

THE HIDDEN COST OF EARLY ACCESS TO RETIREMENT ASSETS



Michelle Teng, PhD
michelle.teng@pgim.com



Aili Chen
aili.chen@pgim.com

As defined contribution (DC) plans have grown and have increasingly become the primary retirement savings vehicle, asset allocators are increasingly interested in incorporating illiquid private assets in these retirement funds to offer participants access to investment portfolios and risk-adjusted returns similar to defined benefit (DB) plans. In addition, governments are encouraging plans to bolster retirement outcomes and support national economic growth by investing in illiquid private assets such as private equity and infrastructure. However, these illiquid private assets pose well-known liquidity management challenges: uncertain cash flows, commitment pacing and rebalancing.

Across the globe, multi-employer retirement plans such as Australian superannuation funds and UK Master Trusts now operate in an increasingly dynamic and evolving market and regulatory environment. Today these funds face additional and novel liquidity challenges arising from participant actions such as members switching assets to alternative low-risk funds or from government actions such as “early access programs” that unexpectedly allow participants to withdraw retirement assets without penalty during bad economic times or climate calamities. For example, the Australian government announced a program at the onset of the pandemic, which allowed adversely impacted participants to withdraw up to A\$10,000 in each of the two pre-defined periods from their superannuation account balance. In the U.S., after the IRS introduced the coronavirus-related distribution (CRDs) with a limit of \$100,000 from eligible retirement plans in 2020, the Consolidated Appropriations Act of 2021 allowed participants to take up to \$100,000 in disaster distributions from retirement plans for calamities other than the COVID-19 without tax penalties. When participants are presented with opportunities to gain early access to their retirement assets, retirement plans are no longer solely for retirement savings anymore as they may withdraw their plan assets well before reaching retirement.

These government and participant actions bring uncertainty and complicate fund liquidity management, especially when private assets are in the mix. While well-intentioned, early access programs affect portfolio liquidity risk that may compel CIOs to adjust asset allocations today to make sure they have enough liquidity to meet these liquidity management challenges of the sudden outflows.

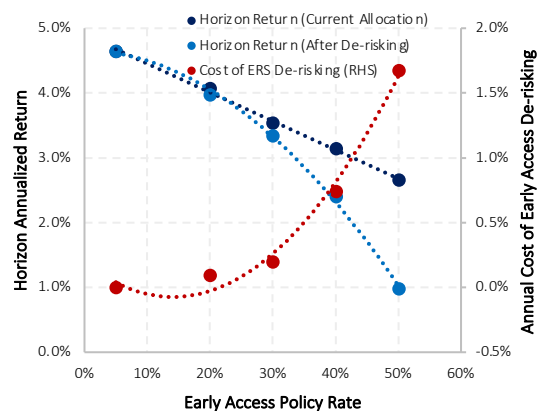
The confluence of these two trends – more illiquid assets and liberal early access programs portends heightened portfolio management challenges. A CIO of an Australian superannuation fund cannot respond to these liquidity risks by simply becoming conservative with a large allocation to cash and a small allocation to illiquid assets. This conservatism may be costly in terms of future potential fund performance, which is subject to regulators’ annual performance tests.

Quantifying the “hidden” performance cost of early access to retirement funds helps CIOs and regulators make more-informed decisions

Grappling with this question, we provide a framework to help CIOs examine how to adjust their asset allocations when faced with the possibility of different levels of early access permissioning. CIOs will need to “de-risk” their plans to manage the heightened liquidity uncertainty by holding more lower-risk, lower-return assets. However, these portfolio adjustments are likely to incur a potential cost to portfolio performance. Unlike a performance or management fee, this cost is not explicit for all to see and lacks a formula to calculate.

This “hidden cost” will be continually borne by all fund participants. We offer CIOs a framework to quantify this hidden cost associated with de-risking when faced with different levels of early access permissioning. Our framework allows CIOs to evaluate how their portfolio’s liquidity and performance might change under different early access scenarios. As shown below, as the liberality of early access programs increases, the potential hidden cost to all plan participants can increase at an accelerating rate, reflecting the increased portfolio conservatism required by CIOs to maintain an adequate level of liquidity.

The Hidden Cost of Early Access Programs



Source: PGIM IAS. For information purposes only.

By examining the potential tradeoff between the liberality of the early access programs and portfolio performance, we try to help CIOs become more confident in making portfolio allocation decisions and help regulators identify possible portfolio allocation consequences and costs of contemplated rule changes.

See M. Teng and A. Chen, ‘Super Funds & Master Trusts in a World of Member Switching, Early Release Schemes & Climate Calamities,’ PGIM IAS, Forthcoming 2022.

Past performance is no guarantee or reliable indicator of future results. All investments involve risk, including the possible loss of capital. These materials are for informational or educational purposes only. In providing these materials, PGIM is not acting as your fiduciary.

Alternative investments are speculative, typically highly illiquid and include a high degree of risk. Investors could lose all or a substantial amount of their investment. Alternative investments are suitable only for long-term investors willing to forego liquidity and put capital at risk for an indefinite period of time. Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk and liquidity risk. Commodities contain heightened risk, including market, political, regulatory and natural conditions and may not be suitable for all investors. The use of models to evaluate securities or securities markets based on certain assumptions concerning the interplay of market factors, may not adequately take into account certain factors and may result in a decline in the value of an investment, which could be substantial.

All charts contained herein were created as of the date of this presentation, unless otherwise noted. Performance results for certain charts and graphs may be limited by date ranges, as stated on the charts and graphs. Different time periods may produce different results. Charts and figures are provided for illustrative purposes and are not an indication of past or future performance of any PGIM product.

These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein, and are subject to change without notice. Certain information contained herein has been obtained from sources that PGIM believes to be reliable; however, PGIM cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. Any forecasts, estimates and certain information contained herein are based upon proprietary research and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM or its affiliates. The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

The information contained herein is provided by PGIM, Inc., the principal asset management business of Prudential Financial, Inc. (PFI), and an investment adviser registered with the US Securities and Exchange Commission. In the United Kingdom and various European Economic Area jurisdictions, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority of the United Kingdom (registration number 193418) and duly passported in various jurisdictions in the EEA. Prudential Financial, Inc. of the United States is not affiliated with Prudential plc, incorporated in the United Kingdom or with Prudential Assurance Company, a subsidiary of M&G plc, incorporated in the United Kingdom. These materials are issued by PGIM Limited to persons who are professional clients or eligible counterparties as defined in Directive 2014/65/EU (MiFID II), investing for their own account, for fund of funds, or discretionary clients. In certain countries in Asia, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co. Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is provided by PGIM (Hong Kong) Limited, a regulated entity with the Securities & Futures Commission in Hong Kong to professional investors as defined in Section 1 of Part 1 of Schedule 1 (paragraph (a) to (i) of the Securities and Futures Ordinance (Cap. 571). In Australia, this information is presented by PGIM (Australia) Pty Ltd. ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the Financial Conduct Authority (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. Pursuant to the international adviser registration exemption in National Instrument 31-103, PGIM, Inc. is informing you of that: (1) PGIM, Inc. is not registered in Canada and relies upon an exemption from the adviser registration requirement under National Instrument 31-103; (2) PGIM, Inc.'s jurisdiction of residence is New Jersey, U.S.A.; (3) there may be difficulty enforcing legal rights against PGIM, Inc. because it is resident outside of Canada and all or substantially all of its assets may be situated outside of Canada; and (4) the name and address of the agent for service of process of PGIM, Inc. in the applicable Provinces of Canada are as follows: in Québec: Borden Ladner Gervais LLP, 1000 de La Gauchetière Street West, Suite 900 Montréal, QC H3B 5H4; in British Columbia: Borden Ladner Gervais LLP, 1200 Waterfront Centre, 200 Burrard Street, Vancouver, BC V7X 1T2; in Ontario: Borden Ladner Gervais LLP, 22 Adelaide Street West, Suite 3400, Toronto, ON M5H 4E3; in Nova Scotia: Cox & Palmer, Q.C., 1100 Purdy's Wharf Tower One, 1959 Upper Water Street, P.O. Box 2380 - Stn Central RPO, Halifax, NS B3J 3E5; in Alberta: Borden Ladner Gervais LLP, 530 Third Avenue S.W., Calgary, AB T2P R3