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ASSET MANAGEMENT

EQUITY DESIGNED WITH RETIREMENT IN MIND

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A CHALLENGING ENVIRONMENT FOR EQUITY RETURNS, AND THE POTENTIAL FOR MORE RISK, MAKES QUALITY LOW VOLATILITY A GOOD FIT FOR RETIREMENT INVESTING.

Saving and investing for retirement requires participants to be steadfast in their contributions and stay the course when market volatility tests even the most patient investors. Unfortunately, market volatility is inevitable and has been increasing in frequency and magnitude. In addition, return expectations are much lower, which will require participants to save more or invest differently to reach their retirement goals. With this backdrop, it may be prudent to consider incorporating an equity strategy that can deliver returns and lower overall risk to address these investing challenges participants will face in the future.

RETURNS WILL BE CHALLENGED

Most investors have been fortunate over the last 20 years in their investment outcomes. Whether they have invested their savings in stocks, bonds or a mixture of both, investment returns have been robust with a balanced 60/40 equity/bond portfolio gaining 232% cumulatively since 2000, even after including the recent COVID-19 induced market drawdown.[1] But with stocks widely viewed as at or above average historical valuations and interest rates hovering near all-time lows, investors may find that a traditional 60/40 portfolio will not accomplish their retirement goals in today's unique market environment.

We expect U.S. stock returns to average 4.7% annually over the next five years, versus the 10.8% average growth of the last five years.[2] This is a significant drop that may cause investors to reevaluate how they can achieve their retirement goals. The two most obvious solutions to this low-return environment are to either save more or allocate a larger percentage of retirement assets to riskier investment options, such as equities. However, we know both of these solutions may seem unpalatable to investors during these uncertain times, especially investors nearing or in retirement.

[1] 60% equity and 40% bond portfolio represented by the Russell 1000 index and Barclays US Aggregate Bond Index, respectively. Total return is calculated from 01/01/2000 through 6/30/2020.

[2] Northern Trust Asset Management, Bloomberg. Annualized return data in local currency from 6/30/2015 to 6/30/2020. Past performance does not guarantee future results.

VOLATILITY SHOCKS BECOMING MORE FREQUENT

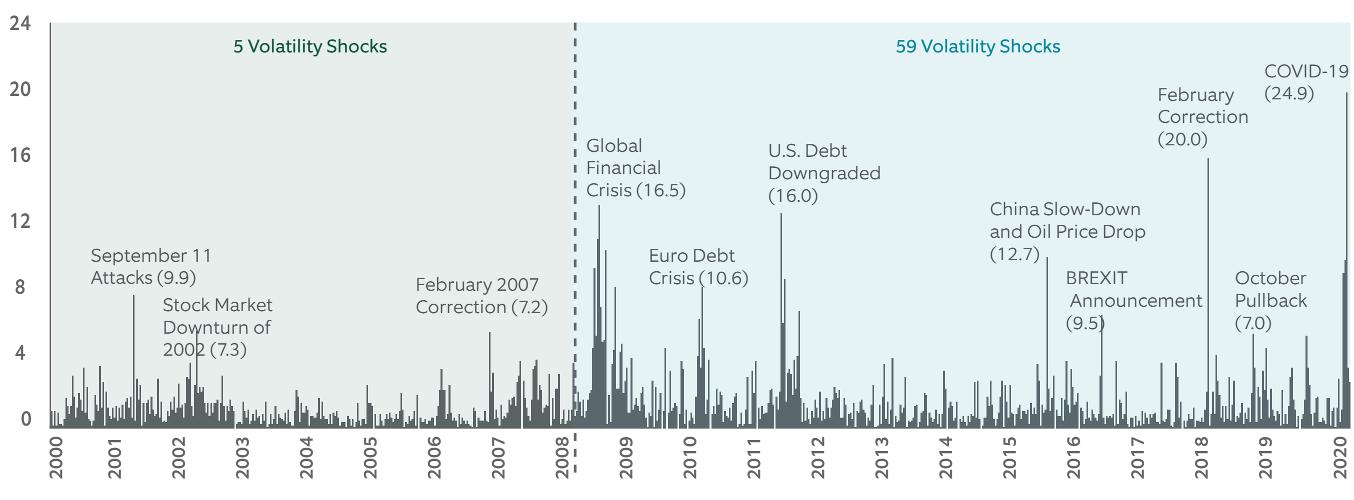
It is already challenging for many retirement plan participants to keep pace with their current deferrals in their employer-sponsored plan, let alone increase them during the current economic climate. As a result, raising equity allocations may be the most logical option, but this has its own drawbacks, such as market volatility, that have only increased over time.

As shown in Exhibit 1, we have seen volatility shocks increase dramatically since the Global Financial Crisis of 2008. From January 2000 to the Global Financial Crisis, there were only five volatility shocks, as measured by daily moves of the CBOE Volatility Index (VIX) of five points or more. Since 2008, however, we had seen 59 volatility shocks by June 2020. This is a radical change in the amount of volatility in the market. It is driven by three main factors:

1. COVID-19 has shaken the economy to its core and will continue to disrupt businesses and government entities alike until the economy enters a sustained recovery.
2. Leverage, or the amount of borrowing in our economy, has also grown over time. Leverage displays a high correlation with volatility because investment gains and losses are amplified as leverage rises.
3. Sophisticated trading algorithms have also become more common since the 2008 financial crisis, and such trading strategies tend to exacerbate market moves in either direction.

EXHIBIT 1: VOLATILITY INCREASES[1] OVER TIME

Volatility spikes can hurt performance and make participants abandon their strategic investment plans.



Source: Northern Trust Asset Management, Bloomberg. Past performance is no guarantee of future results. Volatility shocks are defined as when the CBOE VIX Index rises more than five points in a day. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. The time period is January 1, 2000, to June 30, 2020.

In addition to these factors, we face many upcoming potential headwinds with a possible divided government based upon U.S. election results, social justice issues around the globe and ongoing tension with China. These ongoing issues suggest that volatility is probably here to stay. One way we believe participants can mitigate risk and market volatility within their retirement plan is through the use of a Quality Low Volatility (QLV) portfolio.

BENEFITS OF A LOW VOLATILITY APPROACH THAT FOCUSES ON QUALITY

Let's begin with what low volatility stocks are and why to consider them in a portfolio. Low volatility stocks are shares of companies that tend to experience a narrower range of returns versus the market as a whole, such as the Russell 1000 Index, a large-cap stock index. Further, our research shows that investors are compensated for investing in low volatility stocks, which have historically outperformed the benchmark on a risk-adjusted basis. Participants who invest in low volatility stocks are less likely to experience severe market declines. They also are less likely to panic and abandon long-term investment goals when markets are in turmoil.

In addition to using low volatility stocks to smooth the investment ride, our research shows that investing in the highest quality companies – those with strong cash flows, profitability and management efficiency – may further mitigate market drawdowns and potentially improve performance. The lowest quality 20% of stocks in the Russell 1000 Index historically contribute the lowest returns. However, they also have the most risk. We believe that removing these low quality securities may further enhance returns while mitigating market declines. Performance of the Northern Trust Quality Low Volatility Strategy versus the Russell 1000 Index proves to be quite compelling.

EXHIBIT 2: WHAT LOW VOLATILITY EQUITIES MEAN TO PERFORMANCE AND RISK MANAGEMENT

The risk management characteristics of the Northern Trust Quality Low Volatility Strategy aid performance and volatility.

[1]Northern Trust Quality Low Volatility Total Return Index (NTUQLVTR)

[2]Russell 1000 Index

Source: Northern Trust Asset Management. Graphic shows annualized performance of the Northern Trust Quality Low Volatility Total Return Index and Russell 1000 Index from December 31, 1999, to June 30, 2020. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Past performance is no guarantee of future results.

Not only has the Northern Trust Quality Low Volatility Index outperformed the Russell 1000 (14.5% annualized return vs. 10.5%) over 20 years ended June 30, 2020, but it has done so with 29% less volatility.

While certainly any investor would benefit from an investment solution that can potentially increase return and lower risk, we feel that these outcomes are especially important within a defined contribution retirement plan. Participants in these plans typically have access to a large-cap equity option, but must endure the wild market swings that are inevitable with this traditional style of equity investing. As previously discussed, this can be problematic because investors are susceptible to volatility that comes along with traditional market-capitalization-weighted investments and may ditch an underperforming asset class at inopportune times. By including a quality low volatility strategy in the investment menu of a defined contribution plan, participants across all life stages can allocate to a strategy that can potentially smooth otherwise volatile large-capitalization equity returns, while also potentially enhancing results.

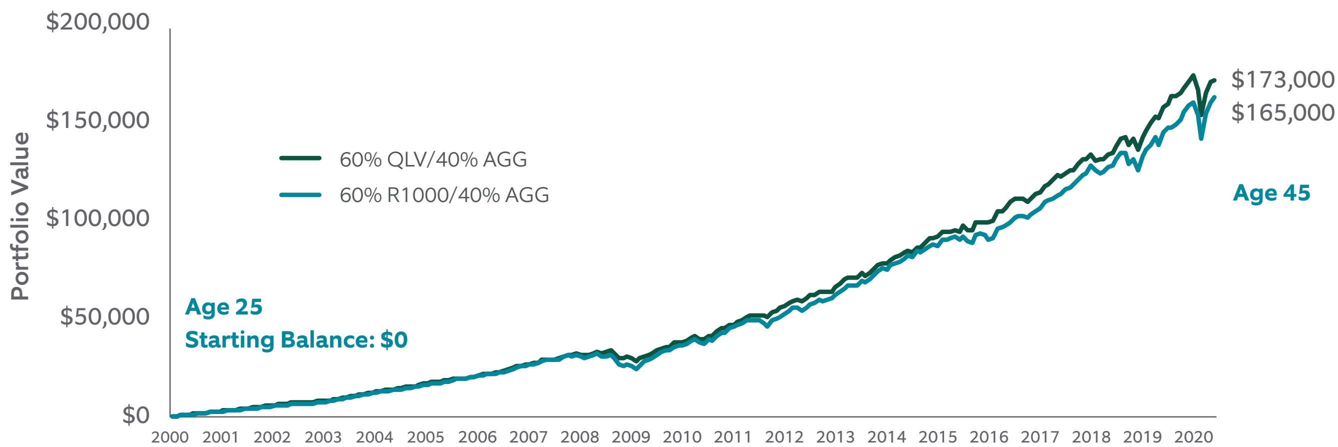
ACCUMULATION PHASE FOR YOUNG INVESTORS

With this backdrop, we examine the impact of including a quality low volatility portfolio in a retirement account during the accumulation phase, and compare it with using the Russell 1000 Index. To keep this analysis simple, we use a traditional 60/40 equity/bond portfolio. We compare two 60/40 portfolios, one using the Northern Trust Quality Low Volatility Index for equity and the other using the Russell 1000 Index. The Bloomberg Barclays US Aggregate Bond Index represents bonds in both cases. We begin by examining how a 25-year-old investor would have fared after investing in both portfolios from the beginning of 2000 through mid-2020, with the caveat, of course, that this period includes one of the longest bull markets in history.

EXHIBIT 3: HYPOTHETICAL ILLUSTRATION: QUALITY LOW VOLATILITY FOR YOUNG INVESTORS

A 25-year-old investor who used a quality low volatility strategy 20 years ago would have come out ahead. The difference between these two portfolios may not seem that meaningful. However, it can grow to a significant amount when we consider compounding effects over the next 20 or even 40 years.

Portfolio Growth from $0: Accumulation Phase



Source: Northern Trust Asset Management. The illustration assumes a 25-year-old worker with a beginning salary of $45,000, a salary growth rate of 3% annually, and a monthly retirement contribution of 6% of the annual salary. QLV is the Northern Trust Quality Low Volatility Index and R1000 is the Russell 1000 Index. The bond allocation is represented by the Bloomberg Barclays US Aggregate Bond Index. The time period is January 1, 2000, to June 30, 2020. Past performance is no guarantee of future results.

This person starts working at age 25 with a $0 portfolio balance and begins to contribute their entire savings (6% of salary) to a portfolio with 60/40 with either QLV/U.S. bonds or Russell 1000/U.S. bonds. Over 20 years of working and saving from 2000 to 2020, this person, at age 45, would have amassed a nominal balance of $173,000 investing in a QLV/U.S. bonds portfolio versus a nominal balance of $165,000 investing in a Russell 1000/U.S. bonds portfolio. The $8,000 difference between these two portfolios may not seem that meaningful. However, it can grow to a significant amount when we consider compounding effects over the next 20 or even 40 years. Additionally, the difference would be even more pronounced with higher savings levels of, say, 10% to 15%, as suggested for most retirement savers. Now, let's consider the impact these portfolios might have on future retirement outcomes for a mid-career saver.

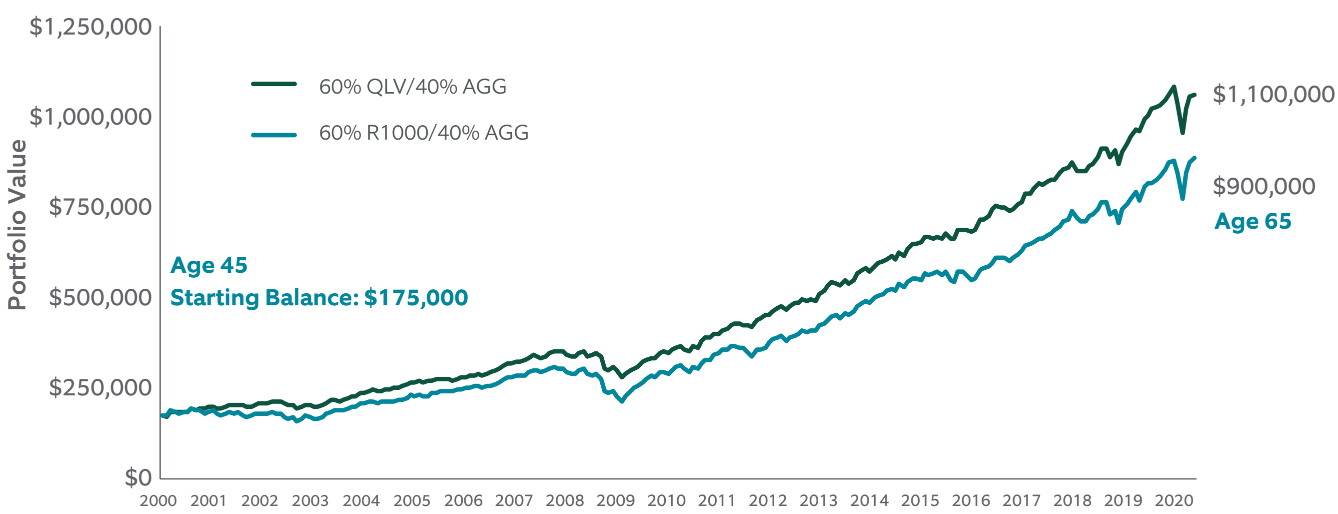
ACCUMULATION PHASE FOR MID-CAREER INVESTOR

We use the same performance data from 2000 to 2020 to examine the impact of a mid-career worker investing in the split portfolios as previously shown. This time, the beginning point is a 45-year-old investor with a higher salary, and similar salary growth and contribution rates. Furthermore, they have a nominal starting balance of $175,000 that they have accumulated over the past 20 years.

EXHIBIT 4: HYPOTHETICAL ILLUSTRATION: QUALITY LOW VOLATILITY FOR MID-CAREER INVESTOR

For an investor with more retirement savings as a starting point, the Quality Low Volatility makes even more of a difference.

Portfolio Growth from $175,000: Accumulation Phase



Source: Northern Trust Asset Management. The hypothetical illustration assumes a 45-year-old investor with a beginning salary of $85,000, a salary growth rate of 3% a year and monthly contributions of 6% of salary annually. QLV is the Northern Trust Quality Low Volatility Index. The bond allocation is represented by the Bloomberg Barclays US Aggregate Bond Index. The time period is January 1, 2000, to June 30, 2020. Past performance is no guarantee of future results.

The higher account balances and compounding savings would have generated a higher ending balance for both portfolios, but the difference between them is stark even though we're covering the same time period and return patterns. Over 20 years, the portfolio with the Quality Low Volatility approach would have generated a balance at age 65 that was approximately $200,000 greater than the portfolio with the Russell 1000 approach.

DECUMULATION PHASE FOR RETIREE

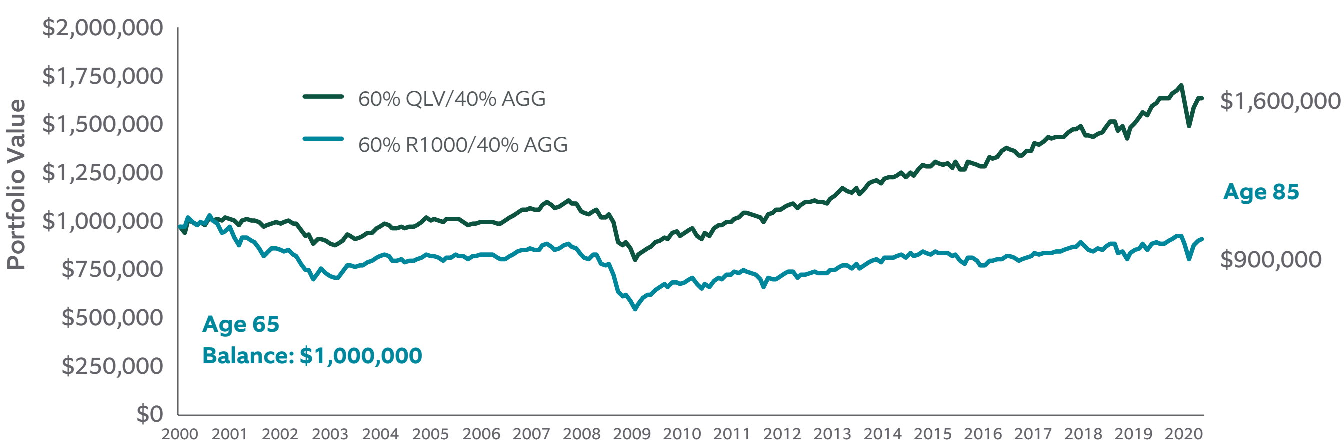
Finally, we examine the effects in the decumulation phase by examining what would have happened if a 65-year-old person had drawn from either of these portfolio mixes in retirement to meet their expenses. We start with a nominal portfolio value of $1 million and draw down $50,000 each year, or 5% of this original portfolio value on a monthly basis.

Starting with $1 million, the portfolio with the Quality Low Volatility allocation grows to $1.6 million at age 85, even with drawing down $50,000 per year. The portfolio with the Russell 1000 Index equity allocation fell to $900,000, for an ending value almost 50% lower than that of the Quality Low Volatility portfolio. Interestingly, we looked at what drawdown percentage for each portfolio would exhaust the balance by age 85. For the portfolio with Quality Low Volatility, retirees could have drawn down the portfolio by 8.25% per year and exhausted the portfolio in 20 years at age 85. For the portfolio with Russell 1000, the drawdown maximum was only 6.75% over 20 years before the balance hit zero. During retirement, the potential for a higher drawdown amount could result in a better quality of life through improved health benefits or better long-term care, among other things.

EXHIBIT 5: HYPOTHETICAL ILLUSTRATION: QUALITY LOW VOLATILITY FOR RETIREES

The retiree would end up with more savings after 20 years, even after withdrawals of 5% of assets annually. Quality Low Volatility would have allowed for even more spending over the time period versus the index, potentially contributing to a better quality of life.

Portfolio Growth from $1,000,000: Decumulation Phase



Source: Northern Trust Asset Management. The hypothetical illustration assumes a 65-year-old investor starting with an annual withdrawal of $50,000 a year. For example, with $1 million in assets, annual income would be $50,000. QLV is the Northern Trust Quality Low Volatility Index. The bond allocation is represented by the Bloomberg Barclays US Aggregate Bond Index. The time period is January 1, 2000, to June 30, 2020. Past performance is no guarantee of future results.

In summary, a Quality Low Volatility approach as part of a prudent retirement equity strategy has benefits across the investor lifecycle. Whether in the early years of accumulating assets or in retirement relying on the portfolio to provide income, the Quality Low Volatility approach improved results compared to the use of the Russell 1000 Index in each of the three scenarios tested.

APPLICATION TO A DEFINED CONTRIBUTION PLAN

We see that the performance of a Quality Low Volatility strategy can stand on its own merits, but how would such a strategy be implemented within a defined contribution plan?

1. The first method is to offer a Quality Low Volatility strategy as a core equity option on the investment menu. This can be done by offering it as the stand-alone core U.S. equity fund to replace a current investment option, or as a complement to an existing passively managed U.S. equity portfolio. The Northern Trust Quality Low Volatility strategy is offered in U.S., developed market excluding U.S., and emerging market equity formats, depending on the desired exposure in the plan menu.
2. Existing white-labeled solutions are also a great way to incorporate the strategy into a defined contribution plan menu. White-labeled solutions are typically made up of several underlying strategies that are constructed to complement each other. Adding the strategy into an existing equity white-labeled solution may enhance overall returns, while also reducing the portfolio risk.
3. Use a custom target date fund. If a plan has or is considering a target date fund that is customized for plan participants, plan sponsors can augment the underlying investments used with the addition of a Quality Low Volatility Strategy.

CONCLUSION: A STRATEGY TO CONFRONT RISK AND A LOW-RETURN EQUITY MARKET

While the past 20 years have been kind to investors who have stayed the course, there is no guarantee that future returns will be as generous. Investors may also be forced to consider investing a higher allocation in equity assets, as returns are expected to be depressed moving forward. To combat this increased risk amid heightened market volatility, incorporating a Quality Low Volatility equity strategy into a retirement plan can aid investors at all ages while helping to smooth the highs and lows that come with traditional equity-based approaches. This can encourage participants to stay the course and reduce the temptation to abandon their plan at the worst possible time, while also potentially allowing them to capture higher returns and achieve a successful and dignified retirement.

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How helpful was this paper?

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