Bellwether CONSULTING

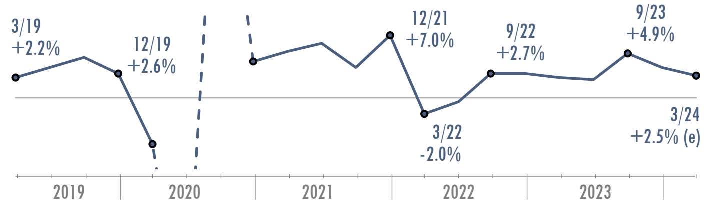
Your Quarterly Update on the Financial Markets
March 31, 2024

MARKET Recap

The US Economy: "Price Dots and Windows"

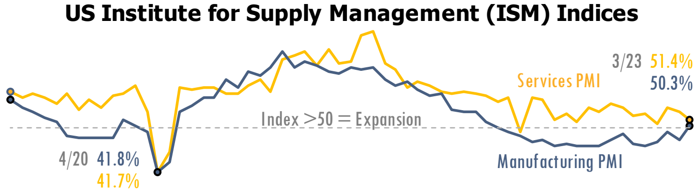
Economic growth came in at a 3.4% pace for the final quarter of 2023 and is currently estimated at 2.5% for Q1 according to the Atlanta Fed's GDPNow model. Deceleration from the odd spike in Q3 of 2023 came primarily from decreased business inventory spending and increased imports. Importantly, all sources of non-inventory spending were strong and revised upwards late in Q4. Personal consumption expenditures through February increased as well.

Annualized Real GDP Growth

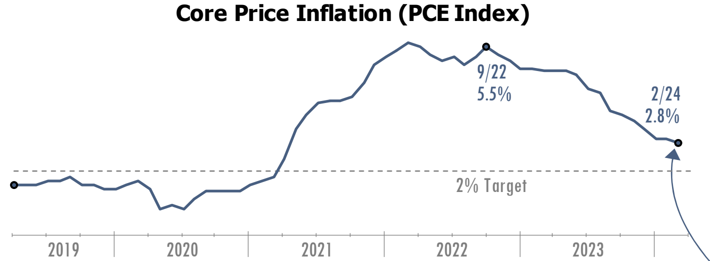


Other indicators paint a stable picture of an economy that is expanding modestly, notwithstanding pressure on the financing side due to elevated short-term rates. The widely-followed Purchasing Managers Index for manufacturing showed continued improvement and crossed over the key 50-point level, indicating a return to expanding conditions. The services version of the index also indicates expansion, decelerating somewhat for February and March following a January surge.

US Institute for Supply Management (ISM) Indices



Core Price Inflation (PCE Index)



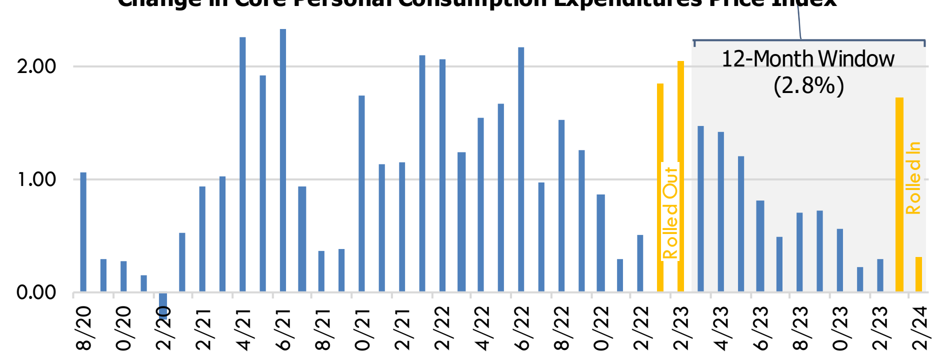
For a third consecutive quarter, Fed-guessing dominated the headlines and drove investment performance. There remains little doubt as to the direction of monetary policy, but the pace of rate cuts is constantly questioned. The data offers the Fed little reason to accelerate from their baseline, which is to cut rates gradually this year (around 75 basis points by year-end).

In their communications, most notably following the March 19-20 FOMC meeting, the Fed has stressed the need for patience. Chairman Powell noted that "...inflation is still too high, ongoing progress in bringing it down is not assured, and the path forward is uncertain. We are fully committed to returning inflation to our 2 percent goal."

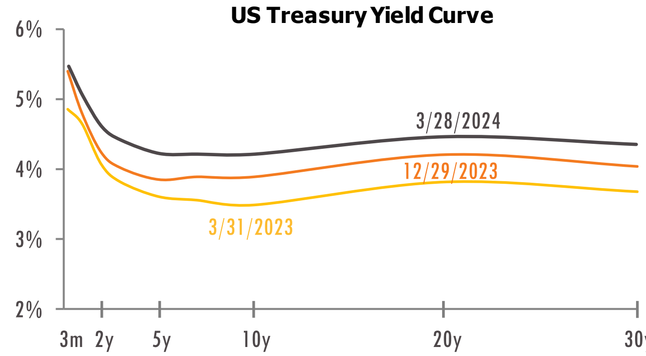
Why are they so worried? Using the Fed's preferred inflation measure (the Core PCE Price Index), inflation appears to be gradually and smoothly declining, with the latest dot very nearly on target. However, the 2.8% inflation rate quoted is a 12-month number, updated on a rolling monthly basis. It is impacted not only by each month's new increment of data but by the size of the index growth that "rolls out" of the 12-month window as it moves. A quick look at the monthly data shows a sharp increase for January, followed by more moderate price growth in February. The more widely-followed Core Consumer Price Index experienced surges for both months. What lies ahead is smaller price growth increments rolling out of the measurement, and uncertain growth increments rolling in.

This does not indicate that inflation is out of control, but it demonstrates how tricky it is to measure and how volatile it can be in the short run. The Fed is aware of this, hence their bias toward caution. The most recent revisions to their economic projections show modestly higher growth through 2026 and a modestly higher Fed Funds rate across the board compared to their December baseline. Absent new labor or output challenges, we expect the Fed will remain reluctant to move faster.

Change in Core Personal Consumption Expenditures Price Index



The US Bond Market



Key rates beyond the 1-year Treasury shifted higher by approximately 25-40 basis points as the market sensibly conceded the Fed will wait until the second half of 2024 to start cutting rates. The FOMC is telegraphing a trio of 25 bps rate cuts in the second half. For now, overnight rates remain fixed at the FOMC target range of 5.25-5.50%, and this somewhat restrictive monetary policy appears to have achieved the desired outcome in moderating inflation without choking off growth.

As the Fed remains "data-dependent," expectations of a recession remain as the base case for many economists. This aligns with the rate cuts intimated by the Fed and market yields towards the front of the curve. However, the FOMC's long-run rates forecast remains at 2.6%, which is far lower than what the back of the curve suggests, even after accounting for term risk premia. Whether this suggests a higher "long-run" neutral rate more in line with historical averages or insistence on more meaningful compensation for exposure to inflation is difficult to tell.

Credit spreads on high yield bonds tightened approximately one-quarter of a percentage point during the first quarter, though the movement would be twice as large measured from January 3rd, due to a brief risk-off hiccup to start the year. High yield spreads are trading back near their historical post-GFC (Global Financial Crisis) lows.

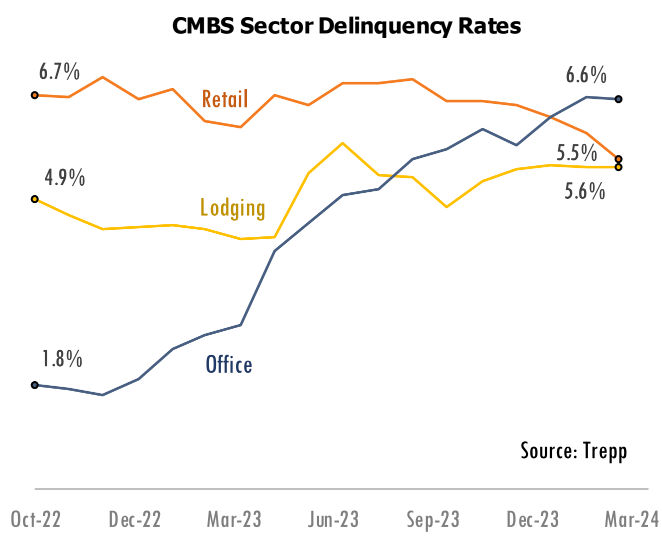
US Bond Index Returns

Bloomberg Idx	1Q24
Aggregate	-0.78%
Short Gov't	0.79%
Interm. Gov't	-0.35%
Long Gov't	-3.24%
TIPS	-0.08%
Municipal	-0.39%
Interm. Credit	0.20%
Long Credit	-1.65%
High Yield	1.47%
(CS) Lev. Loan	2.52%
MBS	-1.04%

Due to narrow credit spreads and a tentative market appetite for risk, investment grade and high yield bond issuance ramped up in the first quarter, exceeding the volume issued throughout the entire second half of 2023. With rate cuts on the horizon, this trend may continue into the second half of 2024, depending on how well credit spreads cooperate.

US bond returns were flat to slightly negative overall. Longer duration and higher credit quality bonds lagged. However, investors should pay mind to the improved yields of high-quality long duration fixed income compared to one year ago or even the past quarter. With credit spreads as tight as they are and the threat of recession, though likely mild, the opportunity cost for some ballast in the portfolio is relatively low overhead with more room to benefit from a flight to quality compared with most points in time over the past 15 years.

For most of 2023, Agency mortgage-backed securities (those issued by government-sponsored entities such as Fannie Mae, Ginnie Mae, and Freddie Mac) traded at wider-than-usual spreads, more than 1.6% (and peaking over 1.9%). Since December, Agency MBS have traded at spreads between 1.4% and 1.5%. This is far higher than the 65-75 bps spreads experienced throughout 2021. Consolidation in mortgage-makers, investor migration to money market instruments, and the exit of the Fed's massive balance sheet warehousing MBS support the thesis that wider spreads are likely to last. This unfortunately translates to higher mortgage rates for homeowners.



Meanwhile, collateralized mortgage-backed securities are running even hotter. Loan delinquency rates on US CMBS in the office sector are expected to increase, from less than 4% in 2023 to over 8% in 2024 before approaching double digits in 2025 [Fitch]. Moody's estimates that 80% of office CMBS are at risk for default or workout in 2024. Almost one-quarter of CMBS are in the office sector, with lower-delinquency industrial and multi-family being the next two largest sectors. Regional banks may be on the hook for an outsized portion of the CMBS losses, and their equity performance reflects that, with the majority posting negative returns for the quarter. Fed rate cuts are the most likely hope to avert these losses. In addition, lenders may acquiesce to borrower-friendly loan extensions to avoid defaults. However, there are limits to this. Regardless, issuance in CMBS is running high, doubling year-over-year on the back of stability and strength in other real estate sectors.

The US Stock Market

The US stock market pulled out a solid 1Q despite a rocky January. The S&P 500, the Dow Jones Industrial Average, and the Nasdaq Composite all notched multiple record closes. Continued enthusiasm for AI along with late-quarter confidence that sticky inflation would not derail the Fed's plans for 3 rate cuts later this year fueled the run-up in US equities. The rally surprised many on Wall Street, and muted 2024 expectations for the S&P 500 set in December were revised up [MarketWatch].

US Stock Indices - Total Returns			
Largecaps	**1Q24**	**Midcaps**	**1Q24**
S&P 500	10.56%	S&P Midcap 400	9.96%
Russell 1000	10.30%	Russell Midcap	8.60%
Growth	11.41%	Growth	9.50%
Value	8.99%	Value	8.23%
Broad Markets		**Smallcaps**	
S&P 1500	10.31%	S&P Smallcap 600	2.46%
Russell 3000	10.02%	Russell 2000	5.18%
Growth	11.23%	Growth	7.58%
Value	8.62%	Value	2.90%

Growth stocks held onto their lead in large and mid caps while also extending their outperformance into small caps, based on the Russell indices. The big swing toward growth in small caps can be attributed to the astonishing performance of Super Micro Computer, an AI dedicated server firm which posted a Q1 return of 255.3% and a 12-month return of 847.9%. After its meteoric rise, SMCI joined the S&P 500 on March 18th. Since Russell reconstitutes on an annual basis, Super Micro Computer won't move in their indices until after market close on June 28th. At a market cap of nearly $60 billion, the firm now makes up 4% of the Russell 2000 Growth Index and 2% of the Russell 2000 Index.

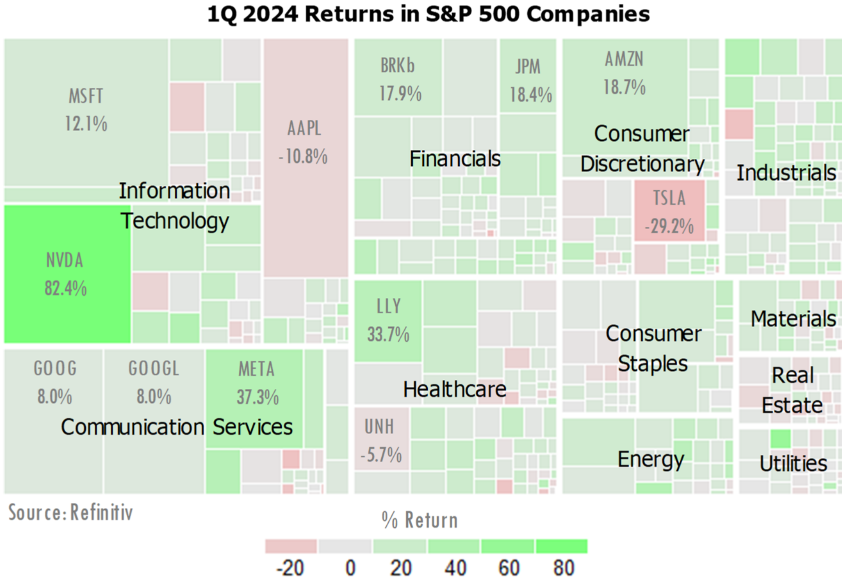
The energy sector saw yet another quarterly reversal, becoming one of the top-performing sectors in Q1. Oil prices moved higher over the period on fears of a broadening conflict in the Middle East. The late March announcement of a Q2 output cut from Russia further supported prices.

S&P 500 Sector Components - Total Returns			
Sector	**1Q24**	**Sector**	**1Q24**
Comm. Services	15.82%	Health Care	8.85%
Energy	13.69%	Consumer Stpls	7.52%
Info Tech	12.69%	Consumer Disc	4.98%
Financials	12.46%	Utilities	4.57%
Industrials	10.97%	Real Estate	-0.55%
Materials	8.95%		

Real estate took the opposite trip, plummeting to the worst-performing sector of Q1. The three large-cap cell tower REITs were the primary drag. As heavy borrowers, SBA Communications, American Tower Corporation, and Crown Castle already had a challenging 2023. Unfortunately, the rate-cut optimism prevalent in other parts of the market seemed notably missing for these firms. But the real estate story that got the most press was in the mid- and small-cap space. Stocks like Zillow Group, Redfin, and Opendoor Technologies dropped precipitously on March 15th when the National Association of Realtors announced the settlement of a group of commission lawsuits. If approved, the settlement is expected to result in a reduction of brokerage commission structures and a weakening of the MLS System (the private databases created by real estate professionals). Returns for the quarter ranged from -15.7% for Zillow Group to -35.6% for Redfin.

The spread in performance between the best and worst sectors topped 16%, continuing the challenging environment for actively-managed strategies. For a third consecutive quarter, the Magnificent Seven did not perform in lockstep. In fact, the market-dominating cohort contained both the best (Nvidia) and worst (Tesla) performers in the S&P 500 as a whole. Tesla has been plagued by slowing demand and increased EV competition, especially from China. Apple, the other Mag 7 underperformer, has been hurt by decreasing demand and competition from Chinese telecom conglomerate Huawei. Another commonality between the two Q1 laggards is that neither has managed to produce a serious AI play. While Nvidia is the obvious beneficiary of AI enthusiasm, Meta, Microsoft, and Amazon each have established a stake in AI.

1Q 2024 Returns in S&P 500 Companies



In a surprise move, Meta began paying dividends. While we have always been skeptical of dividend yield as a basis for an equity investment strategy, there is no arguing that dividends still appeal to many investors. Will Meta's move force Alphabet and Amazon to adopt the same practice? It's hard to tell. In the meantime, read our March 2012 Focus On: The Dividend Fallacy for more on our view on dividends.

International Markets

Global markets finished a strong Q1 driven by retreating inflation. Consensus expectations are for a soft landing as the global monetary tightening cycle comes to an end with developed market inflation set to fall close to central bank targets in 2024. However, economic growth is expected to remain flat this year in both developed and emerging markets. The IMF forecast for global GDP growth remains at 3.1% this year and 3.2% next year with headline inflation expected to drop to 5.8% in 2024 and 4.4% in 2025.

Unhedged Foreign Markets Indices - Total Returns

Stocks	1Q24	Bonds	1Q24
MSCI ACWI ex-US	4.69%	Global Aggregate	-2.08%
EAFE (Developed)	5.78%	Pan-Euro	-2.64%
Emerging Markets	2.37%	Asian-Pacific	-3.89%
Europe	5.23%	Eurodollar	0.68%
Japan	11.01%	Other Currencies	-0.16%
China	-2.19%		
Latin America	-3.96%		

Asia

In 2023, China's economy showed signs of resilience, growing by 5.2%. This was largely propelled by a resurgence in the manufacturing sector, with industrial profits rebounding and exports surpassing expectations in the first two months of the year. In March, factory activity expanded after five months of decline, signaling a stabilizing economy. Both the manufacturing and nonmanufacturing PMIs increased above the 50 mark, which delineates expansion from contraction.

China's Economy

Y/Y Statistics	12/2023	1/2024	2/2024
Manufacturing PMI	49.0%	49.2%	49.1%
Non-Manufacturing PMI	50.4%	50.7%	51.4%
Industrial Output	6.8%	7.0%	7.0%
Unemployment	5.1%	5.2%	5.3%
Producer Price Index	-2.7%	-2.5%	-2.7%
Consumer Price Index	-0.3%	-0.8%	0.7%
Retail Sales	7.4%	5.5%	5.5%
Exports	2.3%	8.2%	5.6%
Imports	0.2%	15.4%	-8.2%

Source: National Bureau of Statistics of China

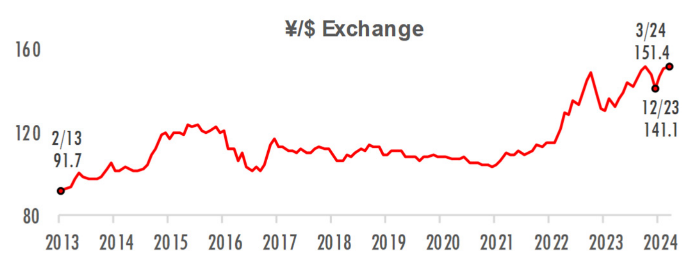
Exports started the year on strong footing as well, offering a possible pathway for Beijing to hit its 2024 growth target of 5%. However, higher exports also raise the likelihood of increased trade tensions. Outbound shipments rose 7.1% in the January-February period when compared with a year earlier, accelerating from a 2.3% increase in December.

Amidst these positive indicators, China grappled with a host of challenges. Notably, the real estate downturn deepened. Troubled property giant Country Garden Holdings said it will miss a deadline for reporting annual results, needing more time to assess its financial situation. Meanwhile, Shenzhen-based China Vanke saw net profits tumble 46% last year, the biggest drop since its 1991 listing. The slump in the property market reverberated through the economy, dampening consumer confidence and leading to subdued retail sales. Additionally, persistent deflationary pressures on both consumer and producer prices impacted corporate profits and consumer spending.

The labor market faced strains as well, with joblessness rising for the third consecutive month. At 5.3%, the official jobless rate is back to its July level after increases in December and January reversed almost half a year of steady progress. This labor-market signal points to a pocket of weakness in the economy.

While China's economy demonstrated resilience and certain sectors showed signs of growth, challenges such as the real estate downturn, deflation, and labor market strains continue to pose threats to a sustained recovery. Geopolitical tensions with the West added further uncertainty to China's economic outlook. Addressing these challenges effectively will be critical for China to achieve its growth targets and ensure long-term economic stability.

In mid-March, Japan's central bank raised interest rates for the first time since 2007, tightening its monetary policy to fight stubborn inflation. Financial markets were generally unmoved by the event. The BoJ's policy rate went from -0.1% to a range between 0% - 0.1%. The Bank said it would also scrap its yield curve control which had been in place since 2016.



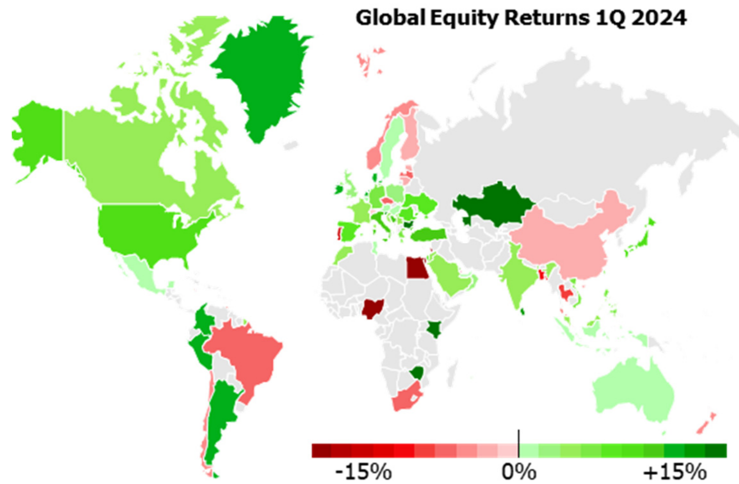
As March drew to a close, concerns surrounding the weak yen came to the fore as the BoJ, the Finance Ministry and Japan's Financial Services Agency met and suggested they were ready to intervene to stop "disorderly and speculative" moves in the currency. A weaker yen makes exports cheaper. It can also push up prices of energy and other imports, fueling inflation and pushing the cost of living higher. The yen continued to move lower despite the BoJ raising interest rates and increasing the yen's use in carry trades. It ended Q1 as the worst-performing major currency, down over 7% versus the dollar.

Americas

Canada's real GDP grew by 0.2% in Q4 after a Q3 contraction, signaling a potential "soft landing" for its economy. Inflation fell to 2.8% in February from 3.4% in December. The BoC maintained its overnight lending rate at 5% in March, calling it too early to cut rates.

Mexico's economy slowed in Q4, growing just 0.1% when 3.3% was expected. Underperformance was led by a contraction in agriculture. Inflation peaked in January at 4.9% before receding to 4.4% in February. Mirroring other Latin American monetary policy adjustments, Mexico cut its interest rate for the first time in March by 25 basis points.

The Brazilian economy ended Q4 flat, missing expectations of a sequential expansion. The downturn was partly due to a slowdown in the agricultural sector, which had previously helped with record exports. A decline in household consumption highlighted reduced spending power and confidence among consumers and affected overall economic momentum. Despite this, Latin America's largest economy ended the year with 2.9% GDP growth, surpassing early forecasts of 0.8% due to high interest rates. Inflation softened in Q1, settling at 4.5% in February, just above predictions of 4.4%. Brazil's Central Bank continued efforts to spur economic activity by lowering interest rates from a July high of 13.75% to 10.75% in March 2024 in a series of half-point reductions.



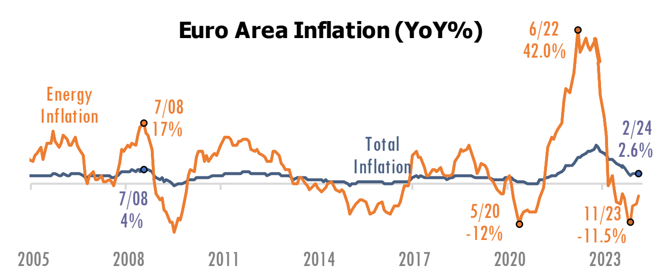
In Argentina, a Q4 drop in private consumption, decreased government expenditures, and a reduction in exports caused a sharp 1.4% contraction. Inflation rates climbed throughout Q1, hitting a high of 25.5% in December before decreasing to 13.2% in February. Argentina has emerged as the nation most adversely affected by inflation globally with an annual rate topping 276% in February. The Central Bank of Argentina reduced interest rates from a November high of 126% to 80% in March, aiming to stabilize and strengthen the peso.

Europe

Growth in the Euro Area is projected to nearly double from 0.5% in 2023 to 0.9% this year. The low rate was impacted by continued exposure to the war in Ukraine. With real income growth supported by lower energy costs and easing inflation, stronger household consumption is expected to drive the recovery.

Business and consumer sentiment improved in February. Inflation resumed its downward trend, but stickier services prices may complicate the ECB's decision-making. In its March meeting, the bank left its main policy rate unchanged at a high of 4% as central banks around the world struggle to decide whether inflation has cooled enough to start cutting rates.

The ECB had raised its key rate to the current level to combat double-digit inflation driven by supply chain issues stemming from the pandemic and an energy crisis after Russia invaded Ukraine, with impact felt across the zone. Construction activity has stalled in Germany, Europe's largest economy. The nearly decadelong rise in home prices in the 20 Eurozone countries also has come to an end as tighter credit deterred borrowers and sellers. The eurozone saw no growth in Q4 2023 after shrinking 0.1% in the previous quarter. Germany expects growth of just 0.2% this year.



Source: Federal Reserve Bank of St. Louis

ECB President Christine Lagarde stated that the central bank was "making good progress" on lowering inflation to its 2% target, but economic data would decide the bank's next move. This may come in the form of wage growth as workers bargain to make up for purchasing power lost to ballooning inflation. As this growth has been slowing, a June rate cut is the likely scenario.

Inflation was down to 2.6% in February, well below its peak of 10.6% in October 2022. But the consumer price index has been stuck between 2% and 3% for five months. While the spikes in food and energy prices have eased, inflation has spread to services, a broad economic sector including everything from movie tickets and office cleaning to tuition and medical care.

Europe also faces a number of external challenges this year. As manufacturing picks up in the Far East, a surge of cheap imports from China will benefit consumers, but can have the effect of dampening domestic manufacturing. The prospect of a second Trump administration in the US and the possibility of a trade war with a blanket 10% tariff on all imports from Europe also has the potential to stunt growth. In addition, the disruption in shipping via the Red Sea, due mainly to higher insurance surcharges to vessels transiting the Suez Canal and higher fuel costs for re-routing, is expected to increase transportation costs which could hamper European businesses.

Focus On: Revenge of the Defined Benefits

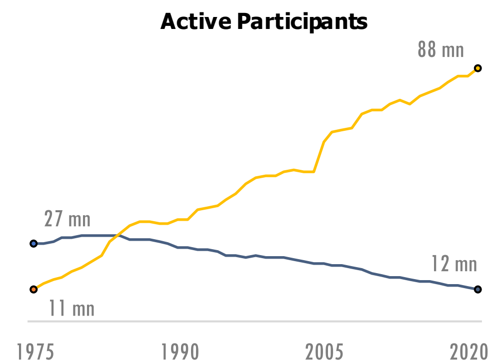
In January, IBM drew attention from the pension world by thawing a very large defined benefit (DB) plan they had frozen more than 15 years ago. Relatively few plan sponsors maintain a large, overfunded, frozen DB plan; and, some of them have already taken similar action. However, this headline spotlights the potential benefits to employers and participants of offering a combination of defined benefit and defined contribution (DC) plan features, in one form or another.

IBM had been contributing a 5% match to employee 401(k) accounts. Starting in 2024, the company will instead credit 5% of each employee's salary into a cash balance account. This allows IBM to fund an ongoing benefit using "trapped" surplus in an otherwise frozen pension plan. Whether participants will view the trade as equitable may be trickier. But regardless, plan sponsors may need to think differently about their frozen, over-funded pension plans, and those of their competitors.

Should IBM's action attract new hires and promote employee retention, others may want to take a fresh look at the potential added value of their pension plan. Will Microsoft and Google launch defined benefit plans to compete with IBM? We doubt it, but they might consider adding DB-like components to their already generous DC plans. Offering features such as guaranteed income and profit-sharing could help DC-only sponsors level the field in competing for talent.

The Era of 401(k)

Before the 1980s, defined benefits anchored retirement planning. In 1975, DB plans commanded twice the number of active participants and twice the inflows. This era was characterized by a commitment from employers to provide a guaranteed income based on years of loyal service and salary levels. By 1985, DC overtook DB, with more active participants and contributions. This marked a pivot in both retirement planning and workforce culture, highlighting a growing preference for individual mobility and control. This followed the Revenue Act of 1978, which introduced the 401(k) as a pre-tax savings vehicle. Prior to the legislation, DC plans existed in various forms but pre-tax employee contributions were limited. Employees flocked to the immediate tax savings and added control, transparency, and portability; employers rushed to shed balance sheet liabilities, costs, and administrative overhead.



This period of transformation was further propelled by the bullish stock market of the 1980s and 1990s. The robust performance of the stock market during these decades made DC plans, particularly 401(k)s, increasingly attractive. Employees began to recognize the potential for higher returns on their retirement savings through these plans, compared to traditional DB plans. This realization, coupled with the flexibility and control over investment choices offered by DC plans, contributed significantly to their surge in popularity. Plummeting DB funding further stoked the migration to DC.

Variable Outcomes

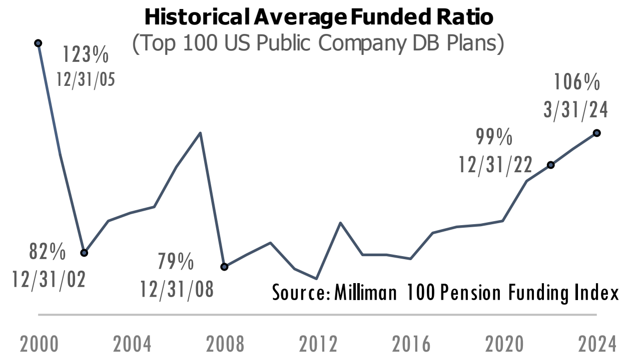
The first employees to have a 401(k) in their early 20s are now entering retirement and, for many, the 401(k) experiment has failed to deliver financial security. Median and average pension benefits in 1970 were in the range of $1,600 to $2,000 per year, roughly $15,000 in purchasing power today. The general rule of thumb for spending down retirement savings is 4% per year. Even at 5%, most retirees fall short of what pensions once provided. Instead of $300,000 in retirement savings, the median retirement account at age 65 is below $200,000. However, the distribution of outcomes is wide, with the average balance near $600,000. The Federal Reserve Bank of Chicago found 75% of US workers are not saving enough for retirement. Low-wage earners and those with limited disposable income often struggle to contribute enough to their DC plan. The Federal Reserve suggests an age-dependent average contribution of 10% versus an actual average of 6.3%.

Another critical shortfall of DC plans has been their pure focus on the accumulation phase. Although SECURE 2.0 has opened the door to new retirement income solutions and better access to annuities, most DC participants still fend for themselves in the decumulation phase and many roll out to an independent account anyway. DC plans offer no protection against meager deferrals, imprudent investment decisions, or bad luck. Participants face the real possibility of outliving their savings.

The investment risk in DC plans is borne individually by each participant, leading to variable outcomes that are highly dependent on market conditions and personal investment choices. This individualized risk does not benefit from the pooling mechanisms inherent in DB plans, which can spread and mitigate the impact of poor market performance over a broad base. Behavioral biases can also degrade DC investment performance due to reactive tendencies like chasing high returns. Restricted access to institutional-focused asset classes, such as private equity and private credit, which can offer attractive returns and diversification benefits, also places DC plans at a disadvantage compared to large DB plans.

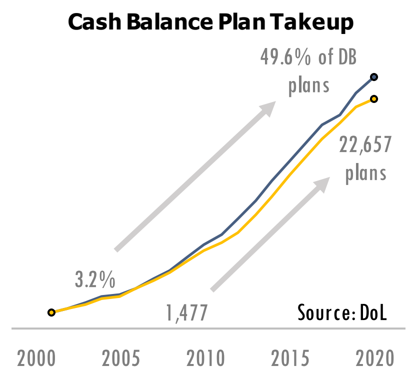
A New Era of Defined Benefit Planning?

One reason for traditional pension plans' dwindling popularity was the apparent difficulty in keeping them well-funded. Plan sponsors have learned from past mistakes of ignoring interest rate risk or targeting too high (or low) of a return. With the recent run-up in yields and strong returns from riskier asset classes, corporate pension funding has improved. Funding for the average large corporate plan crossed over 100% in 2023 and has improved to 105.6%, as measured by the Milliman 100. While 5% overfunding may not provide enough surplus for creative use, the percentage of very overfunded plans (e.g., 120% or greater) has increased proportionally. Put simply, more plan sponsors have access to creative design options.



In 2022, two community banks took action similar to IBM because of challenges in retaining talent and bridging employee shortages. They revitalized their DB plans by transitioning to cash balance plans, a move that set them apart from other local employers. In 2023, the United Auto Workers (representing ~150,000 workers at General Motors, Ford, and Stellantis) pushed for the reestablishment of defined benefit pension plans. Although this was ultimately unsuccessful, it highlights the perceived value of stable retirement benefits. Whether or not the benefit is measurably greater, clearly some employees view a defined benefit as a better benefit. In the war for talent, employers should consider every weapon.

Although traditional defined benefit plans show no signs of resurgence, cash balance plans have seen significant growth over the past 25 years, accumulating more than $1 trillion in assets within the US. Cash balance plans address some of the shortcomings of traditional pension plans. Because cash balance plans incorporate aspects of both DB and DC plans, they are sometimes referred to as hybrid plans.



The cornerstone of cash balance is the crediting rate, which enables the plan sponsor to create liabilities that grow predictably or are easy to hedge. The shift to a cash balance benefit allows IBM to use a captive $3.6 billion in existing plan surplus to fund new benefits. Given that employer contributions to IBM's 401(k) plan totaled $550 million in 2022, this strategic move could defray cash payments otherwise needed to fund DC matching contributions for many years.

IBM employees who were not contributing enough to the 401(k) plan to receive the full company match will be glad to receive the full 5% in the cash balance plan. Yet, other participants may end up with a reduced future benefit amount should the crediting rate lag their 401(k) investment returns. A higher contribution rate to the cash balance plan versus the 401(k) match would be required to achieve expected parity, something that may be justified by expected gains in recruiting and retention.

The Dark Side of Cash Balance

Cash balance plans also come with drawbacks, primarily the financial and administrative responsibilities of the plan sponsor. Pay credits start as fixed dollar amounts or a percent the employee's W2 income but grow at a sponsor-selected crediting rate that may be fixed or variable. For example, IBM's cash balance credits initially grow at a fixed 6% per year then tracks the 10-year US Treasury key rate. However, cash balance liabilities can be difficult to hedge with assets – and design features that make the liability easier to hedge (e.g., eliminating floor rates, linking to shorter-term yields) also make the benefit less competitive. Plan sponsors need to carefully analyze asset-liability mismatch risk before committing to greater cash balance contributions and make sure they are comfortable with the potential funding risks.

Cash balance plans are administratively demanding. Unlike 401(k) plans, they require regular actuarial valuations to determine funding needs and appropriate contribution levels, leading to higher initial setup and ongoing administrative costs. Plans are insured by the Pension Benefit Guaranty Corporation, requiring premium payments by the plan sponsor. Additionally, as the contributions are employer-mandated, fluctuating financial circumstances can pose challenges. Another detractor for the employer is that cash balance plans sit on the company's balance sheet as a liability, which can adversely impact the company's credit rating and stock price. Compared to traditional defined benefit plans, cash balance plans require more frequent valuation and communication -- otherwise participants may not perceive it as a valuable benefit like a 401(k). They also generally allow for lump-sum distributions, placing a greater premium on asset liquidity.

Getting the Best of Both

Cash balance is not the only type of hybrid plan. For example, one can be constructed simply by requiring participants to contribute to both a DB and a DC plan. The Tennessee Department of Treasury implemented such a model in 2013 by requiring state employees, higher education staff, and certified teachers to contribute to both components. The employer contributed 4% to DB and 5% to DC, as employees made minimum contributions of 5% to DB and 2% to DC.

A more practical alternative for most plan sponsors would be to supplement a 401(k) with features such as profit-sharing, annuities, or retirement income funds to address under-saving and uncertainty in the decumulation phase. By enhancing a 401(k) plan with profit-sharing contributions, an employer can address the under-saving epidemic with flexible infusions during bumper years. Annuity windows and retirement income products are rolling out in a wave of new offerings, enabled by SECURE 2.0. These new solutions for DC plans meet a distinct need for portable, cost-efficient, guaranteed income.

Annuities are often regarded as cost-prohibitive due to high fees and conservative return assumptions. Yet, fees have come down over time as annuity purchasers have become more sophisticated and cost-conscious while annuity providers have become more transparent and direct in their sales approach. With interest rates meaningfully higher today than over the past 15 years, return assumptions are also more favorable for annuitants. The recent and ongoing development of institutional-quality annuity platforms enables 401(k) participants to select a standardized annuity from many competitive bids.

Innovative retirement income products are rolling out to take advantage of the Qualified Longevity Annuity Contract (QLAC) provision in SECURE 2.0, permitting participants to purchase up to $200,000 in QLACs within their 401(k) plan. QLACs are annuities that defer payment until the latter years of retirement, for example at age 73 or 85. This reduces the cost greatly compared to purchasing an immediate annuity at age 65 for the same monthly benefit payment. A $1,000 immediate annuity contract purchased at age 65 currently pays out around $75 per year, but $300 per year if deferred 15 years.

When Does a DB Plan Make Sense for Your Company?

Offering a hybrid plan can be a significant differentiator to attract and retain desirable employees. The growing disenchantment with DC plans, increased by current economic volatilities such as market fluctuations and high inflation, has led workers to value the stability and predictability of DB plans more than ever. Job-posting platform Indeed reports a 12% increase in searches for positions offering pension benefits over the past three years. Though off a small base, help wanted ads boasting traditional pension benefits surged by 130% over the same period. This trend is particularly pronounced among younger workers, who actively seek these benefits and consider them a key factor in their long-term career planning.

The challenges younger and lower-paid workers face in contributing to DC plans highlight the inclusive advantage of cash balance and profit sharing, which do not require employee contributions for eligibility. This inclusivity aligns well with the desires of a workforce increasingly skeptical about the reliability of Social Security and rising costs. As employers in the tech sector and beyond grapple with the twin challenges of employee retention and talent attraction, adopting a DB plan (or a hybrid approach that includes elements of both DB and DC plans) can not only enhance their value proposition to current and prospective employees but also foster a more loyal, stable, and engaged workforce.

We believe younger, well-educated employees are increasingly concerned about retirement security. To attract them, it's no longer sufficient to give them stock. They expect to gradually accumulate wealth, but they worry greatly about the future and will increasingly appreciate benefits that provide security.

If your company is one of the few with a frozen, overfunded DB plan in addition to a DC plan, you can look to follow IBM's lead. For others, hybrid approaches are worth considering. In talent-scarce industries, creative plan design can become a source of competitive advantage.

Plan Type	DC	DC + Income + Profit-share	Cash Balance	DB
Portability	yes	maybe	yes	no
Funded by	employee + employer match	employee + employer	employer	employer
Investment risk	employee	employee + possible floor	employer (vs. chosen rate)	employer
Longevity risk	yes	limited or none	limited	none

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