What do our Long-Term Capital Market Assumptions mean for defined contribution plans?

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Our 2023 Long-Term Capital Market Assumptions, which forecast asset class returns over a 10- to 15-year horizon, suggest that public markets today offer the best potential long-term returns in more than a decade. For those who are early in their retirement savings journeys, this is unequivocally good news. For their older colleagues, however, the situation may not be so rosy—after all, forecasts of higher returns tomorrow are simply the flip side of recent capital losses.

Examining these two perspectives can be a “teachable moment,” shedding light on what makes up a successful outcome for defined contribution (DC) plan participants.

The defined contribution system is designed to foster the patient accumulation of capital over a working lifetime and then to put that capital to use in delivering adequate income during retirement. Given the long time horizons involved, one might be tempted to assume that timing and luck don’t matter much—that it all averages out in the end.

While this may well be true for younger participants, it does not apply to participants later in their working lives. DC participants can find themselves subject to a great deal of timing risk if their portfolio experiences a severe market drawdown as they approach or enter retirement, leaving them with insufficient assets for adequate income replacement and little time to recover their losses.

Market risk is inescapable. But plan managers and participants can take actions to mitigate its effects. A thoughtful and disciplined investment strategy, implemented via a well-designed DC plan utilizing industry best practices such as automatic features can go a long way toward setting participants up for a successful retirement. As markets transition through a period of exceptional volatility, three key lessons are worth remembering:

**Fortitude** is needed to remain invested during periods of market volatility and to maximize contributions to the extent possible.

**Foresight** is required to reduce risk patiently and carefully as retirement approaches, avoiding market risk at the most critical moments.

**Flexibility** is essential during the transition from accumulation to decumulation, when the need for income replaces the need for total return.

While participants make critical decisions within their own DC plans, sponsors can do a great deal to set up participants for a positive outcome. There is no simple road map. Indeed, the challenges posed by the current environment will serve to test existing models and suggest enhancements for the future.

**Fortitude: Investing through downturns to achieve long-term goals**

There is an oft-repeated adage that states “success is not about timing the market, it’s about time in the market.” Broadly speaking, this is excellent advice. Staying the course and remaining invested through market ups and downs is a proven approach to capital accumulation. During some periods, valuations are high and contributions earn lower returns. At other times, valuations are lower and contributions earn much higher returns. Investors, even those later in their working lives, should be wary of pulling money out of the market in response to short-term negative returns.

History suggests that timing the market correctly is very difficult, even for savvy professional investors. For DC plan participants, the odds are long indeed. Often, risk aversion rises after a market sell-off, leading investors to de-risk too late. Conversely, markets often rebound strongly from the lows, and capital that has sought the safety of low-risk asset classes can miss out on the much-needed upside.

Fortitude is needed to stay invested, to stay diversified and to contribute over time.

What does this mean at the granular level of DC plan allocation and investment? A disciplined asset allocation
strategy that embraces prudent risk-taking and diversification across market sectors will deliver long-term returns with acceptable risk.

As market conditions change, the use of active management across core menu and target date options can allow a participant’s portfolio to respond to market shifts by proactively deviating from market benchmarks while remaining fully invested. Maintaining contributions during periods of volatility ensures that participants won’t miss attractive entry points.

A much-improved long-term outlook

From today’s vantage point, the outlook for future returns is much brighter than it has been in many years.

A year ago, high valuations for stocks and bonds reduced our long-term return assumptions to their lowest levels in decades. Then came the bear market of 2022, in which stocks and bonds both suffered significant losses—a rare phenomenon. Amid the heightened level of market volatility and the absence of diversification across traditional asset allocations, we made a few key observations.

First, the ability of active managers to diversify portfolios away from the concentrated exposures of capitalization-weighted passive benchmarks may have delivered differentiated performance. And second, alternative asset classes such as real estate provided a measure of risk reduction as they shielded capital from stocks’ and bonds’ simultaneous downturns.

Our forecasted annual return for a 60/40 stock-bond portfolio leaps to 7.20%

Following the past year’s market decline, our forecasted annual return for a 60/40 stock-bond portfolio over the next 10 years has almost doubled, from 4.30% last year to 7.20% (Exhibit 1).

A fully invested portfolio will benefit from a market recovery, but of course, such a portfolio has recently experienced losses that will need to be recovered. Contributions invested today will almost certainly generate materially higher long-term returns over time, accelerating the portfolio’s recovery and augmenting its long-term performance.

Foresight: De-risking as retirement approaches protects defined contribution plan participants

Whatever the phase in the market cycle, an individual participant makes a critical choice in deciding when to retire. Someone who experiences a significant market downturn immediately before or after retiring may suffer long-term financial consequences. The loss of capital may diminish a participant’s ability to earn sufficient income in retirement. To earn back losses, a participant may need to take on additional risk. Both of these situations are clearly undesirable.

Fortunately though, steps can be taken to help protect a plan participant from the fallout of a “retirement eve” bear market.

In practice, this means reducing market risk in the period leading up to retirement. It is far better to forgo some potential returns in the last few years of a working life than to risk the disaster of a downturn striking at exactly the wrong moment.

Lower volatility fixed income strategies can take some of the sting out of bear market losses

Exhibit 2: 60/40 portfolio vs. Target Date Retirement Income Index performance in bear markets

A well-designed target date strategy will accomplish this goal by reducing asset risk as the strategy matures and the participants in each vintage approach retirement. Offering access to lower volatility, active fixed income strategies on the core menu can also mitigate the effects of sudden market moves (Exhibit 2).

The volatility of the past 12 months has been an object lesson in how target date strategies can protect participants. The most mature vintages have declined less than younger vintages or a more generic 60/40 portfolio. This is by design: Younger participants will be able to recoup recent losses over their investment time horizons, but older participants at or near retirement may not. The relative security of a late-vintage target date strategy may mean lower returns for a period, but that’s a trade-off worth taking.

Flexibility: Finding retirement income and risk diversification

As participants transition from working life to retirement, their portfolios must undergo two shifts from capital accumulation: first to capital preservation and then to income generation. Flexibility is essential, as the markets will determine how much income is available and where it comes from. Income might be the yield on diversified fixed income securities and/or the dividend payments from equity and certain alternative strategies.

US Aggregate Bond Index yields have risen sharply over the past year

Exhibit 3: US Aggregate yields, November 2021–November 2022

The bond market today offers much higher levels of yield than at any time in the past decade (Exhibit 3). Plan participants who are already in retirement have a compelling opportunity to lock in high levels of income. For workers nearing retirement, who may have lost a portion of their capital during the recent sell-off, the higher yields are a welcome relief. Equity strategies with an income focus may also offer attractive dividend yields, as well as the opportunity to participate in any future market rebound.

Plan sponsors must facilitate the retirement transition by offering dedicated retirement income strategies, as well as specific core menu options geared to retirees who elect to remain in the plan. Many customized retirement income strategies offer a diversified allocation across fixed income sectors and equities, augmented by active management within individual strategies and top-down flexibility to shift allocations as the opportunities change across time. Standalone menu options should include actively managed multi-sector fixed income strategies as well as income-focused equity strategies.
Luck is not a strategy

Today’s investing environment is testing DC strategies. For sponsors, it will be critical to establish a plan design that facilitates continuing investments over time, offers prudent risk reduction as retirement approaches, and that delivers income in retirement.

For participants seeking a simple solution, the answer will likely be a target date strategy that combines active management with flexibility along the glidepath. For participants seeking to direct their own investments, a well-curated core menu should include vehicles that can take advantage of the current investment environment to capture opportunities for growth and income.

Successful retirement planning is built around long-term averages, not short-term extremes. Yet in volatile markets, some plan participants, feeling whipsawed between good and bad fortune, may look to deviate from their plans. To keep participants on course, sponsors will need a well-designed plan that can turn volatility into an opportunity through steady contributions, diversified investments and prudent risk management. Three virtues—fortitude, foresight and flexibility—can guide participants and sponsors in the direction of a successful retirement outcome.