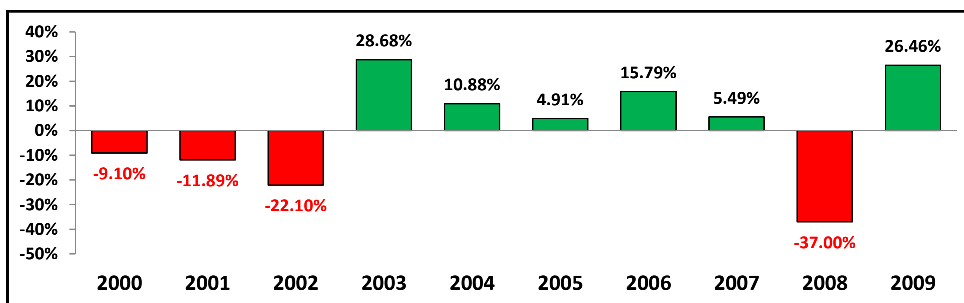
The Smart Way to Manage Market Volatility On NQDC Account Balances

Recent stock market swings find many executives, like you, seeking safer places to put away what's left of wealth accumulation, especially nonqualified deferred compensation (NQDC) balances. Double-digit losses can take a serious toll on nonqualified plan assets.

These at risk assets represent the financial security many executives and key employees anticipate enjoying in retirement. Some account holders report that they are considering postponing their original targeted retirement date due to these shrinking account balances. *Are you?*

Despite the recent run-up in the stock market, many executives remember the economic turbulence during the decade of the 2000's. Following the market downturn in 2000, 2001, 2002 and, again, in 2008, NQDC balances dropped substantially. An executive with a deferred compensation balance of $1 million in 2000, invested in the S&P 500, saw that balance drop 9.1 percent that year, and then again 11.9 percent in 2001 and 22.1 percent in 2002. At the end of 2002, the executive's $1 million account balance was worth only $624,000.

S&P 500 TOTAL RETURN - 2000 thru 2009 (10 Years)



Indices are unmanaged and investors cannot invest directly in an index. Unless otherwise noted, performance of indices do not account for any fees, commissions or other expenses that would be incurred. Returns do not include reinvested dividends.

The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. It is a market value weighted index with each stock's weight in the index proportionate to its market value.

As we all sighed with relief, the market began to rebound in 2003 with a gain of 26.7 percent, and continued gaining each year for the next four years. Assuming our executive stayed invested in the S&P 500, his account balance would have been back up to $1,141,000 by the end of 2007, which was a 1.7 percent return for those eight years.

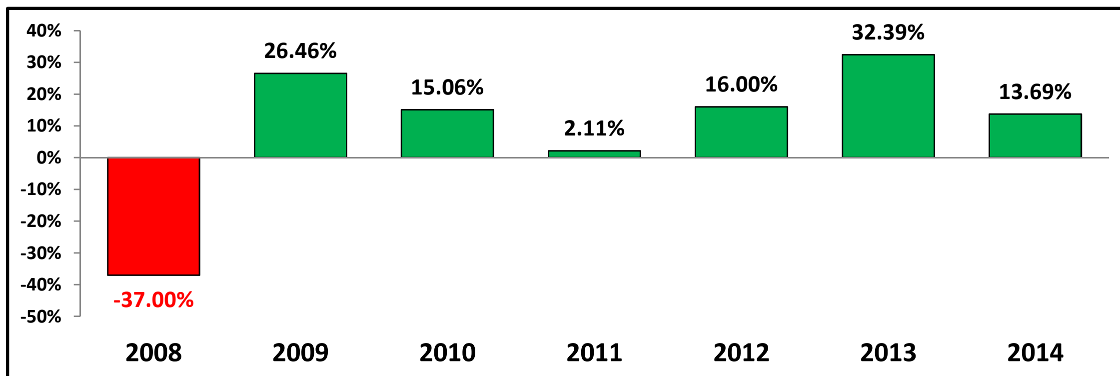
2008 Debacle

Suddenly, 2008 arrived, and we witnessed in disbelief the S&P 500 lose 37 percent. To our executive, that meant a spiral-down to an account balance of $719,000, a single year drop of more than $400,000. Now, go back to 1999: The stock market had finished a remarkable decade, up 18.2 percent annually, and equity linked investments were very popular. But, investing in the S&P 500 (including dividends) during the 2000’s was essentially flat–the so-called “lost decade”–with a compound return of negative .9 percent on a beginning of the decade investment account.

The uncertainty of the market is even more critical in retirement years when you are dependent on your investment portfolio for a large portion of your retirement income. Fast forward to the dilemma facing executives now in 2015. With five straight years of positive results, and some restoration of deferred compensation account balances, the question becomes: *Will the market continue to grow? Will interest rates go up, leading to negative fixed income returns?* Once thought as “safer” investments, money market yields are essentially zero percent. Ugh. What to do?

Let’s look at this recovery period since 2008, and let’s pin this down:

S&P 500 TOTAL RETURN - Market Recovery since 2008



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How do you deal with the ups and downs of the stock market and the economy? Is it possible to get into the market as it is going up and out of the market as it is going down—or practice market timing?

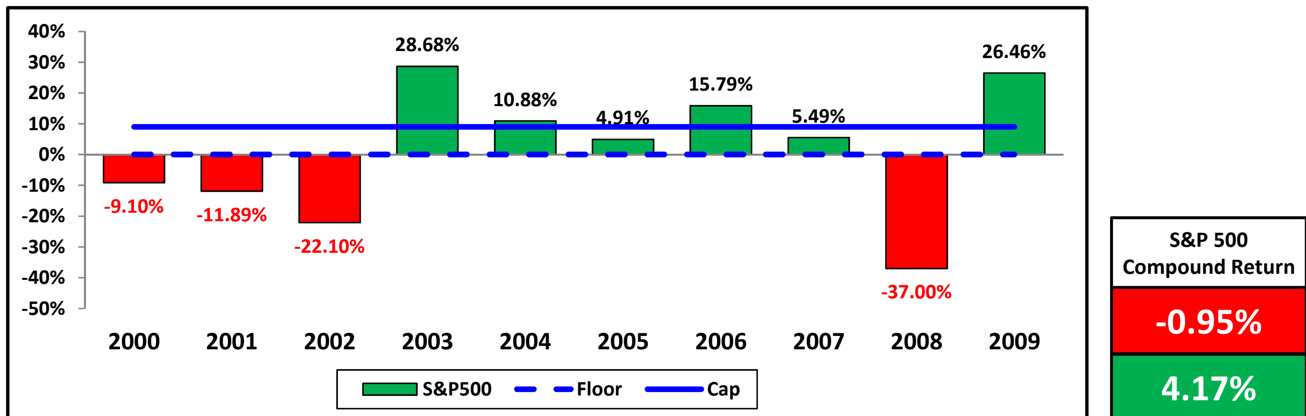
Regrettably, market timing is impossible to do. The other option is to go to fixed income, which in today's low interest environment, with rates likely to head up at some point, could be risky and unattractive. The ultimate solution is to eliminate market losses, again hard to do.

New Nonqualified Investment Option

Not to worry. There is an effective strategy that does not involve a crystal ball. What if, while allocating funds to an account that tracked the S&P 500 (excluding dividends), you could eliminate market losses with a minimum 0% return, in exchange for a cap in any one year's growth at 9 percent; you'd be interested, right?

Using this modified approach (floor of 0%, cap of 9%) during the decade of the 2000's, our executive with a $1 million dollar starting balance could have achieved a **4.2 percent return** compounded annually, compared to a loss of .9% without the floor and cap. See chart below.

S&P 500 TOTAL RETURN w & w/o Collar - 2000 thru 2009 (10 Years)



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Collared Index Strategy—How It's Possible

This modified approach is possible by adding the **"collared index"** to your deferred compensation investment line-up or rolling your account balance into this strategy at retirement to eliminate volatility in your retirement years. The collared index can also be purchased individually on an after-tax basis.

How It Works

When you add an Indexed Option with a Collar to the NQDC plan, participants can:

- Enjoy growth potential based on performance of the S&P 500 (excluding dividends)
- But with protection from investment losses (due to 0% minimum crediting rate)
- In exchange for a cap on return; that is, 9% - 12% annually

Importantly, the Collared Index Strategy helps reduce **two investor fears**:

1. Fear of suffering significant losses from market declines
2. Fear of being out of the market and missing upside returns

Executive Benefit Solutions can demonstrate for you how to incorporate a collared option into your NQDC plan, as well as how corporate finance can hedge the liability in order to eliminate P&L volatility and reduce cost. Here's to better days ahead.

See you on the upside,

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Managing Directors

Note: The examples used in this blog are hypothetical and are intended for illustration purposes only. The examples used were historic returns and pricing, past performance is no indication of future performance.

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