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How rising interest rates may affect your retirement plan

With stronger U.S. economic and job growth, the Federal Reserve is continuing to raise short-term interest rates. The Fed began raising rates from near zero a year ago and followed up with a second hike in December 2016 to a target rate of 0.50% to 0.75%. Rates are likely to continue rising at a moderate pace, given the current low inflation rates. This may cause market volatility and have an impact on a wide variety of investments in your plan's lineup. As a result, your employees may be concerned about how this will affect their retirement savings.

You can start addressing their concerns by reviewing your plan's investment menu. An effective plan menu should offer a range of options that allows your employees to establish diversified asset allocations. A diversified portfolio can help employees meet long-term retirement goals and weather interest rate changes. But having the right investment options isn't enough. Your employees also need help in making investment decisions. It's important to encourage them to take advantage of the education and advice services available through the plan.

Understand the implications of rising rates

A cyclical shift in interest rates can be unnerving to both you and your employees. Understanding how interest-rate risk can affect your plan's investment options can better position you to address your employees' concerns.

Interest-rate risk:

The risk that an investment's value will change due to interest rate changes. In this environment, the risk for bonds is that they will lose value because bond prices decline when interest rates rise.

Fixed-income diversification is key

In the months ahead, fixed-income investments face a number of challenges, potentially including low but rising inflation, relatively low bond yields, and moderately rising interest rates. It's important to understand that not all bonds react the same way to these challenges.

Certain types of bonds—such as high-quality corporate bonds and U.S. Treasury bonds—are more sensitive to rising rates than others. Other investments, such as high yield corporate, floating rate notes, emerging market debt and shorter-term issues—can potentially provide a cushion to the decline in bond prices and provide your employees with greater protection from the effects of rising rates. However, it's worth noting that bonds less sensitive to interest rate risk could be more sensitive to other types of risk. A diversified fixed-income portfolio can help manage the different types of risks associated with bonds.

Employees should have access to a diverse set of investment options—including guaranteed retirement income options—to create a diversified portfolio that accounts for current and future retirement planning needs.

Equities may stand to benefit from stronger economic growth
Historically speaking, equity markets have trended higher following periods in which rate increases were fueled by stronger economic growth, as in the current environment. That's because a stronger economy and lower unemployment are welcomed news for corporate earnings. But, it's also possible that high equity valuations (for U.S. markets) and potentially rising bond yields could make bonds a more compelling investment. In this scenario, portfolio overallocations to equities could shift back to bonds.

Similar to bond funds, different types of equity funds are expected to perform differently in periods of rising rates. For example, growth stocks—companies whose earnings are increasing relatively quickly—should outperform value stocks with slower earnings growth. It's also a possibility that non-U.S. developed equities may outperform U.S. equities.

Review your investment menu

As a plan sponsor, it is important to make sure your investment lineup is structured appropriately for changing market environments, such as a rising interest rate environment. As you review your plan's investment menu, you may want to:

- Make sure you're offering the necessary asset classes to build a diversified portfolio.
- Consider the implications of rising rates and whether your investment options address this market environment.
- Remove or add options when appropriate.
- Document your investment review process and actions. This is an important best practice that can help you meet your fiduciary responsibilities.
- Consider working with a retirement provider or advisor to help you determine what investment options are right for your plan.

Rising rates also affect target-date funds

With professional management, a diversified asset allocation and automatic rebalancing, target-date funds offer an effective investment solution for a rising rate environment. Yet, it's important to remember that not all target-date funds are designed the same. Some funds are better positioned for rising rates than others.

When evaluating how target-date funds may perform in a rising rate environment, you may want to consider the fund's glidepath, its investment style (active or passive), and how the fund is managed in the short term. Consider the following attributes among target-date funds.

- Active management can provide greater flexibility to address interest rate risk than passive strategies.
- A higher glidepath allocation to equities may offer stronger performance when rates rise, in addition to helping address longevity risk.
- The flexibility to use tactical positioning can allow managers to adjust allocations to reflect short- and medium-term market views.

With these product attributes in mind, you can evaluate the target-date funds in your plan menu to understand how they may react to rising interest rates.

Get the support you need

Ensuring employees have access to a well-rounded investment menu can help them develop an effective asset allocation strategy. You can work with your plan provider and financial advisor to review your investment mix and help your employees position their portfolios to provide lifetime income in any interest rate environment. To learn more about the impact of rising rates, click here.

Help alleviate employees' concerns

Ongoing communication and support can help your employees prepare for rising interest rates. Your plan provider and advisor can work with you to develop a strategy to address your employees' concerns and provide them with the resources needed to build a balanced investment portfolio.

✓ Help employees understand the value of a well-diversified strategy

As part of your plan's communication and education programs, remind employees that maintaining a diversified portfolio can help them meet their goals for a secure retirement. With a well-diversified portfolio, your employees are more likely to take a long-term perspective to investing and not overreact to short-term market events.

This may provide your employees with the comfort in knowing that with the right plan they can manage the impact of rising rates. You can further reassure your employees by letting them know that market corrections are part of investing and occur more frequently than they may realize.

✓ Take advantage of employee education resources

More than one-third (39%) of Americans who participate in an employer-sponsored retirement plan say they are not familiar with the investment options in their plan.[1] Helping your employees understand the investment options available to them is key to creating a diversified portfolio. Make sure you're taking advantage of all the education tools and resources available to your plan.

✓ Offer advice and information

You can encourage your employees to work with the plan's financial advisor to review their current asset allocation. Your employees should have an asset allocation that is appropriate for their age, risk tolerance and retirement goals, and takes into consideration assets outside of the retirement plan. An advisor can help employees select the investment options best suited to their needs.

You can especially encourage employees nearing retirement to consult with an advisor, as rising rates could have a significant impact on their ability to retire. Advisors can help these employees properly allocate their portfolios in order to manage interest rate risk and generate a stream of retirement income they can't outlive.

1. The TIAA-CREF 2015 Lifetime Income Survey was conducted by KRC Research by phone among a national random sample of 1,000 adults, age 18 years and older, from Jan. 7–13, 2015, using a combination of landline and cell phone interviews. The margin of error for the entire sample is plus or minus 3.1 percentage points.

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