SAPERS & WALLACK

Retirement Report

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Happy Holidays!

It is our pleasure to extend to you the greetings of this special season. It is certainly one of our favorite times of year, and the perfect opportunity to express our gratitude to you for selecting us as your committed consultants. As we look forward to a new year and the hope it brings, we also look back on our achievements in 2014, and the degree to which we accomplished our primary goals — protecting you as a fiduciary and helping your plan participants prepare for a meaningful retirement. Congratulations on all that you accomplished in 2014. We remain fiercely proud of being your dedicated retirement plan consultant.

As we do each December, this month's Retirement Times highlights "excerpts" from issues published in 2014. Please contact us with any questions or feedback. We look forward to serving you in 2015!

Weathering All Market Conditions

In today's market environment, many people are asking themselves "where can I find opportunity in fixed income?" It is a fair question, as rising rates will inevitably hurt the performance of most fixed income sectors. Participants have been riding a massive wave of decreasing rates and have become accustomed to 8 percent annual rates of return to their retirement plans from their core fixed income fund. Since those days are likely over, where do you go from here?

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Some plans are considering adding alternative fixed income sectors to their core lineups to allow their participants to improve their fixed income risk/return profile in a rising rate environment. Traditionally, a single core fixed income fund has been the staple of the bond offerings of many retirement plans. Comprised mostly of intermediate-term, investment-grade government and corporate debt, core fixed income funds worked fantastically in the steadily decreasing interest rate environment of the past 30 years. Since interest rates are bounded at zero (cannot have negative rates), they have nowhere to go but up. When rates do turn up, as we have already started to see, most fixed income securities will be negatively affected. Certain classes of bonds, however, have traditionally been affected more than others in rising rate environments. This observation has led plans to consider adding alternative fixed income, such as high-yield, emerging market debt or floating rate bond funds, to their core lineups.

Although the changing investment universe is certainly worth considering when looking at potential investments to include in plan lineups, a more fruitful pursuit is to construct a well-diversified core lineup that will allow the plan and its participants to weather all market conditions. It is problematic to constantly add investment options as the investment horizon shifts. These additions tend to be of non-core asset classes and can make for more difficult monitoring of the lineup. This can also cause confusion on the part of the participants who may not be (and in most cases are not) savvy enough to utilize these newly injected asset classes to their advantage. How many participants would know how to incorporate a floating rate bond fund into their portfolios? Accordingly, when the investment outlook turns unfavorable for these alternative asset classes, what do you do with the fund? Using the same logic as when added, it would then be removed from the lineup. This fund turnover can be confusing for participants. As mentioned, alternative asset classes are generally more difficult to monitor, which can further complicate committee decisions. This is reminiscent of the gold rally during the summer of 2011 when it seemed like every retirement plan committee wanted to add a gold exchange-traded fund to its lineup.

Ultimately, much depends on your plan participants. If they are sophisticated and have a working knowledge of investing, then adding these options could be highly beneficial. High-yield bond funds, short-duration funds and others could offer fixed income exposure for participants with relatively less interest rate sensitivity than a traditional core fixed income fund. For most, however, the sophisticated investors will be savvy enough to find this desired exposure outside the plan, via an individual retirement account or brokerage account. A good option might be to allow a core plus or multi-sector bond strategy in the lineup, which allows for some manager flexibility to allocate to other fixed income asset classes as they see fit. In rising rate environments, these managers tend to shorten duration and allocate to alternative exposures to reduce interest rate sensitivity. In this manner, participants are receiving the fixed income exposure they need within one professionally managed fund, rather than attempting to allocate to separate funds themselves. This is where the Scorecard can be extremely beneficial in finding skillful core plus managers that have proven track records in allocating across the fixed income universe.

What to Expect When Transitioning Providers

The thought of moving from one service provider to another may be intimidating and overwhelming. It doesn't have to be. If you work with an experienced conversion team, the process should be seamless.

If a plan sponsor is unhappy with its current provider's services and technology, it may very likely want to switch providers. Furthermore, if the plan sponsor feels it or its participants are not receiving sufficient value for the fees being charged, it may explore the idea of moving to a different provider.

To ensure the transition from the incumbent provider to the new provider happens smoothly, and with little disruption to you and your staff, it is important to keep the following in mind:

- Conversions are typically a 90-day process.
- You will most likely be working with a conversion team of members from your advisor's firm, your provider or both.
- Creating and adhering to a conversion timeline is crucial.
- Constant communication is key. Be sure to set aside time in your schedule for a multitude of both regularly scheduled and impromptu phone calls and emails.
- Gather important plan documents that will be requested of you — signed plan document, summary plan description, most current 5500, adoption agreement and all amendments.
- Your payroll department will play an important role in the conversion. Be sure to keep them in the loop throughout the process.

Although the conversion process is cumbersome and time-consuming, it encompasses a relatively brief time in the life of your retirement plan. Look forward to the enhancements a new provider brings to you and your participants.

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Index Funds: More Than Meets the Eye

The largest misconception about index funds is that their only distinguishing feature is their fees. It's not uncommon to hear "Index funds are just holding the stocks or bonds in the index, so we don't need to pay attention to them." This assumption, however, is an oversimplification. Many investors don't realize that all index funds are not created equal.

A key difference between indexes and index funds is that index funds are exactly that — funds. Index funds manage obstacles that indexes themselves don't face. The largest difference is that funds actually must transact in securities whereas indexes do not.

As an example, when Standard and Poor's recently added Facebook (FB) to the S&P 500 Index to replace Teradyne (TER), S&P simply recalculated the index values based on the closing prices of the securities on the effective date. Index funds that track the S&P 500, however, had to sell out of their positions in TER and purchase FB, plus rebalance the weightings of any remaining securities that were affected by the change. Trading in these securities exposed the funds to transaction costs, such as commissions and market impact. Additionally, funds face the risk that their realized trade prices on the securities may be different than the values used to calculate the index, creating a difference in performance. In this example, the impact of these factors is generally small.

Where the impact is more meaningful is in areas such as fixed income and international equities, where liquidity in the securities tends to be significantly lower, there are more securities in the indexes and changes are more frequent. The Barclays Aggregate Index, for example, has over 8,500 securities in it, with many of them not trading every day. In addition, the index rebalances on a monthly basis, so managers tracking this index must constantly adjust the fund.

Index funds must also efficiently manage flows in and out of the funds, dividends and interest payments, mergers, tax consequences and securities lending — all challenges that the underlying indexes do not face.

Fortunately, most index managers are adept at keeping their funds in line with their benchmarks, so the impact of these factors on fund performance is generally small — small, but important. Just like active funds, evaluating index funds requires careful analysis beyond fees and should also include performance and risk. The index fund metrics in the Scorecard System incorporate all of these, providing a complete picture of the factors that produce the most effective index funds.

Communication Corner: One Is All You Need

This month's employee memo is titled "One Is All You Need." This memo reminds participants that all they really need is one target-date fund to have a diversified portfolio.

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.

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