Reimagining Retirement 2030: A Roadmap for Action

CRI Annual Policy Innovation Forum

October 22, 2020

Social media: #2030CRIForum

GEORGETOWN UNIVERSITY
McCourt School of Public Policy

CENTER FOR RETIREMENT INITIATIVES

Do Investment Strategies and Tools Need to Evolve?

Moderator | Chris Hanak
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Panel Participants

Stefano Giglio
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Stefano Giglio

Professor of Finance

Yale School of Management

RETIREMENT INVESTING: NEW CHALLENGES AND OPPORTUNITIES

Stefano Giglio

Yale School of Management

A DIFFERENT LANDSCAPE

- Over the last few years, we have witnessed many important events affecting financial markets

- Many of these have implications for how we think about optimal investment strategies

- My remarks focus on the COVID-19 **market crash**: what can we learn from it?

- At the end, present **key issues and opportunities** for long-term investment

COVID CRASH

- We have just been through yet another **large market crash**

- These events are rare but crucial, because
  1. They have large effects on **investment returns**
  2. They can induce large **mistakes** by investors

- One thing that is special about this one is that we have great **data** to understand **investor behavior**
  - **Fundamental** for regulators and market participants

- Results from my research "*Inside the mind of a stock market crash*"

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COVID MARKET CRASH: A SURVEY OF INVESTOR BEHAVIOR

- Survey of Vanguard investors to track their **beliefs** (e.g., 1-year stock return expectations) over time
- Regular survey: since 2017, a survey wave every 2 months, **2000 responses** per wave
- Extra "flash" wave on March 2020 after the stock market crash
- I'll focus on responses in three waves: **February, March, and April 2020**
- Link survey responses to **portfolios and trading** over the same period

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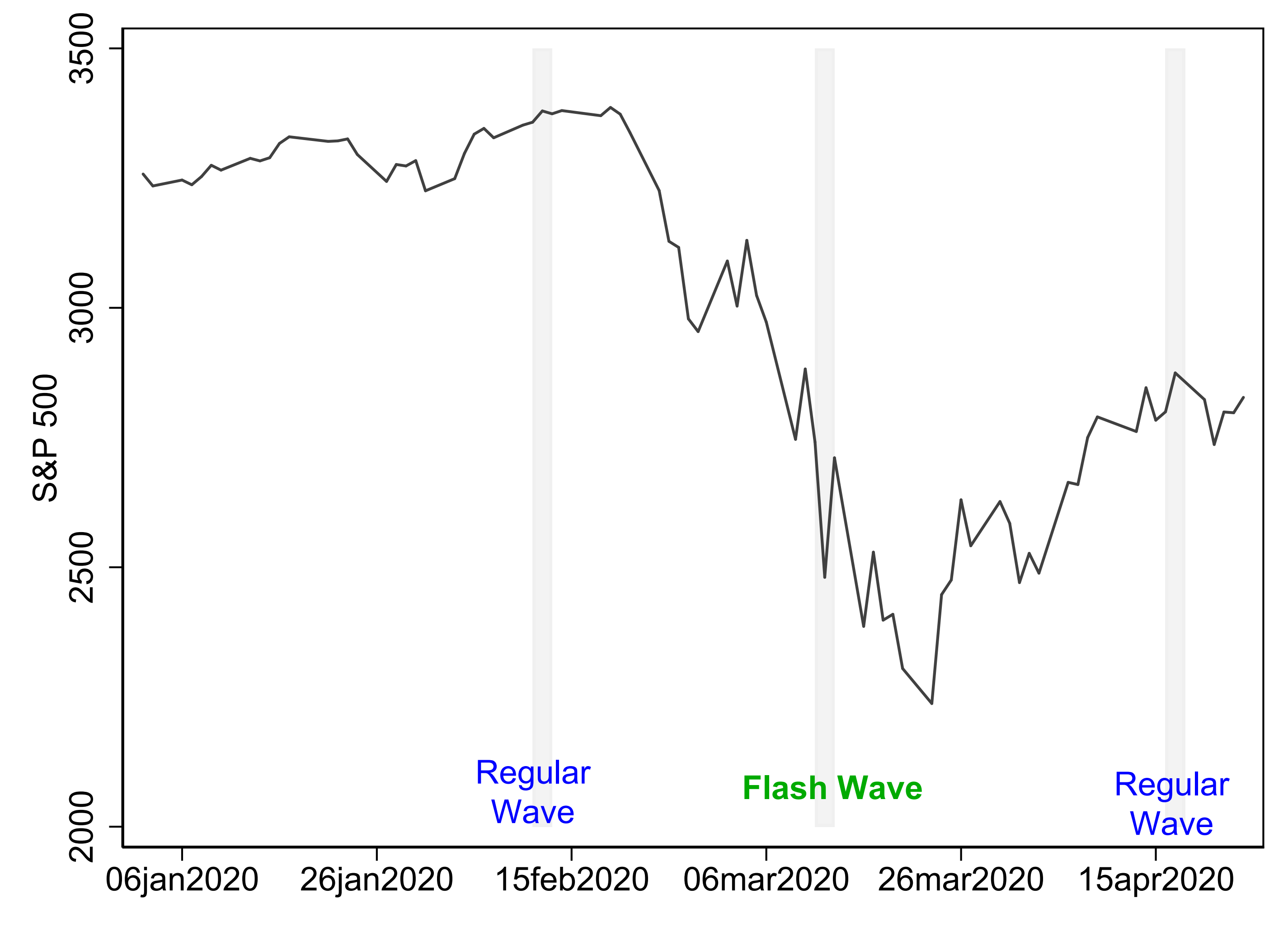
COVID MARKET CRASH: A SURVEY OF INVESTOR BEHAVIOR



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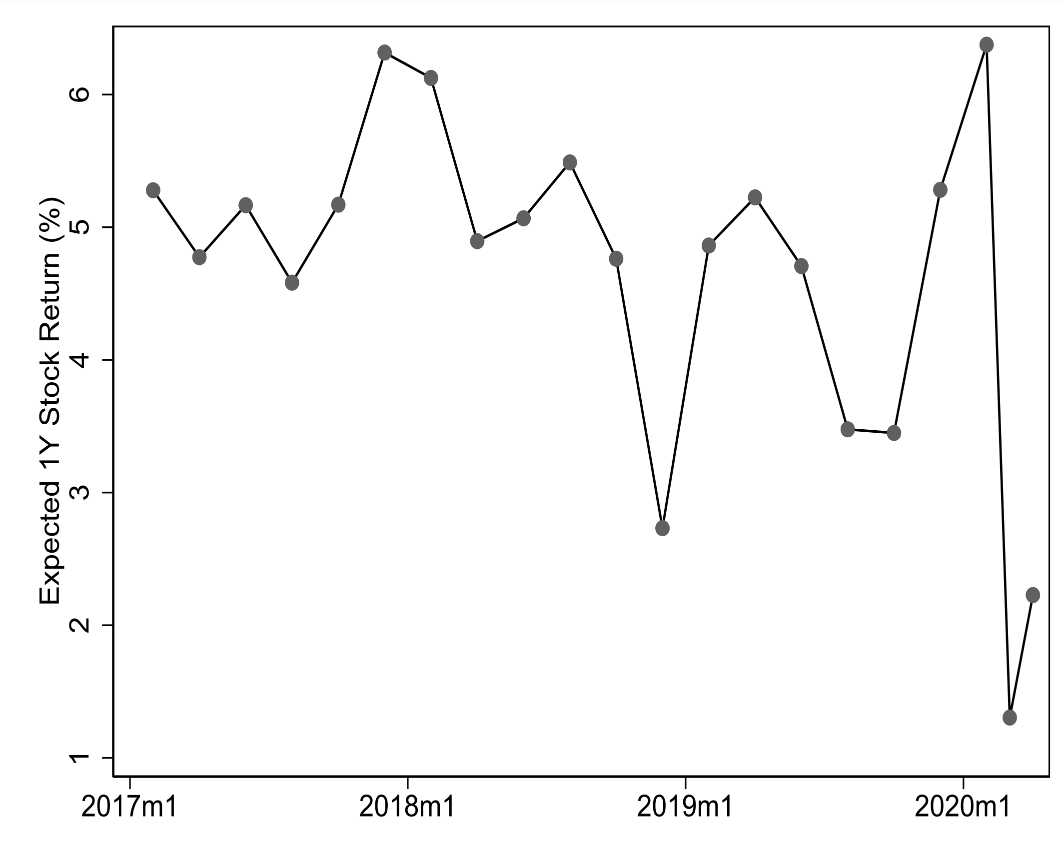
TWO RESULTS: 1. LARGE CHANGE IN BELIEFS OVER TIME

- How do 1-year expectations evolve over time?
- In each wave, average the 2000 responses about 1-year stock returns
- **Sharp drop** from 6% to 1% between February and March
- **Increase in disagreement** about the 1-year expectations among our respondents



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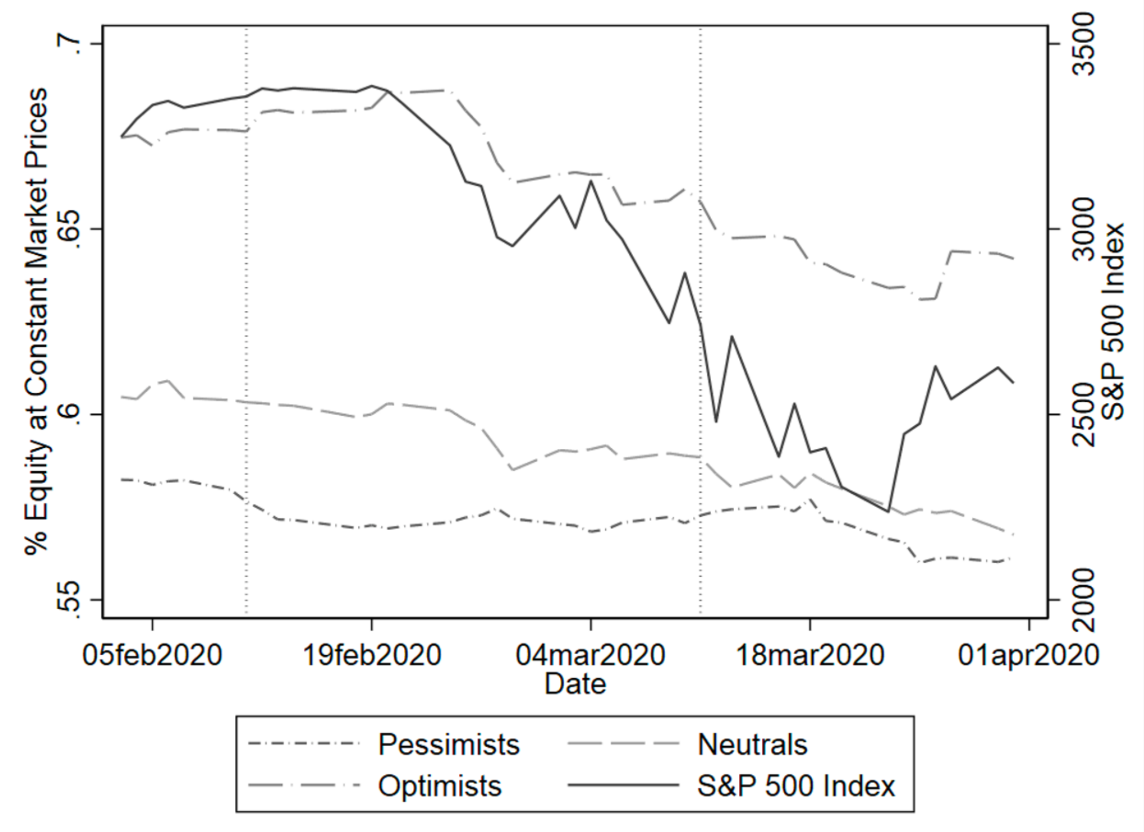
TWO RESULTS: II. LITTLE TRAINING

- **70%** of investors don’t trade at all!
- Those that trade, get out of equity, but little (equity share decreases by up to 3%)
- Optimists sell more equities than pessimists



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LESSONS FROM THE RECENT CRASH

- Market crashes and high volatility are relatively **frequent**
  - Important to understand investor behavior during turbulent times

- Investor **beliefs swing wildly** during these times
  - Potential for large mistakes, e.g., due to extrapolation

- However, we document **slow (or no) adjusting portfolios to beliefs**
  - Bad: portfolios can drift away from optimal allocation
  - Good: may prevent overreaction
  - Highlights role of **education** of investors (Vanguard)
  - Highlights usefulness of detailed **surveys** to track beliefs over time

WHAT'S SPECIAL ABOUT TODAY'S INVESTMENT ENVIRONMENT?

1. We have access to better **data on investors beliefs and behavior**

2. We have learned a lot about different types of **uncertainty**, and how investors react

3. **Interest rates** at short and long term are low, and forecasted to be low for a while

4. **Competition** from passive investments has put pressure on fees from active managers

5. New and more accessible **opportunities for diversification**: alternative investments, ESG investing

Michael Mendelson

Principal

AQR Capital Management

3 Poorly Understood Retirement Investing Issues

Michael Mendelson

October 22, 2020

AQR

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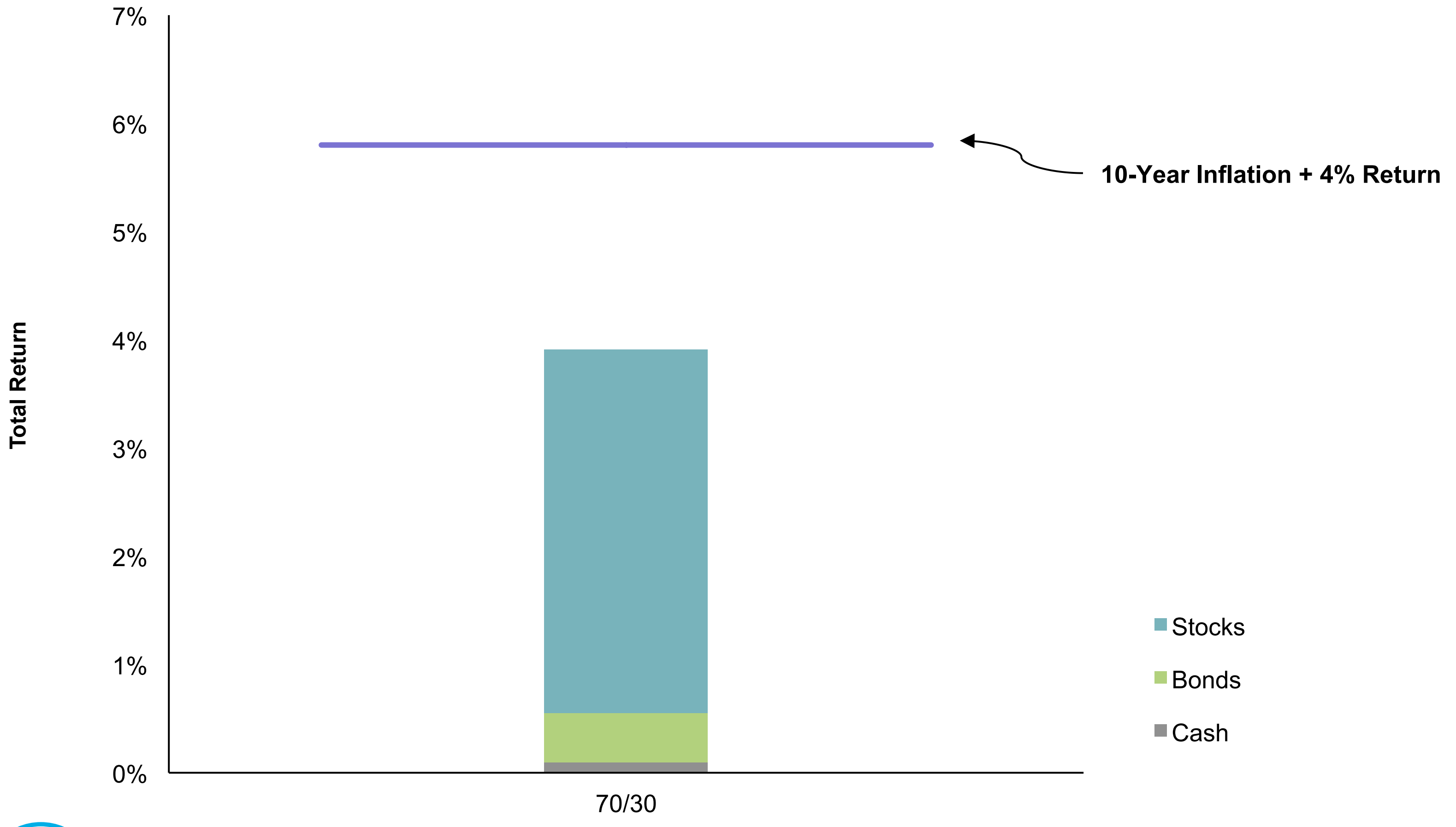
It’s Hard to Save for Retirement When Real Rates are Negative

Savers bear the brunt of cash rates that are far below the rate of inflation

Expected Return Contribution for a 70/30 Stock/Bond Portfolio



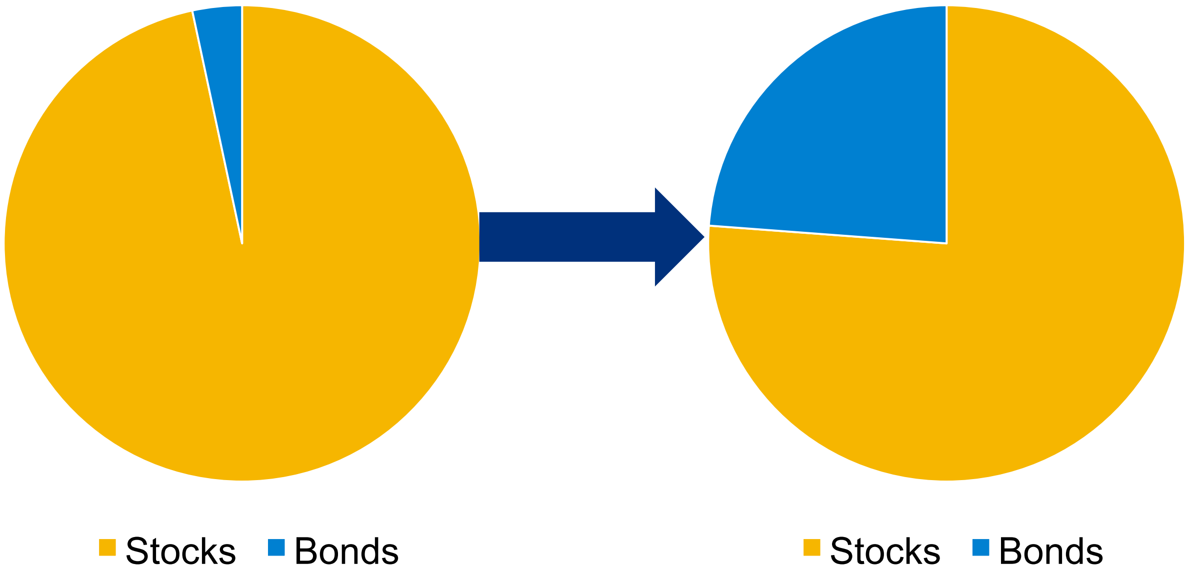
Source: AQR, Bloomberg. Data as of October 12, 2020. Expected return for 70% Stock and 30% Bond portfolio based on prevailing 3-Month Treasury bill yield for Cash and long-term Sharpe ratio and volatility assumptions for stocks and bonds. We assume a 16% volatility for stocks and a 5% volatility for bonds and a 0.3 Sharpe ratio for stocks and bonds. Inflation is based on the 10-Year U.S. Breakeven Inflation Index. For illustrative purposes only and not representative of a portfolio AQR currently manages.

TDFs Are Risk Concentrated Across the *Entire* Glide Path

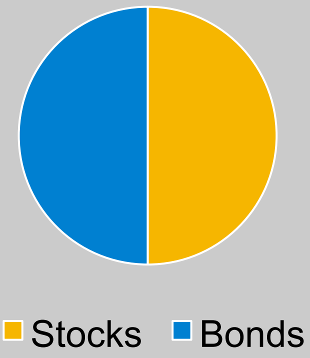
The retirement system is almost fully dependent on equity returns

Hypothetical Risk Allocation

40 Years to Retirement **At Retirement**



We Think Closer to Risk Balanced Should Be Considered



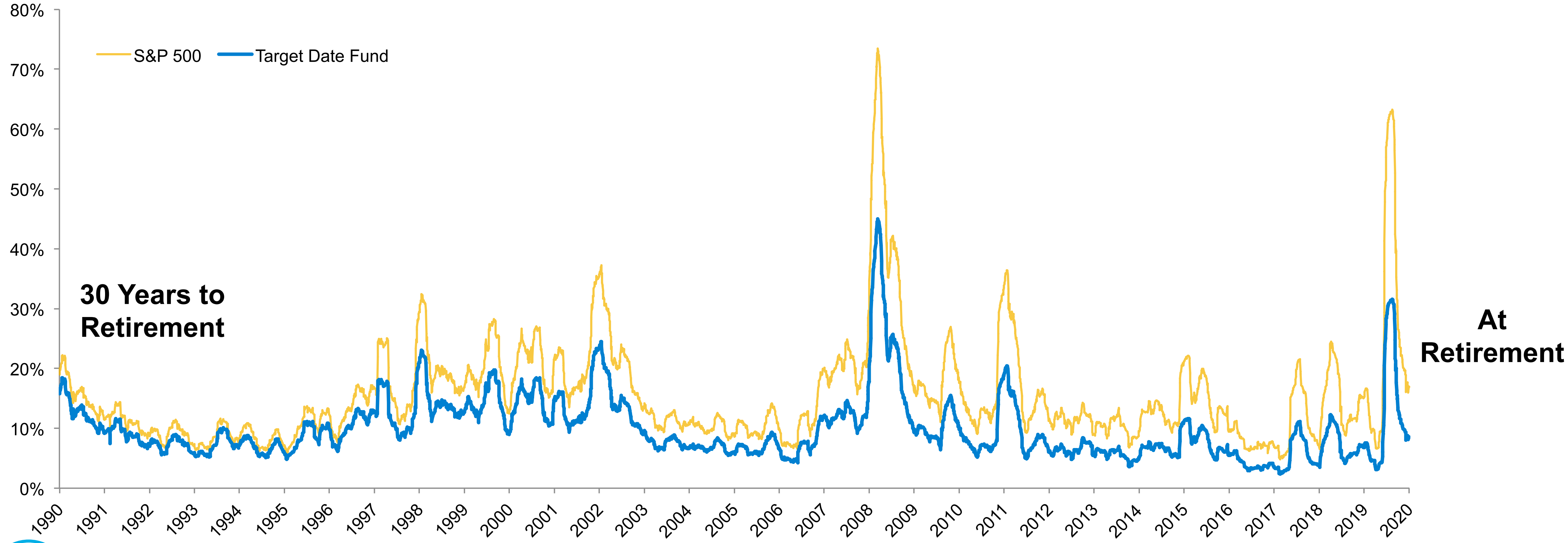
Source: AQR. This assumes investment in a stock/bond glidepath, which transitions from a 90/10 stock/bond mix to a 50/50 stock/bond mix at retirement over a 40 year glidepath. To calculate risk allocation we assume a 16% volatility for stocks and a 5% volatility for bonds and a zero correlation between stocks and bonds. For illustrative purposes only and not representative of a portfolio AQR currently manages. Hypothetical data has inherent limitations, some of which are disclosed in the Appendix.

It's Not a Risk Glide Path, It's Just a Dilution Glide Path

Stock markets are volatile, so portfolio risk varies wildly along the path

Target Date Fund and S&P 500 Volatility

For Hypothetical TDF Participant Starting 30 Years Ago



Source: AQR, Bloomberg. Data from September 1990 to September 2020. The Target Date Fund assumes investment in a stock/bond glidepath, which transitions from a 80/20 stock/bond mix to a 50/50 stock/bond mix at retirement over a 30 year glidepath. Stocks is based on the S&P 500 Index. Bonds is based on the Barclays US Aggregate Index. Rolling realized annualized standard deviation of daily returns of S&P 500 Index and the Target Date Fund over a 60-day horizon. For illustrative purposes only and not representative of a portfolio AQR currently manages.

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Amish Gandhi

Principal

Mercer

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Reimagining Retirement 2030: A Roadmap for Action

Generating Retirement Income: A Look at Alternative Assets in DC Plans

October 22, 2020

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Alternatives in DC plans

1. Are “alts” that “alternative”?

   - Have been highly utilized for DB plans/endowments/foundations
   - Used in DC structures around the world

2. Is the “juice” worth the “squeeze”?

   - Need to evaluate net of fee performance
   - How much to allocate?

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What are the challenges?

1. Complexity
2. Liquidity and Valuation
3. Fees
4. Participant Communication

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Vishal Hindocha

Director of Investment Solutions Group

MFS Investment Management

The Forces Shaping Sustainable Investing

What is sustainable investing and why does it matter for retirement outcomes?

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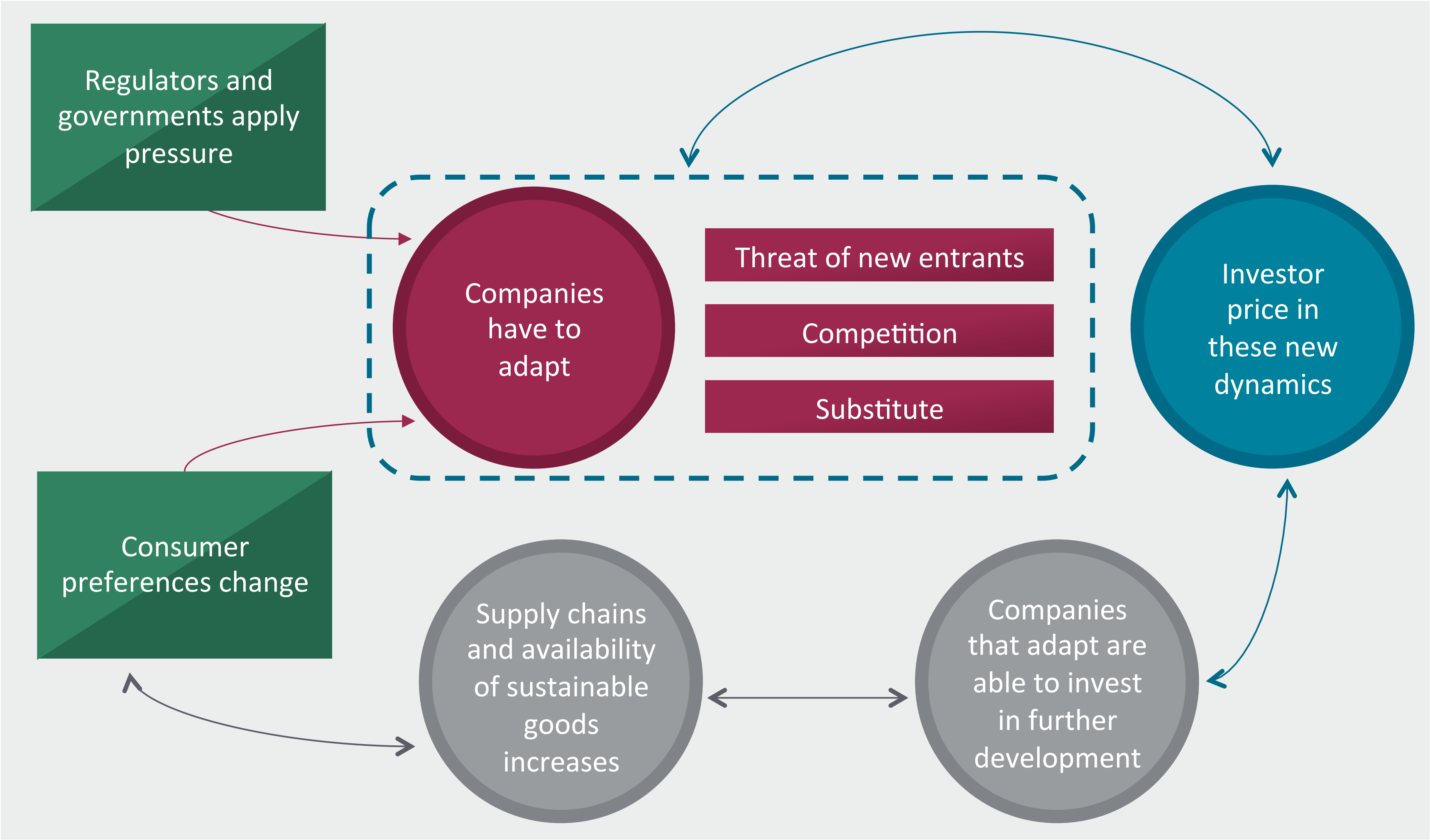
The Forces Shaping Sustainable Investing

The value chain is being reshaped



Why Does Sustainable Investing Matter Now?

Consumers and regulators are increasingly demanding sustainability and companies are taking notice

68%
of consumers rate sustainability as important, regardless of age and gender[4]

Gen Z
will surpass
Millennials in
2019[4]

15%
of millennials say they would exit an investment position due to objectionable firm activity[1]

76%
of younger generations in the UK say it's increasingly important to consider ESG factors when investing[3]

compared to **37%**
of older generations[3]

55%
of CEOs believe that their organizations must look beyond purely financial growth if we are to achieve long-term, sustainable success[2]

Sustainable/ ethical business practices was the
second largest factor
for brand loyalty[4]

When defining a brand as sustainable, what resonates the most with consumers?[4]

- Use of eco-friendly materials **31%**
- Follow ethical practices **15%**
- Don't test on animals **8.8%**
- Donate to a good cause **8.8%**
- Have a strong purpose **8.4%**

Over **1/3** of consumers would pay **25%** or more for sustainable products[4]

Gen Z is more willing to pay **50% - 100%** more for sustainable products[4]

[1] EY Americas, Multidisciplinary professional services organization, June 19, 2018.

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Evolution Into a Purpose-Driven Industry

Create value responsibly: The role of financial markets is price discovery and capital allocation

Creating value responsibly requires monitoring our impact to the broader community

"20th Century Paradigm Maximize Profits for Shareholders"

Emerging Paradigm "Maximize Benefits for Stakeholders"

Sudden and significant change challenges organizations in multiple ways:

Culture
- Virtual environment
- Work / life balance
- Diversity and Inclusion

Stewardship
- Governance
- Sustainability
- Engagement

Capital Allocation
- Alpha / Beta
- Liquidity
- Value

If you can't rely on culture, you can't make a purpose lead change

Department of Labor's Proposed ESG Rule: Death Knell or Opening Bell?

Trick question…the answer is neither.

In our view, the proposed rule…

ESG Themed Funds
(values focused)

Product Choice

ESG Integration
(materiality focused)

Process Choice

Where does that leave us?

- An alternative approach towards sustainable investing is one in which a plan fiduciary selects fund managers that **integrate ESG factors into their investment process based on how they believe those factors could impact the long-term economic outcome** of an investment.
- This **materiality-based approach** assesses ESG issues in light of the investment time horizon. We consider this approach more compatible with the proposed rule.

How Might You Think About ESG and Sustainability in Your Own Portfolio?

- Do the investments you select incorporate ESG standards?
- What approach do you prefer and why?
- What's the difference between ESG and Socially Responsible Investing (SRI)?
- Do my investments screen out companies with bad ESG practices?
- How are you ensuring risk management is part of the process?
- How does Proxy voting affect me and my investments?
- Is management considering the needs of all stakeholders?

Thank You

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