

## Viewpoints

December 2008

### Protecting Defined Contribution Assets



#### **Stacy Schaus, CFP®**

##### Senior Vice President

Ms. Schaus is a senior vice president and account manager in the Newport Beach office and leader of the defined contribution practice. Prior to joining PIMCO in 2006, she led significant strategic initiatives at Hewitt Financial Services, including launching the Hewitt Defined Contribution Alliance and Hewitt Financial Services Investment Consulting and Brokerage, as well as creating the Hewitt 401(k) Index™ and the Hewitt Personal Finance Center. She has 27 years of investment experience and holds an MBA from the Stern School of Business at New York University and an undergraduate degree from the University of California, Santa Barbara. She is also on the board of the Financial Planning Association and has written numerous publications on defined contribution issues, including publishing PIMCO DC Dialogue™. She is also a Certified Financial Planner®.

*In this interview, PIMCO's Defined Contribution (DC) Practice Leader, Stacy Schaus, discusses the defined contribution markets, plan design, and how sponsors and participants are faring in the financial crisis.*

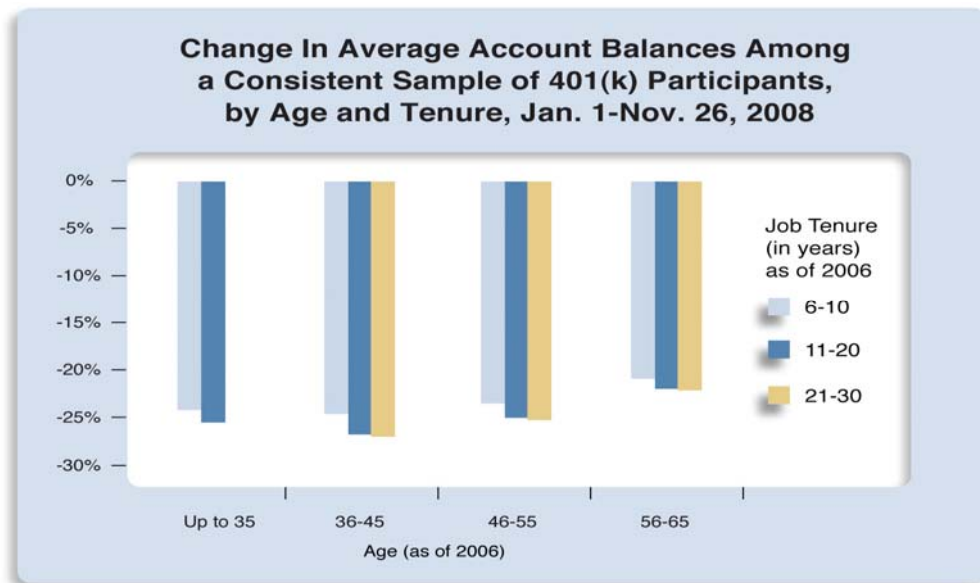
#### **Q: How are defined contribution plans faring in the current environment?**

**Schaus:** Not well; these are difficult times. At the beginning of 2008, total DC assets were estimated at over \$4 trillion. As of December 9, DC assets were believed to have declined by over one trillion dollars to less than \$3 trillion – a decline of about 25%.<sup>1</sup>

Data from the Employee Benefit Research Institute (Chart 1) show how this decline in assets affects participants of all ages, with even those above 55 years of age showing over a 20% loss in account value. Both plan sponsors and their participants are understandably frightened by such dramatic declines in the markets and in the value of their hard-earned retirement savings.

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Source: Employee Benefit Research Institute. 1999 and 2006 account balances: tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project. 2007 and 2008 account balances: EBRI estimates. The analysis is based on a consistent sample of 2.2 million participants with account balances at the end of each year from 1999 through 2006.

Chart 1

**Q: What does such a significant loss in value suggest with regard to the typical asset allocation in DC plans?**

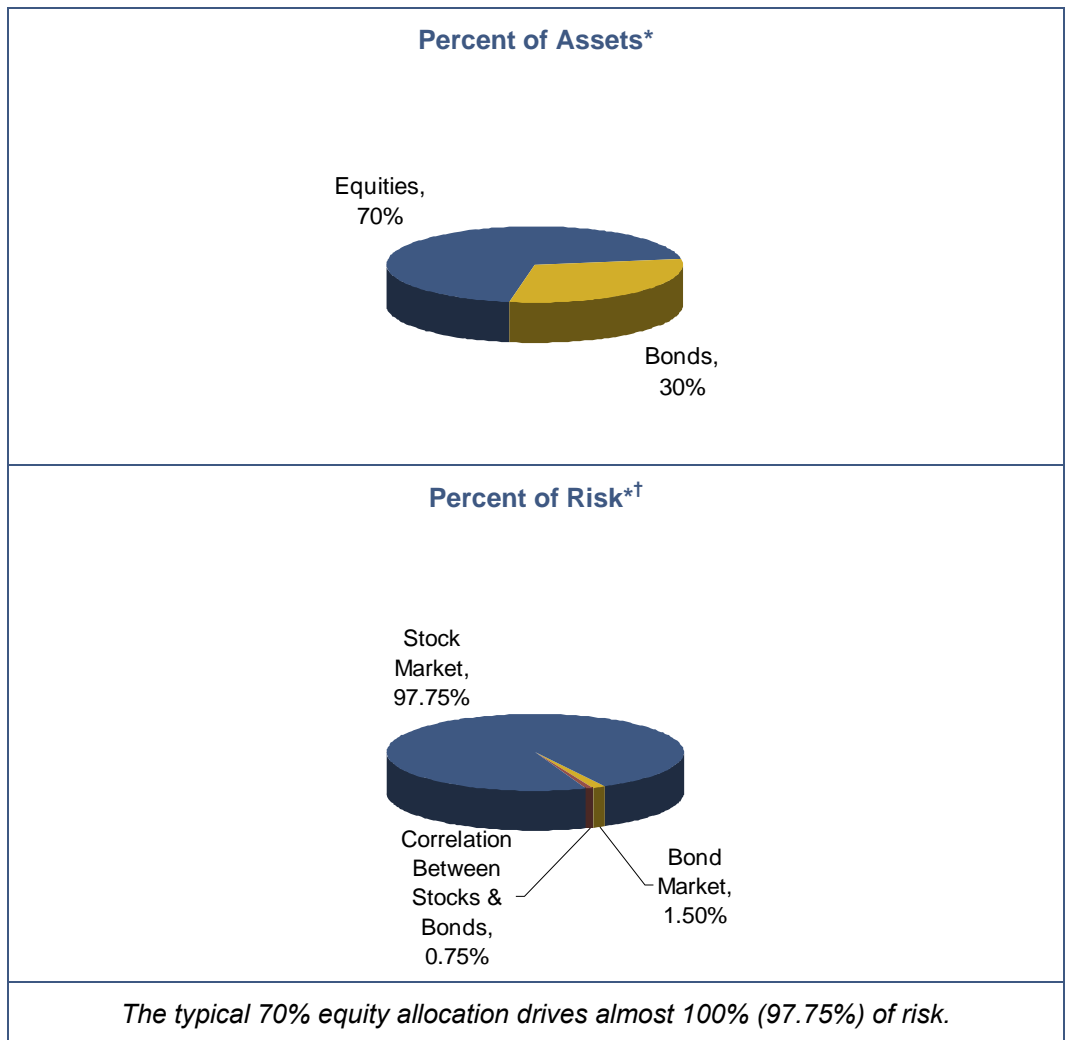
**Schaus:** DC plans on average have a 70% weight in equities and 30% in fixed income.<sup>2</sup> Equity holdings tend to be heavily invested in large-cap U.S. stocks, but they also include small-cap stocks, international developed markets, as well as a small allocation to emerging markets. Given the heavy allocation to equity along with the increasing correlations between domestic and international equity markets (that is, they no longer counterbalance one another), the impact of the bear market has been especially severe for DC participants.

Fixed income assets – largely core bond and stable value or money market – add diversification to DC plans, yet even some of these assets have been negatively impacted during the recent global shock. Yet without a doubt, plans that have a higher allocation to stable value and fixed income as well as broader asset allocation, including Treasury inflation-protected securities (TIPS), have fared better than those that lack such diversifying assets.

At PIMCO, we've taken a look at the typical 70/30 equity-to-bond asset allocation from a risk perspective. What's important to recognize is that from a volatility perspective, an even greater percentage of the portfolio's risk budget is allocated to equity. Our analysis suggests that 97.75% of the risk in DC plans derives from equity (Chart 2). Clearly, the concentration of risk is too great for those relying on their DC plans to meet retirement income needs.

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**Asset Allocation ≠ Risk Allocation**



Source: PIMCO

\* 70% / 30% capital allocation is to S&P 500 Index and Barclays Capital U.S. Aggregate Index, respectively.

† The basic formula for standard deviation of a two-asset portfolio is used to create the exhibit above. Standard deviation is computed as the square root of the following three components:

1. [the weight of asset 1 squared multiplied by its variance] plus
2. [the weight of asset 2 squared multiplied by its variance] plus
3. [2 multiplied by (the correlation of assets 1 and 2 multiplied by the product of their weights multiplied by the product of their individual standard deviations)].

The time period is January 1987 – December 2007.

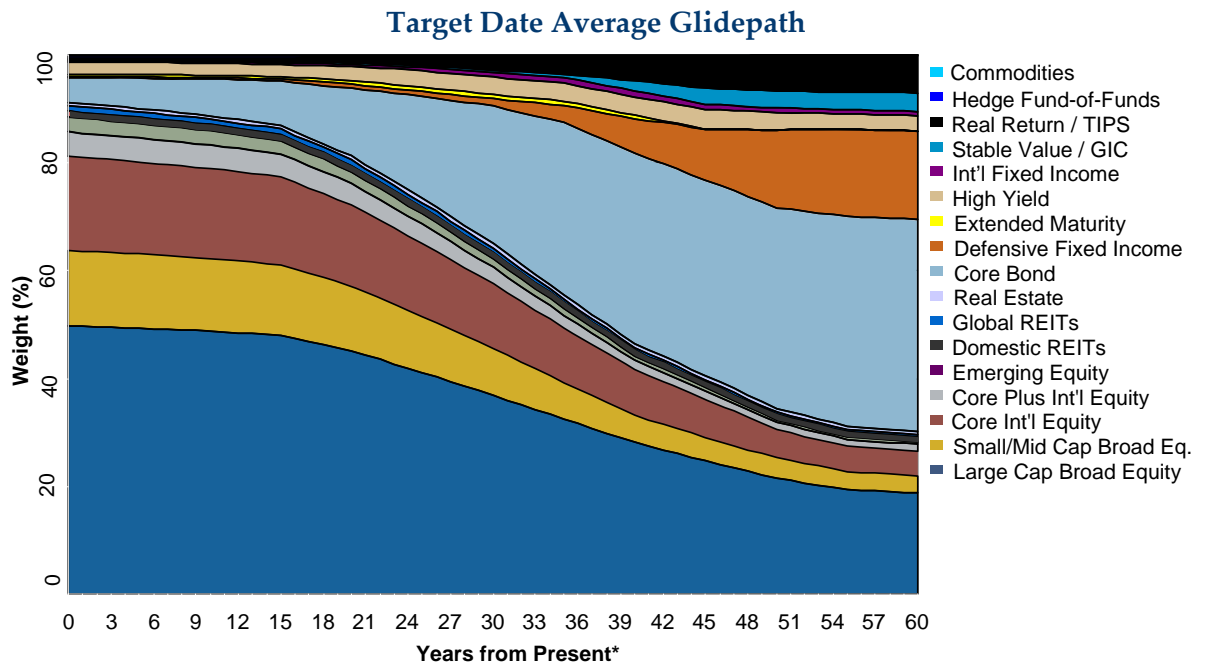
**Chart 2**

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**Q: How are asset allocation strategies such as target date retirement strategies (2010, 2020, etc.) performing in these markets?**

**Schaus:** It depends on their allocation. Most of the strategies have been hit hard as they tend to weight assets heavily toward equity as well. Target date products are designed to manage a participant's money over time and tend to become more conservative as the retirement year approaches, yet as we evaluate target date products for people in their 50s and 60s, the typical equity allocation may range from 40 to 70% (Chart 3)\*.



\*Assumes the participant starts saving for retirement at 25 years old.

Source: Callan Associates Consensus Target Date Glidepath, 2008

**Chart 3**

Given the high equity allocations, participants in 2010 target date strategies (intended for those about to enter retirement) have felt a real shock: on average, these "diversified" portfolios have lost 25% of their value from July 1 to December 9, 2008.<sup>3</sup>

**Q: How have participants reacted to this market volatility and general decline?**

**Schaus:** While most plan participants have stayed the course, the transaction activity among DC participants has risen and the majority of money moved was out of equity and into stable value or fixed income.<sup>4</sup> Yet on a daily basis, just a small fraction of assets tend to move. For instance, on October 9, 2008, when the S&P 500 dropped 7.6%, only 0.19% of assets were moved and most of this amount transferred to fixed income. Then when the S&P rose 11.6% on October 13, 2008, participants chased this performance, yet an even smaller percent (0.15%) of assets moved. Historically,

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participants are more likely to move assets when markets decline versus when they rise, a trading pattern that suggests participants are motivated more by fear than by greed. Clearly, this behavior is detrimental to participants' ability to meet their retirement income needs.

### **Q: Have stable value strategies protected participant assets in this market environment?**

**Schaus:** The objectives of stable value strategies are to preserve capital and generate predictable returns. Yet, the market turmoil has affected stable value managers, and unfortunately some have experienced significant losses in their underlying portfolios. Also, few wrap providers are currently issuing new wraps, reacting to the market turmoil and the increased risk of losses. These two factors – the poor performance of some managers and the lack of wrap capacity – combine to raise concern for some plan sponsors. PIMCO is working with many plan sponsors to improve their stable value offerings by focusing on strengthening the underlying asset management as well as working with wrap providers to secure capacity.

### **Q: How are plan sponsors helping their participants through this crisis?**

**Schaus:** We've spoken with many plan sponsors who are encouraging their participants to stay the course and not shift their asset allocation under pressure. At the same time, many sponsors are questioning the asset allocation and general design of their plans. They are paying particular attention to the plan investment default and asking how they can better protect their participants' assets. For instance, they may seek a higher allocation to low-risk assets less correlated to equities, such as Treasury inflation-protected securities (TIPS). They also may seek a Treasury money market strategy for principal preservation (though little if any earnings at this time).

In addition, some plan sponsors are adding non-traditional assets, which we can define as investments that are not tightly correlated to either equity or to fixed income; the assets that make up the two primary risk categories in DC plans today. Non-traditional assets may include a global tactical asset allocation strategy or other assets such as real estate (primarily via REITs) or even commodities. What's more, some sponsors are looking closely at risk mitigation approaches beyond asset diversification, such as tail hedging strategies or guarantee products (such as lifetime income) for their plans.

### **Q: Is inflation protection important in this environment?**

**Schaus:** We believe inflation protection is critical in a DC plan regardless of the economic environment, as inflation is one of the greatest risks participants and retirees face – that is, their money must retain purchasing power as they approach and enter retirement. While we anticipate inflation to be relatively low over the near term, we expect inflation to increase within the next couple of years. Timing the market for inflation protection securities is dangerous; plan sponsors shouldn't wait until inflation spikes to add protection, just as participants shouldn't wait until the dam breaks to get flood insurance. Now is the time to add this important hedging tool within DC plans. Plus, keep in mind that these assets may also add important diversification benefits – so they may help reduce volatility and improve return potential even in times of low inflation.

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### **Q: What types of investments provide inflation protection?**

**Schaus:** As mentioned, TIPS offer important inflation protection as well as the credit quality of Treasury securities. Plan sponsors tend to add TIPS to their plans first. In addition, they may add real estate and even commodities which are often used as a hedge against inflation. In addition, some may look at infrastructure, timber, energy or other types of investments. Or, they may prefer to add a diversified global tactical asset allocation strategy that may tap into all of these investment types and is managed to outpace inflation.

### **Q: Will asset diversification help protect participants' DC assets?**

**Schaus:** We believe that broader diversification will reduce volatility and help participants reach acceptable retirement income goals. However, we must distinguish between the probability of meeting a goal by means of diversification and the certainty of meeting the same goal by means of insurance vehicles. Many plan sponsors have told us that the volatility their participants have faced over the last year is simply unacceptable. We know the vast majority of participants are depending on their DC plan as their primary source of retirement income beyond social security. Merely understanding the probable outcomes and being asked to "ride it out" is simply not good enough for many participants. People nearing or in retirement often can't stomach the ride and need a guarantee that they will have at least a base level of income from their DC plan in retirement.

### **Q: What types of insurance guarantees are available?**

**Schaus:** Sponsors are evaluating a number of guarantee products, such as fixed and variable annuities, including guaranteed minimum withdrawal products. In addition, longevity insurance is gaining interest. My informal survey of plan sponsors at recent conferences found that while few of them currently have these types of products, a majority is considering adding them in the next year or two. Yet, many sponsors say they are concerned with guarantee product fees and complexity as well as fiduciary oversight – these concerns need to be addressed over the coming years to help more sponsors move forward with such programs.

### **Q: How is PIMCO helping clients who have concerns about DC assets?**

**Schaus:** We're helping many of our clients evaluate their current asset allocation structures, including evaluating the probability of the plan meeting real retirement income replacement goals, and the ability to minimize volatility and other risks in the plan. We offer our clients as well as the consulting community access to proprietary software that we have created to support the asset allocation analysis; the software is called PIMCO YODcA™ (Your Optimal DC Allocation). We also help plan sponsors and consultants with a broad range of investment solutions, including stable value, bond strategies, real assets, global tactical asset allocation and tail risk hedging.

### **Q: Who should clients and consultants contact to discuss DC issues?**

**Schaus:** They can speak with their primary relationship manager at PIMCO or send us an email at [pimcodcpractice@pimco.com](mailto:pimcodcpractice@pimco.com), or simply call us at 1-888-845-5012.

**Q: Thank you, Stacy.**

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<sup>1</sup> Source: PIMCO. Given a typical DC plan asset allocation of 70% equity and 30% fixed income / stable value, applied year-to-date returns as of December 9, 2008, of the S&P 500 (-38.1%) and the Barclays Capital U.S. Aggregate Index (+2.8%).

<sup>2</sup> Source: Callan Associates, 2008

<sup>3</sup> This was calculated by averaging out the returns of the top ten 2010 funds (Fidelity Freedom 2010, T. Rowe Price Retirement 2010, Vanguard Target Retirement 2010, Wells Fargo Advantage DJ Target 2010, Barclay's Global Investors LP 2010, TIAA-CREF Inst Lifecycle 2010, AllianceBernstein 2010 Retirement Strategy, JPMorgan SmartRetirement 2010, Schwab Target 2010, Blackrock Lifecycle Prepared 2010)

<sup>4</sup> Source: Hewitt 401(k) Index™

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