Heritage Institutional January 2017

To Bond or Not to Bond?

Over the last few years, there has been a fair bit of concern in the market over the general impact of rising interest rates. "You shouldn't be holding bonds because rates will rise soon" goes the logic. But what does this really mean for investors? If interest rates rise, what will ultimately be the impact on investors' portfolios?

To understand this, we first need to understand how all of the moving pieces fit together. At a high level, if interest rates increase, this generally has a negative impact on bond prices, and to get a sense for how large this impact could be, we can look to a bond's duration[1] or interest rate sensitivity[2]. Using the broad Bloomberg Barclays U.S. Aggregate Bond Index to approximate an investor's diversified bond portfolio, we see that the index has a duration of about 5.5. This means that if interest rates at ALL maturities move higher by 1 percent, the PRICE of the bonds will fall by an average of 5.5 percent.

There are a couple of key distinctions in that statement. The first is that all interest rates need to move together, not just some. The Federal Reserve can move short-term rates, but they have little direct control over 30-year rates, which contribute more heavily to price changes in bonds. The second note is that the price of the bonds will decline for a change in interest rates, but investors also still receive coupon payments[3] or yield[4]. Currently (as of 12/8/16), the yield on the index is about 2.5 percent, which helps to offset losses from bond price movements. Taking these two sources of return together, if all interest rates move higher by 1 percent over the next year, bond investors could see a total loss of 3 percent.

To put this into historical context, the largest total return loss on the Bloomberg Barclays U.S. Aggregate Bond Index, going back to 1976 was 2.92 percent and the index has only been negative on a total return basis in three of those 40 years.[5]

If a relatively significant move higher in interest rates can be expected to result in a loss (no matter how small) for fixed income investors, why take the risk of holding bonds? One way to think about fixed income is like insurance. On your car, you probably pay an insurance premium of about $150 per month, or $1,800 per year. If you are driving a $20,000 car, that annual premium represents 9 percent of your car's value every year for protection against a significant financial loss in the case of an accident. While nobody likes paying for insurance, it's a necessary expense that people understand and fixed income in a portfolio might be the cheapest insurance you can buy.

"Bond insurance" provides a very strong diversifier to stocks. Going back to 1976, the Bloomberg Barclays U.S. Aggregate Bond Index had a positive total return in EVERY year that stocks had a negative return (and stocks had a positive return every year that bonds had a negative return). Highlighting a couple of examples when the "insurance" paid off, 2008 was a year when stocks (S&P

500) declined 37.0 percent, but bonds returned 5.2 percent and in 2002, stocks were down 22.1 percent and bonds were positive 10.3 percent.[6]

Over the last 40 years, stocks have outperformed bonds, so there is no denying that holding some exposure to fixed income over that time may have underperformed a pure stock portfolio, but the overall volatility of the portfolio would have been lower as well. A portfolio consisting of half S&P 500 and half Bloomberg Barclays U.S. Aggregate Bond Index could have experienced a 1.5 percent lower annual return with 40 percent lower volatility than a pure stock exposure.[7] In other words, 1.5 percent annual "insurance premium" reduced your risk by over 40 percent - that's a lot cheaper than car insurance.

[1]A measure of the sensitivity of the price of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years.
[2]Interest rate sensitivity is a measure of how much the price of a fixed-income asset will fluctuate as a result of changes in the interest rate environment. Securities that are more sensitive have greater price fluctuations than those with less sensitivity.
[3]The annual interest rate paid on a bond, expressed as a percentage of the face value.
[4]The income return on an investment, such as the interest or dividends received from holding a particular security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value or face value.
[5]Morningstar through 2015.
[6]Morningstar from 1976 through 2015 comparing the total return of both the Bloomberg Barclays U.S. Aggregate Bond Index and the S&P 500 Index
[7]The annualized return (the returns an investment provides over a period of time, expressed as a time-weighted annual percentage) on the S&P 500 TR index from 1976 through 2015 was 11.35% with a standard deviation (a measure of the dispersion of a set of data from its mean) of 16.4. The same metrics for the 50/50 portfolio of stocks and bonds are 9.85% annualized returns and a standard deviation of 9.6. The volatility value of 9.6 is over 40% lower than 16.4. The 50/50 portfolio simply blends the annual returns of the indexes in equal amounts each year. All data sourced from Morningstar.

Complying With ERISA 404(c)

According to ERISA, plans intending to comply with 404(c) must provide that participants: Have the opportunity to choose from a broad range of investment alternatives (which are adequately diversified); may direct the investment of their accounts with a frequency which is appropriate; and can obtain sufficient information to make informed investment decisions. The plan sponsor must provide annual written notification to participants with its intent to comply with 404(c), and be able to provide the following:

- Information about investment instructions (including contact information of the fiduciary responsible for carrying out participant investment instructions);
- Notification of voting and tender rights;
- Information about each investment alternative; and
- A description of transaction fees and investment expenses.

Compliance with section 404(c) of ERISA protects plan fiduciaries from liability for losses that result from the investment decisions made by participants. Conversely, failure to comply with 404(c) could result in liability for losses due to poor investment decisions made by plan participants. To comply with some of the important requirements of 404(c), we encourage our clients to review and execute a formal 404(c) Policy Statement and Employee Notice and send the Notice at least annually to all employees. As your plan consultant, we assist you by providing you with a boiler plate template you can use for your plan. Contact your plan consultant for assistance.

Considering a Safe Harbor Retirement Plan

It may be advantageous for a plan sponsor to consider adopting a safe harbor design for their retirement plan. Adopting a safe harbor retirement plan design permits an employer to essentially avoid discrimination testing (the testing is deemed met). Remember, this testing limits highly compensated employees' contributions based upon non-highly compensated employees' contributions. By making a safe harbor contribution highly compensated employees can defer the maximum amount allowed by their plan and Internal Revenue Code limits, without receiving any refunds. General rules for all safe harbor contributions include the following:

- Safe harbor contributions are 100 percent vested.
- There may be no allocation requirements imposed on safe harbor contributions, for example, a 1,000-hour service requirement or a last day employment rule.
- Safe harbor contributions may be used toward satisfying the top heavy plan minimum contribution requirement.
- All eligible participants must receive a written notice describing the applicable safe harbor provisions between 30 and 90 days before the beginning of the plan year. This notice must be provided for each year the plan will be safe harbored.

Generally, there are two types of safe harbor contributions: 1) the non-elective contribution, which is a 3 percent contribution to all eligible participants, or 2) a matching contribution to participants who are contributing to your plan. There are two options from which to choose, for the matching contribution, either the basic or the enhanced match. The basic safe harbor matching contribution is defined as a 100 percent match on the first 3 percent of compensation deferred and a 50 percent match on deferrals between 3 percent and 5 percent of compensation. Alternatively, the employer may choose an enhanced matching formula equal to at least the amount of the basic match; for example, 100 percent of the first 4 percent deferred. All that said, employers wishing to explore a safe harbor solution should also be aware that it may entail more cost (if their present contribution structure is less than the required safe harbor required structure).

To learn if a safe harbor feature is appropriate for your plan, contact your plan consultant.

Communication Corner: Rebalancing Your Portfolio

This month's employee memo provides participants with information on rebalancing their portfolios – what it is, what its purpose is and how to complete one.

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.

S&P 500 Index is an unmanaged group of securities considered to be representative of the stock market in general. You cannot directly invest in the index.

Performance of indexes reflects the unmanaged result for the market segment the selected stocks represent. Indexes are unmanaged and not available for direct investment.

The B3 Provider Analysis™, RPAG's proprietary retirement plan fee benchmarking and request for proposal (RFP) system, utilizes live-bid benchmarking to provide a comprehensive benchmarking of a plan's fees, services and investments in one robust report.

International investing involves special risks such as currency fluctuation, lower liquidity, political and economic uncertainties, and differences in accounting standards.

The value of fixed income securities may fall when interest rates rise. Fixed income securities with longer maturities tend to be more sensitive to changes in interest rates, usually making them more volatile than fixed income securities with shorter *maturities. For all bonds there is a risk that the issuer will default. High-yield bonds generally are more susceptible to the risk of default than higher rated bonds.*

Please note that all investments are subject to market and other risk factors, which could result in loss of principal.

Mutual funds are sold by prospectus only. Before investing, investors should carefully consider the investment objectives, risks, charges and expenses of a mutual fund. The fund prospectus provides this and other important information. Please contact your representative or the Company to obtain a prospectus. Please read the prospectus carefully before investing or sending money.

To remove yourself from this list, or to add a colleague, please email Garrett Johnson at gjohnson@heritagetrust.com or call (405) 608- 8660

ACR#216789 10/16