PIMCO DC Practice

PIMCO DC Dialogue™

"Plan for the worst, hope for the best."

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This issue features an interview with
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Research Affiliates, LLC.

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In this* PIMCO DC Dialogue, *we talk with Rob Arnott, Chairman of Research Affiliates, about how asset allocation has changed and the need to diversify assets. *Rob discusses investor behavior and the importance of buying when markets are out of favor. He suggests that target-date strategies are an improvement for defined contribution (DC) participants, yet they need to be better diversified. Rob talks about the advantages of more frequent rebalancing and suggests that global tactical asset allocation may add value to DC plans. Finally, he shares his views on inflation, as well as managing risk before as well as in retirement.*

DC Dialogue: ***Rob, can you discuss how asset allocation has changed over time and how it might change as we look forward?***

Rob Arnott: Actually, I think it's more interesting to think about how asset allocation has not changed. The goals in asset allocation always have been, and likely always will be, to seek the benefits of diversification and to seek them broadly in areas with good liquidity and good access, and also to seek to take advantage of market opportunity – markets that are priced to offer better forward-looking rates of return – and to shy away from markets that are popular, trendy or comfortable, for the simple reason that the markets don't typically reward comfort. They reward a willingness to bear risk.

One way that the markets and asset-allocation decisions have changed is that people have developed a heightened awareness of the importance of correlation. Of course, this is because of 2008, when the market crashed. Relative to the normal range of volatility, there were many asset classes that crashed far harder than stocks did.

"People have developed a heightened awareness of the importance of correlation."

DCD: ***In terms of seeking diversification, liquidity and access, how has that changed? Typically we think of asset allocation to stocks and bonds, but is that enough?***

Arnott: That's one area that's seen considerable change in the availability of new markets and new assets. The notion of a strategy that involved investing in emerging markets bonds would have been hard to imagine 20 years ago. Now it's a well-accepted, well-respected asset class in its own right.

The notion of active or tactical asset allocation 20 years ago was largely centered on the question, How much do you want in stocks, bonds and cash? How much do you want in international stocks? That was about it. Now we have the ability to broaden our horizons to span the whole panoply of markets, ranging from real estate investment trusts (REITs) for real estate exposure, to commodities, to convertibles, to high yield bonds, to leveraged bank loans and so on.

DCD: ***For defined contribution investors, that may be the case as well. If you look forward, what else do you anticipate changing in asset allocation, not only in the diversification of assets, but also perhaps in the process we use?***

Arnott: One of the key challenges that investors face in the defined contribution marketplace is the limited spectrum of investment choices that are available to them. A lot of DC plans don't offer much, if any, access to alternative markets outside of mainstream stocks and bonds plus maybe a dose of international stocks. So a lot of plans are not offering their participants the spectrum of choices that are, in fact, available to all of us – institutional but also retail investors. This includes access to real estate, commodities, emerging markets, convertible and high-yield bonds and more.

The other challenge for DC investors is a really simple one: getting past the pain that human emotion can inflict on us and our portfolios. For instance, when DC investors look at the roster of available choices, how often will they identify some funds or strategies that have done well over the last one, three or five years and think, "Gosh, maybe I should have some more of that in my portfolio?" It's as if they believe that the last one, three or five years are a prologue and that the next one, three or five years will be much the same. Yet we know that the past is not a prologue.

In fact, pushing just a bit further, suppose a DC investor were to look down the roster of available choices and instead ask the question, "What's done really badly over the last one, three or five years and is it a bargain now?" There's not more than one person in a hundred who thinks that way.

"A lot of DC plans don't offer much, if any, access to alternative markets—that is, assets beyond mainstream stocks and bonds plus maybe a dose of international stocks."

DCD: ***You mentioned assets beyond mainstream stocks and bonds that are missing from most DC lineups. What about Treasury Inflation-Protected Securities (TIPS)?***

Arnott: For plan sponsors looking at individual categories, it seems a natural choice to offer investors the opportunity to invest in TIPS, which provide inflation protection. In fact, it's shocking to me that DC plans often don't have TIPS as an option. After all, what's one of the biggest risk that your employees face as they approach retirement? Inflation.

Aggregate indebtedness in the United States is huge. As a nation, we may owe five and a half times our annual income in direct debt, bonds, loans and so forth. That's a daunting burden. It seems increasingly likely that – given the three choices available to reduce debt: pay it off, which will likely take decades; abrogate, which may create geopolitical chaos; or partially abrogate by debasing the dollar – there is just one politically expedient and maybe even only one politically tolerable approach, reflation. So there's a very real risk that we will be

trying to re-flate our way out of this by reducing the real value of the debt through the use of inflation.

If that's the case, suppose we want to cut the real value of our debt in half over the next 15 years? You could get there by having 5 percent inflation for 15 years. Worse, it would have to be 5 percent higher than our trading partners'. So call it 7 or 8 percent inflation. That's a real risk for retirees. TIPS offer a wonderful way to mitigate that risk. The yield isn't great but the inflation protection is there in the securities. It's reasonably solid.

DCD: ***How can a DC plan sponsor bring TIPS and other diversifying assets into their plan?***

Arnott: An easy way to bring all of these missing asset classes into a plan is by adding a global tactical asset-allocation strategy (GTAA), which blends these diversifying asset classes and complements the existing stock and bond holdings within a DC plan. An efficient GTAA strategy will typically sell whatever has been wildly successful, out of proportion to its fundamental merit, and buy what's been disappointing while still maintaining substantial fundamental merit.

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In other words, a GTAA strategy is going to be a contrarian strategy, which means selling your winners and buying your losers. It therefore introduces a bit of a tax consequence – not a lot, but some. So overall, a tax-deferred DC plan may be a wonderful place to enact these investment ideas.

DC participants can use GTAA strategies in a very effective and straightforward way, deploying some money into assets that can provide a hedge against inflation, assets that offer diversification into complementary markets, assets that can serve them well when stocks struggle – but won't necessarily soar when stocks soar. In so doing, they may trim the volatility of their returns and allow the manager to have more money invested in seemingly riskier markets.

DCD: ***Do you have any comments on recent arguments that buy-and-hold strategies are dead?***

Arnott: To say that "buy and hold is dead" presumes that it was ever alive. Do you, or I, or anyone reading this know anyone who bought a portfolio and never touched it for life? The reality is most people are often rethinking their investment choices. Investing is a dynamic process, even though at times it can seem like an awfully slow dynamic process. The way I view the choice, it's

not buy and hold versus tactical. The real question is, "How do we choose to handle the asset-allocation decisions?"

Active rebalancing can be a very useful and important part of our toolkit. Tactical asset allocation could be viewed as rebalancing on steroids. If the market goes up, you don't just rebalance back to your intended weight. You overshoot. You move to underweight.

Many investors do precisely the wrong thing. They chase whatever has performed best. I think that's a terrible way to invest. So if we can encourage participants to invest in ways that reduce the damage of chasing the winners, and to invest in a strategy that enjoys the benefits of rebalancing or contrarian tactical asset allocation, we may be doing them a tremendous service. We may be doing them an even greater service if we set them up in such a way that they're overtly encouraged to buy and sell at more opportune times.

"Target-date strategies and tactical asset-allocation approaches that embrace contrarian buying and selling present a great opportunity for participants."

Target-date strategies and tactical asset-allocation approaches that embrace contrarian buying and selling present a great opportunity for participants. By contrast, I think that "buy and hold" is used as a catchall for sitting there and not doing much. There's nothing wrong with that, if it's a deliberate choice, but let's make it a deliberate choice.

DCD: ***Have you looked at how frequently portfolios should be rebalanced?***

Arnott: For domestic portfolios, our studies show that rebalancing improves the risk-adjusted performance of your portfolio by one-third to one-half percent. It's not a huge increment, but it's nice. We found that the decision to engage in occasional rebalancing of the portfolio is where the lion's share of the benefit lies. How extensively to rebalance was secondary, only making a few hundredths of a percentage point difference in long-term returns.

In global portfolios, we find that rebalancing generates one to one-and-a-half percent in added returns. Now that's pretty interesting. It doesn't sound like much, but if you were investing for retirement over the next 20 years, that added return could make a difference of 20 to 30 percent in how much annual income you'll have at your disposal during your retirement. That's big – so adding one to one-and-a-half percent per year matters a lot.

Again, the decision to rebalance is where most of the gain is earned, while the decision how or how often to rebalance is

secondary. Rebalancing a little more often tends to be better than rebalancing infrequently. Once a year should be sufficient. Quarterly adds a few hundredths of a percent. Monthly adds a couple more hundredths of a percent. So it really makes little difference whether you do it monthly, quarterly or annually. Rebalancing at least once a year, or whenever your mix between stocks and bonds strays 5 or 10 percent away from your intended mix, these sorts of broad thresholds are actually sufficient to capture most of the benefit.

DCD: ***If there weren't an issue of transaction costs or operational complexity, would you suggest investors rebalance as often as once a month, in an ideal situation?***

Arnott: I would say that if your DC plan offers an automated rebalancing, whether it's monthly or quarterly, do it. There's no reason not to. If it doesn't have that as an automated option, then do it yourself once a year. That should be sufficient.

"Reduce risk when markets seem safe."

DCD: ***Does increased volatility in the global markets change the nature of investing? Should investors behave differently in volatile markets?***

Arnott: It does, but in a peculiar way; that is, when markets are very volatile, it's usually a time to buy. When markets are quiescent, it's usually a time to pare back on risk. Ironically, when markets get riskier (or more volatile), you should become more risk tolerant, and when markets are less risky (volatile), you should be scared. Be aware that risk is lurking out there. When it strikes, markets that act as if there's no risk are likely to be hit pretty hard.

DCD: ***When we look back at 2008, is there anything that participants could have done to protect themselves better? If you look at DC assets overall, they were down about 25 percent across the board. Even people who were 55 years old and older were down over 20 percent.***

Arnott: What people can do and should do, and what human nature makes it very difficult to do, is reduce risk when markets seem safe. So early in 2007, when we had a strong economy and the appearance that everything was fine, when volatility was at relatively low levels and, in some asset categories, at record low levels, this was the kind of environment when investors should recognize that there's always some sort of market shock just around the corner. In other words, they could have realized that this was the calm before the storm and could have taken risk off the table.

I say "easily," but you have to have the mind-set that fears quiet markets, which goes against human nature. Human nature says, "gosh, these markets are so quiet – I can take more risk and reach for more return." This is like trying to squeeze juice out of an orange that's already been squeezed dry, and that's what happened in a lot of the credit markets. Spreads narrowed to a point where people leveraged up, trying to squeeze more out of an already-dry orange.

DCD: ***Going forward, what should plan participants and sponsors be thinking about?***

Arnott: Right now they can look at their investment mix or target-date strategies and ask, "Am I widely diversified? Where do I have risk in this portfolio?" If the answer is almost all of the risk is in U.S. stocks, then it's time to pose the question, "Can I diversify into other risks? Can I keep just as much risk as I have right now, but spread it out over a lot of other areas so as to reduce my vulnerability to a single market tumbling, such as U.S. stocks?" I believe most investors are unlikely to do that.

"There seems to be group amnesia about what we went through to get where we are now."

I think right now is a great time to reexamine things for a very simple reason: Investors have become complacent again. If you look back over the last two years, yes, stocks are down a bit and credit spreads are right back where they were in 2007. So things look fairly similar to how they looked two years ago. There seems to be group amnesia about what we went through to get where we are now.

That group amnesia creates a new type of risk where investors collectively decide, "Okay, I need to take on more risk because I've got to catch up now that I've lost ground." It's the classic ramping up of risk after a market rises, and ramping down risk after a market falls.

DCD: ***What other risks beyond inflation do you see on the horizon for DC participants?***

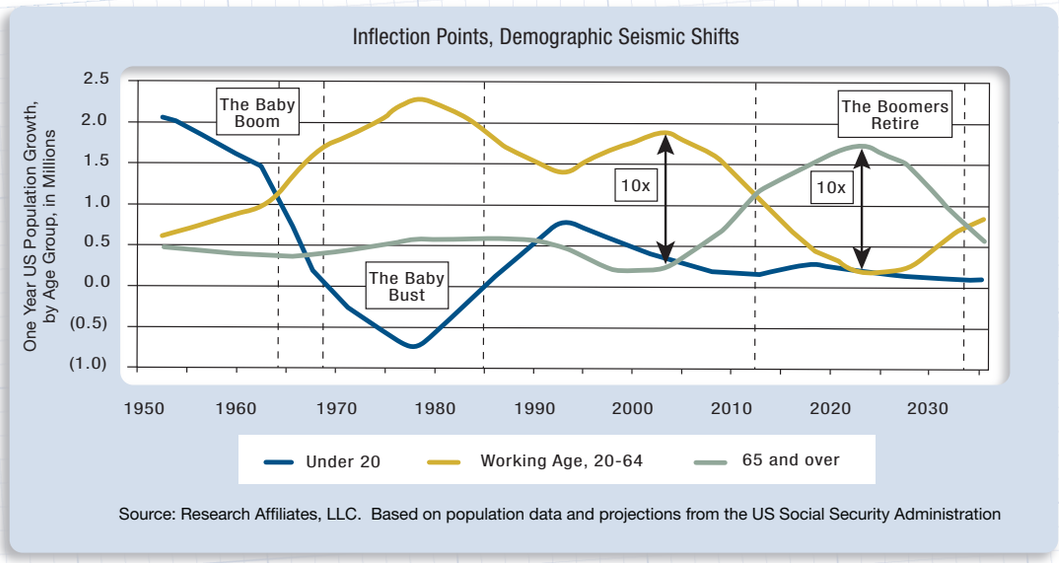
Arnott: The big overhang issue that defined contribution investors should be particularly aware of is demographics. In the early part of this decade, in 2002, there were 10 new additions to the U.S. population in the working age group, from age 20 to 64, for every 1 addition to the 65-and-up crowd of people who typically would want to retire.

Well, that 10-to-1 ratio of new workers to new retirees flips by 2023, when we'll have 10 new retirees for every 1 new worker.

The crossover point is a little over two years from now in early 2012, with 1 new retiree for each 1 new worker.

This is going to be a game changer. It's going to cause seismic shifts in capital markets and the economy and in the political landscape, and it remains to be seen what those shifts will be. I think investors who want their retirement assets to grow enough for them to be able to afford retirement really need to be aware that these risks are very real. That, in turn, means saving as much as you can, and investing it prudently, taking risks when risk looks to be rewarded, when people are afraid, and shying away from risk when people are complacent, when any sort of shock would drive markets far lower.

"This is going to be a game changer."



DCD: ***Aren't you suggesting that DC participants time the markets? This seems to counter much of the education that DC participants have received: "Don't try to time the market. Rather, buy and hold." They also hear "stay the course," and their education materials may suggest that risk dissipates over time.***

Arnott: Market timing for most investors is a disaster because their approach to market timing is to buy whatever's gone up the most lately. So the advice that they've been given – to buy and hold, to "stay the course" and not be tempted to chase the winners – is extremely sound advice for these investors who simply can't change their mind-sets, who can't see falling markets as an opportunity and rising markets as a risk. If they can change their mind-set, they may do better still.

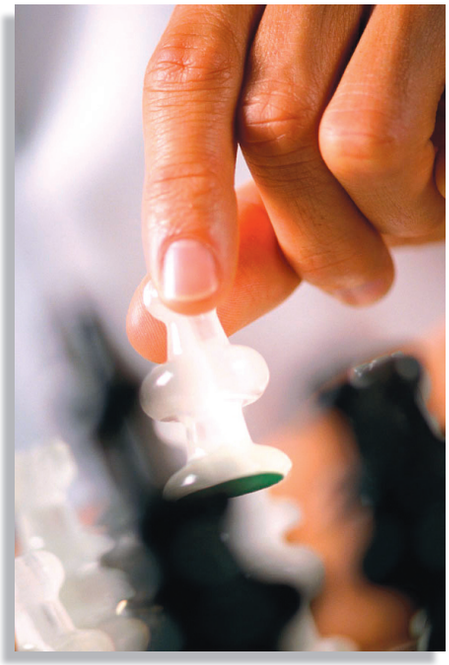
Risk dissipation is an interesting mathematical phenomenon: If markets are random, the risk diminishes as you look at longer and longer spans. For instance, stocks could have a 10 percent return, plus or minus 20 percent, in a particular year. That translates into 10, plus or minus 10, over a 4-year span, and to 10, plus or minus 5, over a 16-year span. So risk seems to dissipate with time.

Where it gets problematic – and this is a very important consideration for people who want the resources to retire – is that in terms of your endpoint wealth, the risk increases with time: A dollar today that grows over the next year to $1.10, plus or minus 20 cents, grows over four years to roughly a buck and a half, plus or minus 50 cents. The range of outcomes is getting wider and wider. While your annualized return falls in a narrower and narrower range as you look at longer time spans, your endpoint wealth falls in a wider and wider range due to the effects of compounding.

"People owe it to themselves to plan for the worst and hope for the best."

For that reason, I think people owe it to themselves to plan for the worst and hope for the best.

What does that mean for retirement? It means saving as much as you possibly can, and investing it prudently and in a contrarian fashion: buying when people are afraid and selling when people are complacent. It means investing with an expectation that you're not going to make much money on your investments, because if you invest with an expectation of lofty returns and you don't get them, your scenario in retirement is bleak.



If you assume poor returns and you get nice returns, your scenario in retirement is really nice. So there's no downside in expecting disappointment and planning accordingly – while hoping for great outcomes. There's a lot of downside in expecting great outcomes and being ill-prepared if the outcomes turn out to be disappointing.

People don't like to think that way. In fact, in the DC world, some companies encourage employees to use tables that show how their money will grow, for instance, at 8 percent. Well, what if they don't get 8 percent? Worse, what if they planned on 8 and they get 4? If that happens, to use a cliché, they may be able to retire earlier and richer.

Reciprocally, if they plan on 4 and get 8, well, gosh, they may be able to retire earlier. It just makes a lot of sense to plan for

disappointment and invest accordingly, while hoping for better, than to do the opposite.

DCD: ***How can plans help protect assets for participants as they approach retirement?***

Arnott: There are three main ways to deal with risk. One is to not take much risk in the first place. Chances are if you do that, you won't be afforded the opportunity to earn particularly good returns, but you won't be adversely shocked. A second solution is tail-risk hedging, where you explicitly seek to hedge against extreme market outcomes (e.g., buying S&P 500 put options that pay off if the market drops below a certain level). It doesn't cost a lot to hedge against extreme outcomes, but it does cost a little something. The third solution is to try to get out of harm's way before you need the tail-risk protection. In effect, that's what tactical asset allocation is all about.

"There are three main ways to deal with risk."

There's merit to all three approaches, so it's hard to say one's right and one's wrong. With a tactical asset-allocation approach, the goal is to reduce exposure to risky markets before they hurt you and to take on risky exposure when people are most fearful. With tail-risk hedging, it's to invest as if the risk is manageable and to hedge away the extreme moves.

DCD: ***What are some of the special concerns that retirees have, and how would they address them?***

Arnott: The big risk for retirees is outliving their money. That means they need to focus on two things: their spending and their investments. For a retiree, a big part of their investments ought to be in relatively low-volatility inflation-protected assets, as opposed to assets that seek lofty returns.

DCD: ***What about active management versus passive? More plan sponsors have been thinking, "Perhaps we should have a tier of passive strategies available," and many are concerned about fees and the potential litigation that they may face from participants on the reasonableness of fees. What are your thoughts?***

Arnott: Passive management certainly has great merit in that it reduces costs. It also means missing the opportunity to earn incremental returns if active managers are good at what they do. There's an opportunity to add value with better indexes, and with disciplined contrarian strategies. That's not to say you can't add value in the more efficient markets. It just means that it's harder to add a huge amount of value.

To identify superior active managers, gauge the managers' people, process and philosophy, as well as whether their process is sufficiently disciplined to be likely to deliver the goods into the future.

DCD: ***What final suggestions would you like to share with plan sponsors, consultants and others?***

Arnott: For one, we need to stop encouraging our employees to expect the markets to provide their retirement savings for them. They've got to save to make it happen. They should not expect market returns to make up for a bleak, low savings rate.

"We need to stop encouraging our employees to expect the markets to provide their retirement savings for them. They've got to save to make it happen."

Two, we need to encourage our investors to broaden their diversification set, to look outside of mainstream stocks and bonds. We don't do that enough right now. The typical roster of choices would be style buckets spanning the whole array of categories in stocks, and possibly a couple of bond strategies, a couple of balanced strategies, and maybe a default option – typically a target-date strategy.

This typical DC array winds up being too limiting. If 80 percent of the available funds are equity funds, it's likely that 80 percent of your employee money will wind up in stocks. The failure to offer a diversified roster of alternatives, the failure to offer inflation-linked strategies or real-return strategies, could haunt DC plan sponsors in the years ahead because they're not making diversified and protected assets available to their participants.

DCD: ***Thank you, Rob.***

Arnott: Thank you.

DC Dialogue

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PIMCO DC Dialogue *is prepared and distributed by the PIMCO DC Practice. Based in Newport Beach, this practice is dedicated to promoting effective DC plan design and innovative retirement solutions. Our team is pleased to support our clients and broader community by sharing ideas and developments in DC plans in the hopes of fostering a more secure financial future for employees of corporations, not-for-profits, governments, and other organizations.*

If you have questions about PIMCO DC Dialogue *or a topic you'd like to discuss, please contact your PIMCO representative or email us at* ***pimcodcpractice@pimco.com****. We're interested in your ideas and feedback!*

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