WHITE PAPER

RETHINKING RISK FOR U.S. MILLENNIALS

CERULLI ASSOCIATES

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The Pension Protection Act of 2006 has resulted in tremendous improvements in the progress of U.S. retirement savings through the encouragement of automatic enrollment and escalation programs.

Likewise, the continued growth of target-date funds as default investments within 401(k)s has generally been heralded across the industry as a breakthrough for retirement plan participants. While there are definite benefits of never having to hear about an investor who works for 40 years having all their contributions collecting minimal interest in a guaranteed investment contract (GIC), target-date funds still have significant opportunities for improvement—especially in their ability to provide downside protection.

Excessive exposure to downside risk is especially prevalent in the default portfolios offered to investors just entering the workforce. In a traditional investing relationship, investors would be required to complete a risk tolerance assessment to assure that the investments provided to them best match their willingness to take on investment risk. However, in an effort to improve retirement plan participant outcomes, the Pension Protection Act of 2006 offered plan sponsors the opportunity to enhance plan participation by promoting the use of an automatic enrollment feature for newly eligible employees predicated on the use of a qualified default investment alternative (QDIA) to receive the contributions.

Cerulli Notable

Instead of offering the youngest investors an on-ramp to investing, being defaulted into 90% equity portfolios as equity indices hit continuous new highs is essentially dropping them onto the Autobahn and hoping they intuitively know how to drive. Younger investors familiar with the rules of the road should be allowed to change lanes at their own discretion, but continuing to mismatch preferences and implementation for the masses is not a suitable solution.

Summary

Engaging with Millennials in the U.S. has become a major strategic priority among financial services providers, but firms could be undermining their long-term opportunity with this cohort by defaulting them into unsuitable investments.

Key Points

- Though younger investors may have a higher capacity to take on risk, they generally do not have the appetite to do so.
- Individuals just entering the workforce are routinely defaulted into retirement portfolios with allocations of 90% to equities and 10% to fixed income.
- The retirement assets of younger investors are far more dependent upon ongoing contributions than on market returns.
- Having to rebuild younger investors' confidence in the market is a far greater risk than potentially forgoing a few hundred dollars in potential short-term gains.

Key Recommendations

- Providers committed to high equity exposure within the portfolios assigned to younger participants must meaningfully increase their efforts to educate these participants about the nature of investment risks and returns.
- Providers could also differentiate themselves by altering the default equity exposure of the portfolios to better reflect the actual risk preferences of most younger investors. By matching the actual preferences and behaviors of younger investors, providers could better serve this cohort, while also training them to become educated savers over the long term.

Exhibit 1: Wealth-Protective Investors by Age Range, 2016

"To protect my portfolio from significant losses, even if it means periods of underperforming the market"	All Households
<30	82%
30–39	80%
40–49	65%
50–59	67%
60–69	83%
≥70	86%
All households	**77%**

Sources: Phoenix Marketing International, Cerulli Associates

Analyst Note: Responses indicate the percentage of investors who selected, "To protect my portfolio from significant losses, even if it means periods of underperforming the market" as their portfolio goal instead of "To outperform the market, even if it means periods with significant volatility and possibly losses."

Capacity Does Not Equal Appetite

Based on the premise that younger investors have the longest investment horizons, and by extension the highest capacity to take on investment risk, individuals just entering the workforce are routinely defaulted into portfolios with allocations of 90% to equities and 10% to fixed income. However, although younger investors may have a higher capacity to take on risk, they generally do not have the appetite to do so. When asked whether they would prefer their investment portfolios to be focused on the pursuit of aggressive growth or wealth preservation, even at the cost of underperformance, more than 80% of investors under age 40 selected the more cautious path.

This sentiment for protection over growth has been a consistent theme for younger investors. In 2016, when asked to describe their investment approach, investors under age 30 are nearly four times more likely (27%) to describe themselves as conservative investors than as aggressive (7%). This actually represents a step up in aggressive investors under age 30, from the 5% to 7% level present in 2012 through 2015.

While being defaulted into a target-date fund with high equity exposure may offer the greatest opportunity for larger returns over time, it also offers the highest likelihood of significant drawdowns over the shorter term, which is in direct opposition to the stated preference of the vast majority of younger investors. This situation is further compounded by current equity market valuations, which portend limited return expectations over the next five to 10 years.

Exhibit 2: Risk Appetite for Investor Under Age 30, 2012–2016

Household Risk Tolerance	2012	2013	2014	2015	2016
Aggressive	8%	5%	7%	7%	7%
Moderate	64%	66%	66%	67%	66%
Conservative	28%	29%	26%	26%	27%

Sources: Phoenix Marketing International, Cerulli Associates

Focus on Maintaining Activity

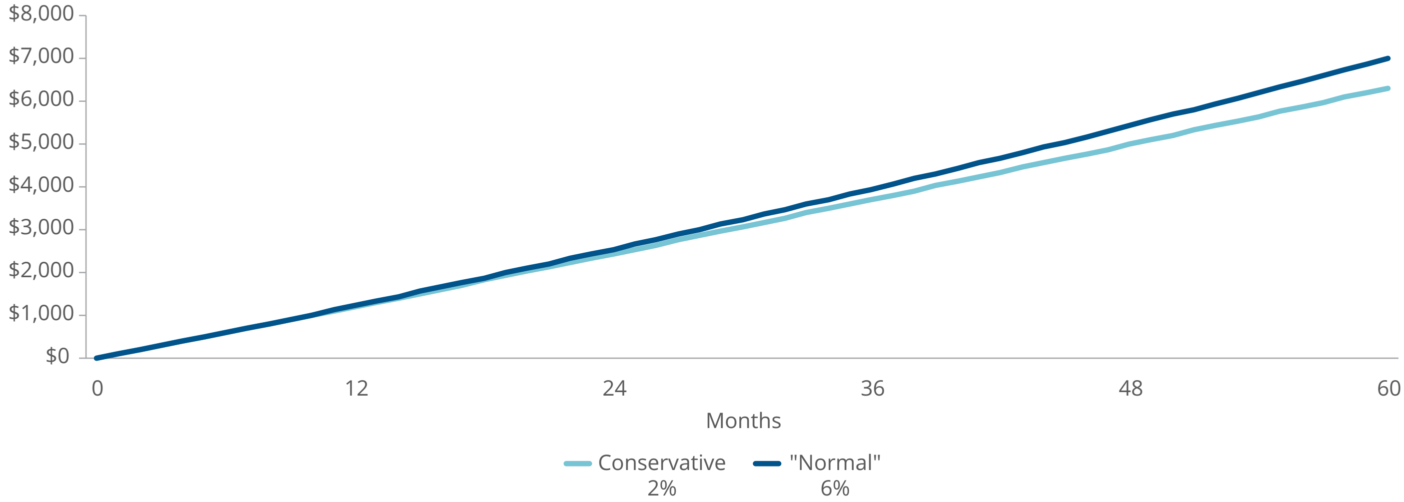
Starting a savings plan early in one's career is clearly a benefit to investors in attaining their retirement goals. As such, auto-enrollment, auto-escalation, and matching programs should be designed to enhance the contribution activity of all eligible participants. The real risk for younger investors is not "suboptimal" asset allocation, but simply not participating, or not continuing to participate, in their employers' plans.

The retirement assets of younger investors are far more dependent upon ongoing contributions than on market returns. For example, if a new participant were to contribute $100 monthly for five years, contributing a total of $6,000, a conservative portfolio growing at 2% annually (compounded monthly) would grow to just more than $6,300. A portfolio that attained 6% annual growth (in line with current long-term capital market expectations) under the same conditions, would reach just greater than $7,000.

While an additional $700 in retirement savings would be a benefit to this investor, we must consider that it is far from a guarantee in this market environment, and, if attained, would likely come with a hefty serving of volatility along the way, which could undermine participants' ongoing plan contributions.

Over the years, research has consistently shown that investors harbor a strong loss aversion bias—they are about twice as likely to fear the adverse impact of losses than they are to recognize the benefits of incremental gains. As young investors have consistently stated a preference for conservative investments, a decline in retirement account value of 10% or 20% could have a devastating effect on future contribution activity. Having to rebuild investors' confidence in the market is a far greater risk than possibly forgoing a few hundred dollars in potential gains.

Exhibit 3: Growth of Monthly $100 Contributions at 2% and 6% Annually, Compounded Monthly



Source: Cerulli Associates

Recommendations

To help younger participants achieve their retirement goals, it is far more important that they maintain regular contributions than maximize potential returns early in their careers. By defaulting younger participants into portfolios with the highest equity risk exposure, sponsors are potentially undermining the future of retirement savers by exposing them to risks beyond their preferences without truly significant upside, especially given current market valuations.

Automatic enrollment programs have made great strides in enhancing participation rates, but they do not address the need to educate younger participants about what they should expect in a long-term investment situation. If providers are committed to high equity exposure within the default portfolios assigned to younger retirement plan participants, they must meaningfully increase their efforts to educate these participants about the nature of investment risks and returns. Of course, this solution is incumbent upon attracting and maintaining the attention of a largely indifferent audience.

Alternatively, providers could take the opportunity to differentiate themselves by altering the default equity exposure of the portfolios to reflect the actual risk preferences of most younger investors. A portfolio with high equity exposure may offer the highest theoretical expected return over the long term, but these results will not matter if younger investors' actual behaviors do not match those of the hypothetical model. By reengineering their target-date glidepaths to match the actual preferences and behaviors of younger investors, providers could better serve this cohort, while also training them to be become educated savers over the long term.