Voices of Expertise and Experience:
Insights to Inform COVID-19 Responses

TIAA Institute

Can households effectively mitigate COVID-19 portfolio risk?

In March of this year, the S&P 500 Index dropped nearly 34%.[1] Despite a rebound, equity markets remain volatile. In response, individuals may be re-evaluating their portfolio risk mitigation strategies, including their defined contribution (DC) retirement plan assets.

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Examining behavior during the Great Recession provides insight into how individuals managed risk within their DC plans during the most recent economic recession. An Institute report (*Trends in Premium and Asset Allocations by TIAA-CREF Participants: 2005-2011*) found small increases in contributions to fixed-income investments but little change to allocations overall. This "inertia"[2] notwithstanding, many participants with allocations to real estate funds reduced their contributions to this asset class. But because the COVID-19 crisis does not stem from fundamental market problems in the financial and real estate sectors, investment in direct real estate can be a useful diversifier in the current environment. Thereby, staying the course may be a good strategy for many retirement savers, especially those with low financial literacy or who exhibit behavioral saving biases.[3]

The absence of substantial asset allocation changes during the Great Recession may be partly due to the increased use of target-date funds. These auto-allocated and rebalanced funds adjust participants' asset allocations based on a single factor, their age, and are a good choice for an average participant who doesn't want to actively manage or worry about their portfolio allocations. However, participants who are more risk averse (or tolerant) may want to customize a portfolio that provides better risk exposure considering their own risk preferences, as discussed in a recent report, *The Role of the Employer Default Allocation in Defined-Contribution Retirement Plan Design*.

Re-evaluating risk preferences can aid in weathering COVID-19 portfolio volatility.

Participants may look to increase allocations to fixed-income assets to preserve capital, reduce volatility, or generate income. But because mutual funds are marked-to-market daily, they are subject to demand volatility in addition to credit and call risks. Guaranteed investments (including deferred annuities) can help participants mitigate some of the risks inherent in bond funds. An independent report, *The Performance of TIAA's Traditional Retirement Annuity for Selected Investment Cohorts, 1970–2005 through 2013*, found the

1 SP500, FRED, Federal Reserve Economic Data. St. Louis, MO: Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org/series/SP500 (accessed April 30, 2020).

2 Madrian, Brigitte and Dennis Shea. (2001). The power of suggestion: Inertia in 401(k) participation and savings behavior. *The Quarterly Journal of Economics*, 116(4), 1149-1187.

3 Benartzi, Shlomo, and Richard Thaler. (2007). Heuristics and biases in retirement savings behavior. *Journal of Economic Perspectives*, 21(3), 81-104.

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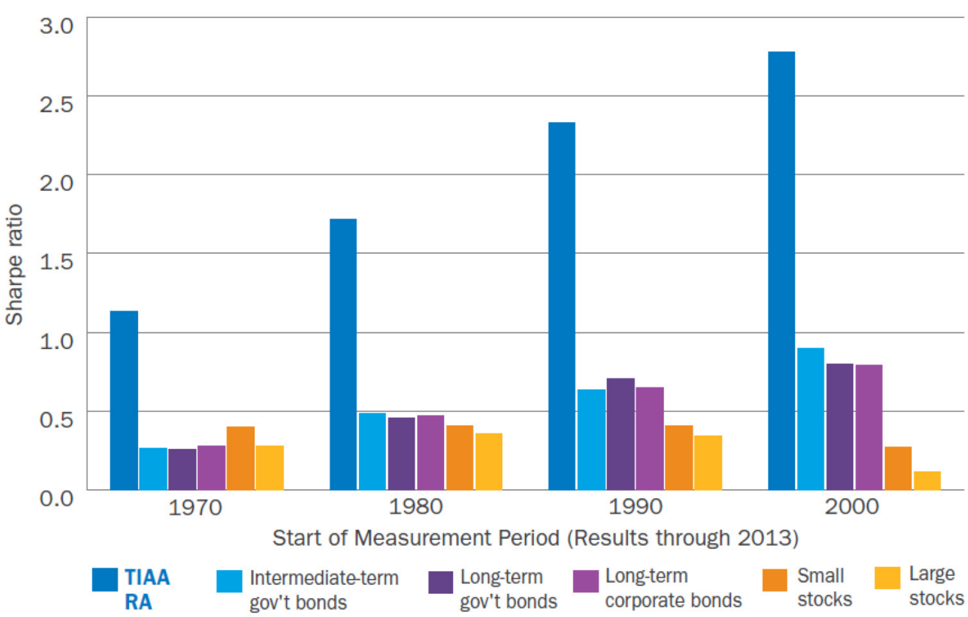
TIAA Retirement Annuity (RA) provided a higher risk-adjusted return on average than other asset classes (see figure below), including corporate and government bonds.

In retirement, holding a portfolio of mutual funds does not mitigate the risk of outliving your assets. Guaranteed income in the form of an annuity provides insurance against longevity risk and reduces consumption risk from market volatility. This is an important consideration for healthy or for high lifetime income individuals because Social Security provides a relatively lower retirement income replacement rate, as discussed in an earlier Institute report, *A Paycheck for Life: The Role of Annuities in Your Retirement Portfolio*. A periodic re-evaluation of risk preferences and mitigation strategies can help households improve their financial well-being in a volatile environment during both working life and retirement.

Diversifying across asset classes can mitigate portfolio risks throughout a participant's lifecycle.

Higher Sharpe ratios indicate greater returns per unit of risk.



TIAA Institute infographic generated from Sharpe ratio analysis in *The Performance of TIAA's Traditional Retirement Annuity for Selected Investment Cohorts, 1970 –2005 through 2013*.

Read more:

Richardson, David P. & Bissette, Benjamin (2014). *Trends in Premium and Asset Allocations by TIAA-CREF Participants: 2005-2011*

Spatt, Chester S. (2018). *The Role of the Employer Default Allocation in Defined-Contribution Retirement Plan Design*

Babbel, David F. & Meyer, Mark F. (2015). *The Performance of TIAA's Traditional Retirement Annuity for Selected Investment Cohorts, 1970 – 2005 through 2013*

Brown, Jeffrey (2008). *A Paycheck for Life: The Role of Annuities in Your Retirement Portfolio*

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