study titled “Out of Sight, Out of Mind: The Effect of Expenses on Mutual Fund Flows” by Brad M. Barber, Terrance Odean, and Lu Zheng which was published in the Journal of Business in 2005, “there is no discernible relationship between performance and expenses for the majority of funds.”² The authors obtained data on U.S. equity mutual funds between 1970 and 1999 from the CRSP database. They then sorted the funds by expense ratios into deciles and calculated the mean monthly return, capital asset pricing model (CAPM) alpha, and Fama-French alpha. After examining the results, their research concluded that only funds in the two most expensive decile groups “underperform by an economically large margin (26 to 37 basis points per month).”

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Complying With ERISA 404(c)

According to ERISA, plans intending to comply with 404(c) must provide that participants: Have the opportunity to choose from a broad range of investment alternatives (which are adequately diversified); may direct the investment of their accounts with a frequency which is appropriate; and can obtain sufficient information to make informed investment decisions. The plan sponsor must provide annual written notification to participants with its intent to comply with 404(c), and be able to provide the following:

- Information about investment instructions (including contact information of the fiduciary responsible for carrying out participant investment instructions);

- Notification of voting and tender rights;
- Information about each investment alternative; and
- A description of transaction fees and investment expenses.

Compliance with section 404(c) of ERISA protects plan fiduciaries from liability for losses that result from the investment decisions made by participants. Conversely, failure to comply with 404(c) could result in liability for losses due to poor investment decisions made by plan participants. To comply with some of the important requirements of 404(c), we encourage our clients to review and execute a formal 404(c) Policy Statement and Employee Notice and send the Notice at least annually to all employees. As your plan consultant, we assist you by providing you with a boiler plate template you can use for your plan. Contact your plan consultant for assistance.

Considering a Safe Harbor Retirement Plan

It may be advantageous for a plan sponsor to consider adopting a safe harbor design for their retirement plan. Adopting a safe harbor retirement plan design permits an employer to essentially avoid discrimination testing (the testing is deemed met). Remember, this testing limits highly compensated employees' contributions based upon non-highly compensated employees' contributions. By making a safe harbor contribution highly compensated employees can defer the maximum amount allowed by their plan and Internal Revenue Code limits, without receiving any refunds. General rules for all safe harbor contributions include the following:

- Safe harbor contributions are 100 percent vested.
- There may be no allocation requirements imposed on safe harbor contributions, for example, a 1,000-hour service requirement or a last day employment rule.
- Safe harbor contributions may be used toward satisfying the top heavy plan minimum contribution requirement.
- All eligible participants must receive a written notice describing the applicable safe harbor provisions between 30 and 90 days before the beginning of the plan year. This notice must be provided for each year the plan will be safe harbored.

Generally, there are two types of safe harbor contributions: 1) the non-elective contribution, which is a 3 percent contribution to all eligible participants, or 2) a matching contribution to participants who are contributing to your plan. There are two options from which to choose, for the matching contribution, either the basic or the enhanced match. The basic safe harbor matching contribution is defined as a 100 percent match on the first 3 percent of compensation deferred and a 50 percent match on deferrals between 3 percent and 5 percent of compensation. Alternatively, the employer may choose an enhanced matching formula equal to at least the amount of the basic match; for example, 100 percent of the first 4 percent deferred. All that said, employers wishing to explore a safe harbor solution should also be aware that it may entail more cost (if their present contribution structure is less than the required safe harbor required structure).

To learn if a safe harbor feature is appropriate for your plan, contact your plan consultant.

To Bond or Not to Bond?

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income investors, why take the risk of holding bonds? One way to think about fixed income is like insurance. On your car, you probably pay an insurance premium of about \$150 per month, or \$1,800 per year. If you are driving a \$20,000 car, that annual premium represents 9 percent of your car's value every year for protection against a significant financial

loss in the case of an accident. While nobody likes paying for insurance, it's a necessary expense that people understand and fixed income in a portfolio might be the cheapest insurance you can buy.

"Bond insurance" can provide a very strong diversifier to stocks. Going back to 1976, the Bloomberg Barclays U.S. Aggregate Bond Index had a positive total return in EVERY year that stocks had a negative return (and stocks had a positive return every year that bonds had a negative return.) Highlighting a couple of examples when the "insurance" paid off, 2008 was a year when stocks (S&P 500) declined 37.0 percent, but bonds returned 5.2 percent and in 2002, stocks were down 22.1 percent and bonds were positive 10.3 percent.⁶

Over the last 40 years, stocks have outperformed bonds, so there is no denying that holding some exposure to fixed income over that time may have underperformed a pure stock portfolio, but the overall volatility of the portfolio could have been lower as well. A portfolio consisting of half S&P 500 and half Bloomberg Barclays U.S. Aggregate Bond Index would have experienced a 1.5 percent lower annual return with 40 percent lower volatility than a pure stock exposure.⁷ In other words, 1.5 percent annual "insurance premium" reduced your risk by over 40 percent - that's a lot cheaper than car insurance.

¹A measure of the sensitivity of the price of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years.

²Interest rate sensitivity is a measure of how much the price of a fixed-income asset will fluctuate as a result of changes in the interest rate environment. Securities that are more sensitive have greater price fluctuations than those with less sensitivity.

³The annual interest rate paid on a bond, expressed as a percentage of the face value.

⁴The income return on an investment, such as the interest or dividends received from holding a particular security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value or face value.

⁵Morningstar through 2015.

⁶Morningstar from 1976 through 2015 comparing the total return of both the Bloomberg Barclays U.S. Aggregate Bond Index and the S&P 500 Index

⁷The annualized return (the returns an investment provides over a period of time, expressed as a time-weighted annual percentage) on the S&P 500 TR index from 1976 through 2015 was 11.35% with a standard deviation (a measure of the dispersion of a set of data from its mean) of 16.4. The same metrics for the 50/50 portfolio of stocks and bonds are 9.85% annualized returns and a standard deviation of 9.6. The volatility value of 9.6 is over 40% lower than 16.4. The 50/50 portfolio simply blends the annual returns of the indexes in equal amounts each year. All data sourced from Morningstar.

Fees, Funds and Fiduciaries

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In the Journal of Financial Planning, March 2016, Vol. 29, No. 3 edition, David Nanigian, Ph.D., provided an update to Barber, Odean and Zheng's original report. In addition to analyzing U.S. actively managed funds between 2000–2015, Nanigian also analyzed passively managed U.S. equity mutual funds, which were not included in the original report. Nanigian's study on the relationship between expenses and performance provides strikingly similar results to Barber, Odean, and Zheng in that, funds in the 9th and 10th decile portfolios, those with the highest expense ratios, delivered negative CAPM alphas. Portfolios in deciles 1 through 8 generated positive alphas during the analysis period. Nanigian further notes that "although the index funds portfolio generated more alpha than the decile 9 and decile 10 portfolios, it generated less alpha than each of the eight portfolios that consisted of funds that ranked in the bottom 80 percent of expense ratio."

Fiduciaries of all size plans, from the mega market to the small market, should be cognizant that selecting investments based on expenses alone may not be considered a prudent process and may expose themselves to additional liability. Additionally, we feel it is imperative that plan sponsors and advisors keep in mind, just as the Department of Labor states in their publication titled "A Look at 401(k) Plan Fees", "cheaper is not necessarily better."³

¹The Cerulli Edge – U.S. Edition October 2015

²<https://faculty.haas.berkeley.edu/odean/Papers%20current%20versions/Out%20of%20Sigt.pdf>

³<https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/401kFeesEmployee.pdf>



This is an excerpt of an article written by Calamos Investments. To read "Fees, Funds and Fiduciaries – Cheaper is Not Always Better" in its entirety please [click here](#) or copy and paste the link below into your web browser.

http://www.calamos.com/~media/Emails/2016_HTML/5403_1016_FINAL.pdf

COMMUNICATION CORNER: Rebalancing Your Portfolio

This month's employee memo provides participants with information on rebalancing their portfolios – what it is, what its purpose is and how to complete one.

As a reminder, we post each monthly participant memo online via the Fiduciary Briefcase™ (fiduciarybriefcase.com).

Call or email your plan consultant if you have questions or need assistance.

The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice.

Past performance does not guarantee future results.

Please note that all investments are subject to market and other risk factors, which could result in loss of principal. Fixed income securities carry interest rate risk. As interest rates rise, bond prices usually fall, and vice versa.

The Barclays U.S. Aggregate Bond Index is an index, with income reinvested, generally representative of intermediate-term government bonds, investment grade corporate debt securities, and mortgage-backed securities.

S&P 500 Index is an unmanaged group of securities considered to be representative of the stock market in general. You cannot directly invest in the index.

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Rebalancing Your Portfolio

As a participant in the company's retirement plan, you are already serious about saving for your future. Whether you are retiring in a few weeks or a few decades, you may need to protect your investment. A healthy way to do this is to rebalance your portfolio.

What is rebalancing?

Rebalancing is simply readjusting your portfolio back to the original asset allocation that took into account your risk tolerance and time horizon. Put another way, rebalancing forces you to adhere to your investment strategy.

Example:

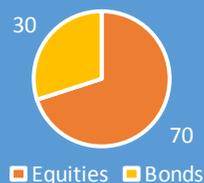
Suppose you enrolled in the plan at the beginning of last year and allocated 40 percent of your portfolio to bond funds and 60 percent to equity funds. Further suppose that when you got your year-end statement, it shows that 70 percent of your assets are in equity funds and 30 percent are in bond funds.

To stay within your acceptable risk level (which is what you determined before entering into the plan), you should sell enough equity funds to bring that back to 60 percent of your assets and buy enough bond funds to bring them up to 40 percent of your assets.

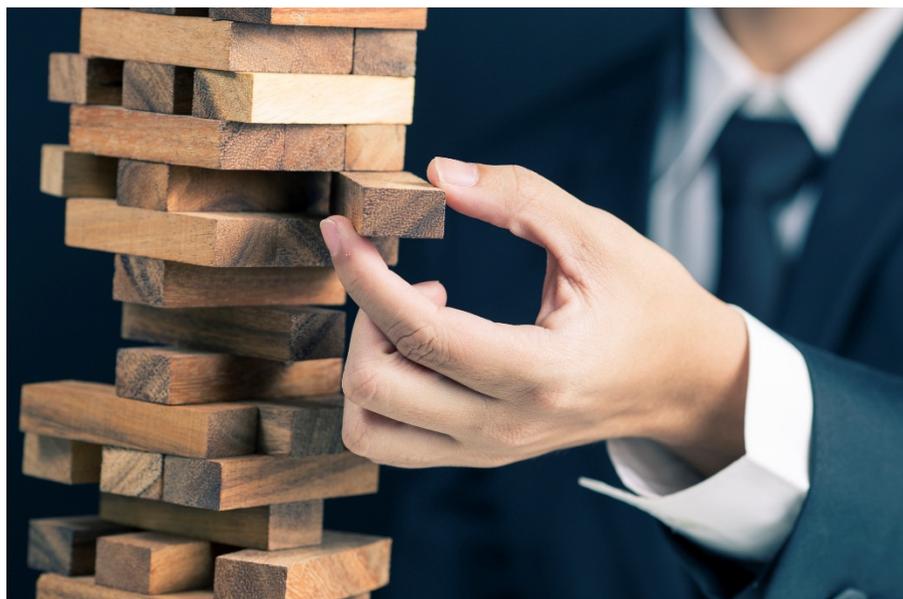
Initial Investment Direction



Investment Allocation After One Year



■ Equities ■ Bonds



You rebalance by selling assets that make up too much of your portfolio and use the proceeds to buy back those that now make up too little of your portfolio. The net effect is to “sell high and buy low.” Ultimately, regular rebalancing can increase the overall return of your portfolio over time. (An automatic rebalancing feature may be available through your current retirement plan provider. Visit your provider's website for more information.)

Keeping in check

Financial planners recommend you rebalance at least once a year and no more than four times a year. Consider this a good opportunity to evaluate if your investment strategy is still in line with your original goals.

If you have questions, or require further assistance, please contact our investment consultant at karl@partnerswealth.com or 630-778-8088.