Market & Legal Update

OCTOBER 2023 REVIEW

USI CONSULTING GROUP

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MARKET UPDATE | All Eyes on the Fed

Stocks investors received no reprieve from September's declines as equity markets declined again in October. Interest rates moved higher in October to 4.9%, as measured by the 10-year Treasury Bond. Rising rates and growing geopolitical concerns in the Middle East, Ukraine and China have undermined both investor and consumer confidence. More importantly, inflation is slowing but there may be still more work for the Fed to do to avoid a recession or a "hard landing."

As expected, the markets reacted negatively to these conditions, as the Dow Jones Industrial Average, S&P 500 and NASDAQ all fell in October, leading to a poor start to the fourth quarter. The tech-heavy NASDAQ declined 2.8% for the month while the S&P 500 Index dropped 2.1% for the month. Finally, the Dow Jones Industrial Average posted a 1.3% loss for the month. On the fixed income side, as rates jumped across the board, bond prices fell in October. The Bloomberg U.S. Aggregate Index lost 1.6% for the month.

Market Return Indexes	Oct 2023	3rd Quarter	YTD 2023
Dow Jones Industrial Average	-1.3%	-2.1%	1.4%
S&P 500	-2.1%	-3.3%	19.7%
NASDAQ (price change)	-2.8%	-3.1%	22.8%
MSCI Eur. Australasia Far East (EAFE)	-4.1%	-4.1%	14.4%
MSCI Emerging Markets	-3.9%	-2.8%	10.8%
Bloomberg High Yield	-1.2%	0.5%	6.2%
Bloomberg U.S. Aggregate Bond	-1.6%	-3.2%	0.4%
Yield Data	**Oct 2023**	**Sept 2023**	**Aug 2023**
U.S. 10-Year Treasury Yield	4.90%	4.59%	4.09%

The September Consumer Price Index (CPI) report showed that Headline inflation held steady at 3.7% on an annual basis according to the U.S. Department of Labor (DOL). However, core CPI, which strips out the volatile food and energy components, rose 4.1%, slightly cooling from 4.3% in August. These measures are important data indicators for the Fed in terms of whether another interest rate hike is necessary, as the Fed has already hiked its benchmark Fed Funds rate to its highest level in 22 years.

On the positive side of price pressures, in addition to slower increases in core inflation, wages are also rising more slowly as of late—the annualized rate over the last three months is close to the target inflation measure of 2.0%. Labor costs are also expected to cool in services where wage pressures are most acute. However, the UAW and Kaiser Permanent strikes show strong worker leverage, especially with unemployment below 4%. This suggests wage pressures remain. Stabilizing prices, coupled with strong U.S. retail sales, should be encouraging to the Fed, especially given that retail sales grew 0.7% in September, far exceeding economists' expectations. So, clearly progress is being made by the Fed in stabilizing prices without running the economy off the cliff.

In addition to stabilizing prices, the economy posted stronger than expected growth in the third quarter. In fact, U.S. Gross Domestic Product (GDP) rose at a 4.9% annualized rate in the third quarter, ahead of the 4.7% predicted by economists. Most experts attribute this growth to contributions from a host of sectors, including consumer and government spending. Accordingly, this is a strong reminder that the behavior of the U.S. consumer, critical to the U.S. economy, shows some reasons for concern. Indeed, consumer confidence fell below 80 in September, which is an indicator of a recession occurring in the next twelve months. This glum outlook of the U.S. consumer can be attributed, but not limited to, dwindling pandemic savings (fell almost 4% in September versus a rise of 32% during the pandemic peak), higher interest rates, and inflation. In terms of consumer financial health, September personal savings was 3.4% versus the historical average of 8.5% (since 1960), default rates are rising, and consumers face higher interest rates. These factors will place negative pressure on future economic growth.

Looking ahead, several risks may persist, thus jeopardizing the Fed's plan for a soft landing or otherwise avoidance of a recession. These include climbing gas prices, geopolitical concerns, higher interest rates and further losses in bonds (headed for a third straight year of losses in 2023), as well as further dents to consumer confidence. Corporate earnings are also another risk for equity investors. Although they remain relatively strong, under various economic pressures they could fall short of analyst projections that could result in market volatility. As the Fed continues to digest incoming data, Fed Fund futures currently indicate there is virtually zero chance of a rate rise this month, a low probability for a rise in December, and an expected decline in rates by 2025. However, it is still unclear whether the Fed will need to raise interest rates further in the future, although rising long term rates have stayed the Fed's hand on raising rates further this year. Despite more recent positive economic data this reflects activity in the past. Therefore, despite the economic uncertainty, clearly the Fed must continue to perform a delicate balancing act by ensuring stable prices without risking an economic downturn. Given these looming risks, the Fed cannot claim victory just yet.

A Primer on Auto-Enrollment for 401(k) Plans

The automatic enrollment of employees in an employer's 401(k) plan (referred to as an Automatic Contribution Arrangement or "ACA") has become an increasingly popular plan design option for 401(k) plan sponsors in recent years. Auto-enrollment plans provide certain advantages, both to employers and employees, and the implementation of auto-enrollment plans has been encouraged by both the Internal Revenue Service (IRS) and the Department of Labor (DOL) as a means of ensuring that employees have sufficient resources available to support themselves in retirement.

There are, however, certain costs and administrative burdens for plan sponsors attendant to the implementation and administration of auto-enrollment plans, so plan sponsors who are considering adopting an auto-enrollment design would be well advised to seek out the advice of a competent retirement plan consultant to review the advantages and disadvantages of adopting such a design.

Following is a summary of the various types of auto-enrollment designs and design considerations.

What Auto-Enrollment Means

Auto-enrollment is a retirement plan savings feature where employees are automatically enrolled in the plan at a default contribution rate unless they actively opt out. In addition to the default contribution rate, there is a default investment option selected for employees who do not actively choose their investments. In most cases plans use a Qualified Default Investment Alternative (QDIA), such as a target date fund, designed to protect the interests of the plan participants. The advantage of adding an auto-enrollment feature is thus that, through leveraging employee inertia, it encourages more employees to actively participate in their employer's 401(k) plan to save for retirement, possibly obtain an employer matching contribution, and obtain certain other advantages.

Types of Auto-Enrollment Plans

There are four basic types of auto-enrollment plans, each of which generally has more stringent requirements (and provides greater plan sponsor advantages) than the prior type, except for the last type (see Mandatory Automatic Contribution Arrangement below) which was recently enacted into law under the SECURE 2.0 Act of 2022 for plans first established on and after December 29, 2022. The sections below describe the various required and optional auto-enrollment plan design features and provisions, as well as the potential plan sponsor costs, benefits and administrative requirements.

1 (Basic) Automatic Contribution Arrangement ("ACA")

For plan sponsors, an ACA provides the greatest design flexibility and is potentially the least costly auto-enrollment option, though it provides only limited advantages. Plan sponsors generally have broad discretion regarding the default investment option that will be used for employees who are auto-enrolled under the plan, the groups of employees subject to the auto-enrollment feature, the respective automatic contribution percentage(s) for each group and increases in such percentage(s) in future years. The main advantage of implementing an ACA for a plan sponsor is that it could increase the plan participation of lower paid employees, which could help the plan pass its non-discrimination (ADP and ACP) tests. The main disadvantage of an ACA are potential increases in the cost of employer matching contributions (for plans that provide them), the inability to refund contributions made by employees who did not want to participate, but inadvertently failed to opt out of the ACA, and the cost and administrative burden of providing notices to new employees, enrolling them in the plan and having additional "small balance" participant accounts in the plan.

2 Eligible Automatic Contribution Arrangement ("EACA")

An EACA provides a plan sponsor with greater advantages, albeit at the cost of some plan design discretion. Unlike an ACA, plan contributions of auto-enrolled employees must be invested in a QDIA, and, while the plan sponsor has discretion to set the default contribution percentage and subsequent increases in future years, such default percentage and increases must be applied uniformly to all employees subject to the EACA. In exchange for complying with these provisions, plan sponsors receive enhanced fiduciary protection under ERISA and are permitted to refund contributions made by employees who inadvertently fail to opt out of the EACA up until 90 days of their initial enrollment.

In addition, if, at the time that a plan sponsor adopts an EACA, such EACA covers both existing employees who did not previously make an "affirmative" election to participate or not participate in the plan as well as new employees, the plan sponsor receives an automatic extension to perform its annual 401(k) non-discrimination testing (and refunds, if applicable) until June 30th rather than March 15th, after each plan year for a calendar year plan. While EACAs are subject to most of the same disadvantages as ACAs (i.e., increased matching contribution costs and added administrative burdens), in addition to the testing advantage of ACAs, EACAs provide enhanced ERISA fiduciary protection, the ability to refund the plan contributions inadvertently made by employees who did not want to participate in the EACA and a three and a half month testing extension.

3 Qualified Automatic Contribution Arrangement ("QACA")

A QACA is essentially a special type of EACA that must satisfy certain additional requirements in exchange for providing a plan sponsor with an exemption from its annual non-discrimination (ADP and ACP) testing requirements. A QACA is thus also a hybrid between an auto-enrollment 401(k) plan and a traditional "safe harbor" 401(k) plan, which similarly exempts a plan sponsor from non-discrimination testing, and which will be discussed in greater detail in a future article in this series.

Unlike both ACAs and EACAs, which have no minimum auto-enrollment contribution percentage or required employer contributions, QACAs require both, and generally must cover all employees who are participants in the plan, regardless of when they were hired.

Under a QACA, at the time of initial plan eligibility (or for employees who were already eligible to participate in the plan at the time that the QACA is adopted) any employee who does not make (or did not previously make) an affirmative election either to opt out of the QACA or to contribute a different percentage must be auto-enrolled in the plan at a minimum employee contribution rate of at least 3% (but not more than 10%) of plan eligible compensation. After being auto-enrolled, the minimum contribution rate for any employee who does not affirmatively opt out (or elect a different contribution amount or percentage) increases to 4%, 5% and 6% over the following three years, after which, at the plan sponsor's discretion, such default contribution rate may continue to increase up to as much as 15%. Such contribution rates (and steps) must also be uniformly applied to all plan eligible employees.

In addition, the primary disadvantage of adopting a QACA is the mandatory employer contribution requirement. A plan sponsor who adopts a QACA must make either a non-elective contribution equal to 3% of the compensation on behalf of all eligible plan participants or an employer matching contribution equal to 100% of the first 2% of compensation contributed by each eligible participant plus 50% of the next 5% of compensation contributed by eligible participants. While a two-year "cliff" vesting schedule may be applied to such contributions, the likely cost of such contributions (especially in light of the auto-enrollment feature), might be prohibitively expensive if a plan sponsor's main purpose in adopting the auto-enrollment feature is simply to improve its 401(k) plan non-discrimination testing results.

4 (Mandatory) Automatic Contribution Arrangement ("MACA")

Under the recently enacted SECURE 2.0 Act of 2022, most new 401(k) plans that are adopted and established after December 29, 2022, must include certain auto-enrollment provisions similar to the EACA type plans described above, with minimum employee contributions of between 3% and 10% of compensation (for employees who do not make an affirmative elect to opt out or contribute a different amount or percentage of their compensation into the plan), and annual increases of 1% per year up to a minimum of 10% of compensation, but with no mandatory employer contributions. This new auto-enrollment mandate is a further indication of governmental encouragement for plan sponsors to adopt auto-enrollment provisions in their plans and additional guidance is expected from the IRS regarding this new plan mandate.

Related Issues & Conclusions

As noted in our **April 2023 Market & Legal Update**, under the SECURE Act of 2019 and the SECURE 2.0 Act of 2022, beginning January 1, 2024, certain long-term part-time (LTPT) employees who work at least 500, but less than 1,000, hours per year, and who previously were excluded from participating in their respective employers' 401(k) plans may need to be permitted to do so, at least with respect to their own (employee) 401(k) contributions. While plan contributions made by such LTPT employees are not subject to IRS non-discrimination testing and certain other requirements (i.e., Top-Heavy minimum contributions, etc.), neither of the above statutes addresses whether (and how) the EACA, QACA or MACA requirements affect such LTPT employees, or a 401(k) plan's satisfaction of the rules regarding EACA's, QACA's or MACA's and the IRS has also not issued any guidance with respect to such issues.

In light of the above, we recommend that plan sponsors who currently maintain plans that have EACA or QACA provisions obtain affirmative elections from any eligible LTPT employees as to whether or not they wish to participate in or opt out of 401(k) plans that they are eligible to participate in, if possible, and that such employees be treated similarly to other employees who are covered under such plans, pending the issuance of IRS guidance.

How USI Consulting Group (USICG) Can Assist

With the proper plan design, the advantages of auto-enrollment can far outweigh the disadvantages. The USICG team can assist with plan design considerations and help answer any questions that you have regarding auto-enrollment.

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Retirement Resources for You

USI Consulting Group's team of experts is happy to assist employers with all retirement plan compliance matters and changes in the market, including those discussed here, to help you mitigate risk and financial impact to your organization.

To learn more, please contact your local USICG representative, visit our **Contact Us** page or reach out to us at **information@usicg.com**.

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An index is a measure of value changes in a representative grouping of stocks, bonds, or other securities. Indexes are used primarily for comparative performance measurement and as a gauge of movements in financial markets. You can not invest directly in an index and, for comparative purposes; they do not reflect the effect of the various fees inherent in actual investment vehicles.

The S&P 500 Index is a market value weighted index showing the change in the aggregate market value of 500 U.S. stocks. It is a commonly used measure of stock market total return performance.

The Dow Jones Industrial Average is a price weighted index comprised of 30 actively traded blue chip stocks; primarily industrial companies, but including some service oriented firms.

The NASDAQ Composite Index is a market-value weighted index that measures all domestic and non-U.S. based securities listed on the NASDAQ Stock Market.

Gross Domestic Product (GDP) is the market value of the goods and services produced by labor and property in the U.S. It is comprised of consumer and government purchases, net exports of goods and services, and private domestic investments. The Commerce Department releases figures for GDP on a quarterly basis. Inflation adjusted GDP (or real GDP) is used to measure growth of the U.S. economy.

The MSCI Europe and Australasia, Far East Equity Index (EAFE) is a market capitalization weighted unmanaged index developed by Morgan Stanley Capital International to measure approximately 1,100 securities in 21 major overseas stock markets. It is a commonly used measure for foreign stock market performance.

The Barclays Capital U.S. Aggregate Index covers the U.S. Dollar denominated investment grade, fixed-rate, taxable bond market of SEC-registered securities.

The Barclays Capital U.S. Corporate High Yield Index covers the U.S. Dollar denominated, non-investment grade, fixed income, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's Fitch, and S&P is Ba1/BB+/BB+ or below.

The MSCI Emerging Markets Index (EM) is a free-float-adjusted market-capitalization index developed by Morgan Stanley Capital International. It is designed to measure the equity market performance of 26 emerging market countries.

The 10 Year Treasury Yield is the interest rate the U.S. government pays to borrow money for a 10-year period. In addition to influencing how much the government pays to borrow over this time-frame, the 10-year Treasury Yields also determines how much investors earn by investing in this debt and it is a good indicator of investor sentiment

The higher the yield, the better the economic outlook.

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