A Preface

There are few things I hate doing more than attempting to predict the future direction of financial markets. No one, including me, seems to do this well. Predicting the next bear market, the next recession or interest rates is destined to fail. That is, at least if you are attempting to fine-tune the prediction. Therefore, I will not be proposing a finely tuned prediction – I apologize to all detail-sticklers.

Interest Rates - Direction

With that preface, we’ve lately received quite a few questions about the direction of interest rates here at the PCA Retirement & Benefits (RBI) office. In essence, many participants want to know how rising interest rates will impact their retirement funds. But to ask this question, you need to know the relationship between interest rates and bond values.

Bonds are investments that typically pay a higher rate of interest than stocks. For instance, a large company that wants to fund a capital project (i.e. build a manufacturing plant) will frequently fund it by issuing bonds that pay semiannual interest to investors. A similar example is how a bank will hold a mortgage on your house.

If you need the capital to buy the house, the bank gives you a mortgage, and you are responsible for paying them back at a set interest rate. Bonds are similar with one exception. Unlike your personal mortgage, most bonds issued by large companies are purchased and sold daily in the market and go up and down in price, which is largely dependent on expected changes in interest rates.

Do you see where I’m going? If you believe you know the direction of interest rates, then you have a fairly good idea whether bond prices in your retirement plan will go up or down. Interest rates and prices for bonds act in an inverse fashion. When interest rates go down, bond prices go up and when interest rates go up, bond prices go down.

Interest Rates - Duration

Now that you hypothetically know how bonds prices work directionally, let’s talk about the magnitude of change. This takes us to the financial concept of duration. Every bond typically has a measure of price sensitivity associated with it called the duration. Duration is a complex calculation that simply tells you the bond’s percentage price sensitivity for every 1 percent change in interest rates. For example, if your bond has a duration of 3.0, then it will decline 3.0 percent for every 1.0 percent increase in interest rates.

Now let’s apply this to a recent analysis that was commissioned by the Investment Committee of the RBI Board of Directors. (found here: pcarbi.org/duration) This document helps us understand the impact a 1% change in interest rates has on each of the PCA Target Date Funds. We found this impact ranges between 1.72% and 0.16% across all Target Date Funds.

Boil all of this down and we get the question: If interest rates continue to move up, shouldn’t I move out of a target date fund that will lose money when rates increase? I believe the answer is no and here’s why:
1. Elimination of loss (losing money) over the short run isn’t an achievable goal. All investments are subject to some form of loss over the short run. Preparing for retirement is a long term strategy that requires patience during times of temporary loss.

2. The Investment Committee has structured the target date fund portfolios to mitigate losses in the event of increases in interest rates. This plan has been carefully implemented over several years. Key changes have been made throughout the fixed income portfolios to reduce duration risk.

3. Moving out of a fund with an appropriate asset allocation for your age or stage of life to something with higher historic returns presumes you know what the future returns will be for various financial markets. The reality is you don’t know. Therefore you may be setting yourself up for a big mistake.

4. The history of market timing is chock-full of money-losing experiences. Timing the next change in interest rates is simply another form of market timing. It is a siren song that has claimed many victims.

If you have questions about your retirement plan, please call us. We can and will help you. Contact us at www.pcarbi.org.

INVESTMENT MANAGER CHANGES: REAL ASSET TO REAL ESTATE

by MARK MELENDEZ

PCA Retirement & Benefits replaced the Principal Diversified Real Asset Fund on Friday, August 3. The fund is an underlying investment within the PCA Target Date Funds, with the J.P. Morgan Core Diversified Commercial Property Fund (CDCPF).

Both funds improve diversification when utilized with stocks and bonds and provide additional inflation protection. The CDCPF, a private real estate fund, provides another attractive feature. Its asset class has historically provided stable and attractive income yields with lower volatility relative to stocks.

The new CDCPF is a commingled fund investing in direct property, and to a lesser extent, real estate securities as well. The CDCPF will invest roughly 85 percent of its assets into a direct real estate product – the J.P. Morgan’s Strategic Property Fund, and the remaining 15 percent into a mix of passive real estate securities, cash, and other liquid investments.
This information is being provided to you to make you aware of the change within the PCA Target Date Funds. If you are an investor in one of our Target Date Funds no action is required. Your investments within the PCA Retirement Plan have automatically updated within one of the PCA Target Fund’s underlying holdings.

INVESTMENT MANAGER MAPPING

Former Investment Manager
Principal Diversified Real Asset Fund

Current Investment Managers
J.P. Morgan Core Diversified Commercial Property Fund

MORE INFORMATION ABOUT OUR NEWEST MANAGER

J.P. Morgan’s direct real estate capabilities are managed by the firm’s Global Real Assets (GRA) team. GRA has managed open-ended core real estate since 1970, and in 1974, began separate account investing on behalf of Tax-Exempt Retirement Plans. Over its 45-year history, GRA has expanded its investment solutions and its client base to include multiple plan types across a diverse and global investor-base.

As of 03/31/18
Benchmark: 85% NCREIF ODCE and 15% the MSCI U.S. REIT Index
Fund Assets (Billions): $1.37
Turnover Ratio: 6% as of 09/30/17

THE BENEFITS OF PRIVATE CORE REAL ESTATE – IN A NUTSHELL

Real Estate is an established asset class with a nearly fifty-year history in certain retirement plans. Only recently have Defined Contribution Retirement Plans (e.g. 401k and 403b plans) gained access to this investment class. Most 401k and 403b type plans have limited exposure to real estate. Those plans with exposure do so through publicly traded real estate investment trusts (REITs). REITs represent one segment of the real estate asset class and typically do not give investors direct exposure to real estate investments.

Our new real estate fund, the JP Morgan Core Diversified Commercial Property Fund (CDCPF), is a unique segment of the real estate sector referred to as Private Real Estate. Private Real Estate typically invests in large high-quality income-producing assets gained from office, retail, industrial and apartment properties. Our newest fund’s ‘core real estate’ exposure is diversified by property type and geography.

The benefits of a Private Real Estate Fund are multi-factored. When used in a traditional portfolio (like the PCA Target Retirement Funds), the new fund should enhance income, diversification, downside protection, and provide the potential for inflation hedging while seeking to reduce volatility.

TO ACT OR NOT TO ACT
by ED DUNNINGTON, CFP®

At PCA Retirement & Benefits, we believe our theological convictions shape the way we think about finances and retirement planning. What we believe about God’s character informs everything from how we steward resources to how we build long-term retirement savings. Yet, you might ask: what about active versus passive management?

If you are not familiar with active or passive management, Kiplinger defines them in the following way:

Actively managed funds work on the premise that experienced professionals can evaluate investment options and craft a portfolio that can strive to outperform an index (i.e. a hypothetical portfolio of securities representing a particular market or a segment of the market). Because there is a hands-on stock picker involved, though, these types of funds typically entail greater fees. Investopedia estimates that “a good, low expense ratio is generally considered to be around 0.50%-0.75% for an actively managed portfolio, while an expense ratio greater than 1.5% is considered on the high side.”

For example, a 1% fee would amount to $1,000 with a $100,000 investment. An actively managed fund may decide how much should be invested in a stock whereas the passive indexed fund has no choice but to buy a certain percentage of a stock.

Passively managed index funds use an algorithm to give the investor a return – positive or negative – based...
upon an index, minus the fee. Examples of the indexes used in passive funds include the S&P 500 index (large 500 companies in the U.S.), European stock indexes such as STOXX Europe 600, government bond indexes, and others. There are dozens of different indexes fund companies can use to construct a portfolio.

Active vs. passive management has become an increasingly popular debate over the years as investment fees have become a greater focus of investors. While making sure you are not paying too much in fees is important, there are many other, more significant issues that impact your retirement savings.

In a recent article in Morningstar Magazine, “Easing the Retirement Crisis: How financial planning and personalized advice can head off extreme austerity,” they make the following statement based on their research:

> We analyzed eight actions...ranging from delaying retirement to increasing the proportion of stock in their portfolios. What did we learn? For the general public...it's the basics that matter most. Saving more, choosing to invest one's savings, delaying retirement, and lowering standard-of-living expectations have a far greater effect than asset allocation, reducing fees or achieving alpha.¹

With all that background, what should an investor do? How does our theology help us navigate this issue? Well, I believe our theology of sanctification gives us a way forward. In the same way that we teach our people that sanctification is a “work” of God’s grace that involves our action in light of God’s action, we can take a both/and approach to active and passive investing.

There are places within the financial markets that an active manager will be able to add very little value, like the S&P 500. These parts of the market are called “efficient” because there is little information that an active manager has that the average investor doesn’t. In addition, a lot of that information is already factored into the stock valuation.

An example of an “inefficient” asset class is emerging markets. A financial analyst, for example, who has spent his or her career studying the Asian markets, has a higher likelihood of making better investment decisions than the corresponding index. Therefore, utilizing both active and passive management can be an excellent investing approach.

If you have any further questions on how our theology influences our view of active and passive management, we would love to talk to you. You can find us online at www.pcarbi.org or call us at (800) 789-8765.

¹ Morningstar Magazine, August/September 2018, p. 16