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M Financial Group™

Q2 2021

QUALIFIED PLAN NEWS

CAPITAL MARKETS REVIEW						PERIOD ENDING JUNE 30, 2021
Index	Qtr	Ytd	1 Yr Return	3 Yr Return	5 Yr Return	10 Yr Return
S&P 500 TR USD	8.55	15.25	40.79	18.67	17.65	14.84
Russell 2000 TR USD	4.29	17.54	62.03	13.52	16.47	12.34
Russell 3000 Value TR USD	5.16	17.67	45.40	12.23	11.99	11.54
Russell 3000 Growth TR USD	11.38	12.71	42.99	24.47	23.31	17.54
MSCI ACWI Ex USA NR USD	5.48	9.16	35.72	9.38	11.08	5.45
BBgBarc US Agg Bond TR USD	1.83	−1.60	−0.33	5.34	3.03	3.39
FTSE Treasury Bill 3 Mon USD	0.01	0.03	0.08	1.31	1.14	0.60

MARKET COMMENTARY

The U.S. equity market gained 8.2% during the quarter as progress toward the full reopening of the U.S. economy continued, which was aided by the distribution of COVID-19 vaccines. News of an agreement in the Senate late in June to approve the infrastructure bill supported stocks through the end of the quarter.

Large-cap stocks outperformed both the mid- and small-cap segments of the market in the quarter. All capitalization segments of the market posted strong returns in the year-to-date period, with small-cap stocks outperforming mid- and large-cap stocks by 1.2 and 2.2 percentage points, respectively. Growth stocks outperformed value stocks by 6.2 percentage points in the quarter. Concerns over rising inflation and increasing interest rates decreased, leading to the favorable relative performance of growth stocks in the period. Value stocks exceeded growth stocks in the year-to-date period by 5.0 percentage points.

The energy sector posted the strongest return for the third consecutive quarter. Rising demand for oil and natural gas drove prices higher as economies around the world continue to reopen. The financial services sector has continued to produce strong relative performance in the year-to-date period. Despite a decline in longer-term interest rates in the quarter, the yield curve has steepened from where it started the year, and a steeper yield curve increases the prospects for lenders' profits on longer-term loans. The utilities' and consumer staples' sectors had the weakest relative returns for the second straight quarter. These two sectors are historically more defensive and lagged the broad market as investors generally favored more growth-oriented companies in the period.

Despite a modest decline in the U.S. dollar, international equities trailed U.S. equities in the quarter, returning 5.5%. Vaccination rates have generally trailed the U.S., and economic restrictions in many countries remain stricter than those in the U.S., resulting in a slower recovery in many non-U.S. economies.

Continental Europe returned 7.8% in the quarter, as the rollout of its vaccination programs increased and assurances for continued support from the European Central Bank aided returns in the quarter. While vaccination rates in Emerging Market countries have generally trailed those in developed market countries, the continued recovery of commodity prices was supportive to stocks in many emerging markets.

Chinese equities returned 2.3% in the quarter as the favorable outlook for a global economic recovery was largely offset by concerns regarding stricter regulation of its large technology companies by the Communist government. Most regions produced positive equity returns during the quarter as global economic activity and outlook was supported by continued distribution of COVID-19 vaccines and reopening of economies.

Preliminary estimates from a subset of core real estate managers show a positive return of over 3% for the quarter. Over the last year, industrial and multifamily properties have performed better than holdings within the office and retail segments of the market. Most managers in the NCREIF ODCE index have maintained redemption queues, although some have increased recent payments to investors seeking liquidity. Public market REITs increased over 11% in the period, responding to improving fundamentals as COVID-19 restrictions eased.

The U.S. fixed income market returned 1.8% in the quarter. The Federal Reserve made no changes to policy at the June meeting but indicated that interest rate hikes could occur one year earlier than previously projected and that they were discussing tapering asset purchases. The Fed continues to communicate that it believes the recent higher inflation is transitory.

The 10-year treasury yield declined from 1.74% to 1.45% during the quarter and U.S. government issues rose 1.7% as a result. Investment grade credits advanced 3.3%, while non-investment grade corporate bonds rose 2.7%. Agency mortgages and other securitized bonds experienced positive results but were more muted than other spread sectors.

TIPS increased 3.3%, which outperformed nominal treasuries in the quarter as inflation expectations increased. The breakeven inflation rate implied in 10-year U.S. TIPS ended the quarter at 2.32%. The realized annual CPI was 5.0% through May 2021. The annualized number is elevated due to the impact of the lockdown on prices during the first half of 2020.

Municipal bonds rose 1.4% in the quarter due to robust investor demand and strong tax revenues. Developed non-U.S. government bonds increased 0.4% in the quarter. Emerging market bonds experienced positive results in the quarter, ranging from 2% to 4%.

CONSIDERING A ROTH 401(K)?

The Roth 401(k) option is becoming increasingly popular with plan sponsors. What general rules and requirements should sponsors know about when considering adding this feature?

Benefits of a Roth 401(k)

Although traditional 401(k)s and Roth 401(k)s have many similarities, they have many important differences. With a traditional 401(k), participants make retirement plan contributions with pretax dollars. For 2021, participants may contribute up to $19,500 ($26,000 if age 50 or older). Taxes on contributions and earnings are deferred until participants take distributions. At that point, withdrawals are included in income, and participants pay taxes based on their tax rate at that time.[1]

In contrast, a Roth 401(k) combines certain features of a traditional 401(k) and a Roth individual retirement account (IRA). As with a Roth IRA, contributions to a Roth 401(k) are made with after-tax dollars. Qualified distributions of contributions—as well as any earnings—from a Roth 401(k) account are income tax free.

To qualify for tax-free treatment, a Roth 401(k) distribution must be made after a five-tax-year period beginning with the first tax year for which the participant made a designated Roth contribution under the same plan. Additionally, the participant must have reached age 59½ or the distribution must be made after the participant's death or because of disability. Unlike Roth IRAs, Roth 401(k)s do not allow a qualified distribution for a first-time home purchase.

The maximum annual contribution to a Roth IRA for 2021 is $6,000 ($7,000 if age 50 or older), and eligibility for Roth IRA contributions is phased out as income rises. No such income limits apply to a designated Roth 401(k) account—a feature that might appeal to highly compensated employees. Moreover, plans may allow eligible participants to make designated Roth contributions up to the limits set for traditional 401(k) plans. These limits will apply to pretax and after-tax Roth contributions combined. Employers may make matching contributions on designated Roth contributions, but they must allocate any matching contributions to a pretax account.

A plan may not consist solely of designated Roth accounts—if offering a Roth 401(k) option, the sponsor must also offer a traditional 401(k) plan. Participants may then be allowed to designate some or all their elective deferrals as Roth 401(k) contributions.

Implementing a Roth 401(k)

When considering a Roth 401(k) option, sponsors should be aware of the need to comply with additional administrative requirements. To implement a Roth 401(k), the sponsor must adopt an appropriate plan amendment by the end of the plan year for which the amendment is effective. Participants must receive amended plan notifications, including an updated summary plan description and election forms. Educational materials may need to be updated as well.

Plans must keep separate accounts for each participant's Roth 401(k) and traditional 401(k) accounts, and employers will need to change their payroll systems to accommodate Roth contributions. If recordkeeping is outsourced, service providers will need to properly account for Roth 401(k) contributions and any earnings.

In-Plan Rollovers

Sponsors may also want to amend their plans to allow participants to make "in-plan Roth rollovers" from their traditional 401(k) accounts to their Roth 401(k)s. Participants who choose to make in-plan Roth rollovers will be subject to income tax on any previously untaxed amounts that are rolled over. However, the 20% withholding requirement that generally applies to eligible rollover distributions does not apply to direct in-plan rollovers. Also, in-plan Roth rollovers are generally not subject to the 10% additional tax on early distributions.

Plans may choose to allow in-plan Roth rollovers even where the amounts are not otherwise distributable under the plan's terms. However, once the rollover is completed, any distribution restrictions that applied before the rollover will again apply to both the rolled-over amount and any earnings thereon.

[1] Penalty-free "coronavirus-related" distributions (CRDs) were available in 2020 under the CARES Act.

Nondiscrimination Testing

Plans may not discriminate in favor of highly compensated employees when offering a Roth 401(k). Additionally, designated Roth 401(k) contributions are treated as elective contributions for purposes of the actual deferral percentage test.

The foregoing is a broad overview of the relevant rules. If you are considering adding a designated Roth contribution option to your plan, consult your financial, tax, or legal professional.

CHOOSING A RETIREMENT PLAN THAT MAXIMIZES BENEFITS FOR OWNERS AND KEY EMPLOYEES

With the various restrictions and limitations on retirement plan contributions and benefits, small-business owners and professionals may wonder whether it is possible to fund adequate retirement benefits for themselves using a tax-qualified plan. In many cases, it is—if the most appropriate plan design is chosen.

Why So Many Restrictions?

Many of the restrictions and limitations added to the federal tax code in the pension area have been aimed at making plans nondiscriminatory—that is, making sure the plan doesn't discriminate in favor of a firm's highly paid employees. In some cases, the perhaps unintended effect of the restrictions has been to dampen enthusiasm for retirement plans because business owners question whether the benefits they will receive justify the expense of maintaining a plan.

What plans should a business owner who is concerned about funding his or her own retirement consider? Several possibilities are discussed below.

Age-Based Profit-Sharing Plan

One type of plan that may be appropriate for many small-business owners and professionals is the age-based profit-sharing plan. The plan combines the traditional benefits of a profit-sharing plan with the ability to allocate employer contributions to participant accounts using factors that consider both compensation and age. In contrast, traditional profit-sharing plans allocate contributions based only on compensation, with each participant receiving a flat percentage of pay.

If employee demographics favor the age-based approach, more of the annual profit-sharing plan contribution is shifted to the accounts of the older owner(s) and key employees participating in the plan. In some instances, the total plan contribution can be lowered while allocations to the owner and the key employees remain at the same levels—or even increase.

Target Benefit Plan

This type of plan is a cross between a defined benefit pension plan and a money purchase plan. It uses actuarial assumptions—including assumptions about remaining years to retirement—in determining the amount to be contributed for each participant. As with an age-based plan, no more than $57,000 a year (in 2020) can be added to each employee's account, regardless of compensation or age. However, the plan is not as flexible as an age-based plan in that an annual employer contribution is generally required.

Defined Benefit Pension Plan

If the per-employee cap on additions to a plan account is a source of concern, a traditional defined benefit pension plan can often provide more lucrative benefits. With this type of plan, the closer a participant is to retirement age and the larger the promised retirement benefit, the higher the plan contribution, all else being equal.

Other Considerations

Before implementing any of these plans, the effect of the tax law's top-heavy rules should be analyzed. These rules generally are triggered when key employees hold more than 60% of the account balances or accrued benefits in all plans sponsored by the employer. When a plan is top heavy, every active participant must receive a minimum contribution or benefit (3% of pay for a defined contribution plan).

WEB RESOURCES FOR PLAN SPONSORS

Internal Revenue Service, Employee Plans
› irs.gov/ep

Department of Labor, Employee Benefits Security Administration
› dol.gov/ebsa

401(k) Help Center
› 401khelpcenter.com

BenefitsLink
› benefitslink.com

Plan Sponsor
› plansponsor.com

Plan Sponsor Council of America
› psca.org

Employee Benefit Research Institute
› ebri.org

S&P 500 is a commonly used measure of common stock performance. Russell 2000 is a commonly used measure of small capitalization stocks. Russell 3000 Value measures performance of U.S. equity universe broad value segment with lower price-to-book ratios and lower forecasted growth values. Russell 3000 Growth measures performance of Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. MSCI ACWI EX U.S. tracks 850 stocks traded in 22 world markets (excludes U.S. based stocks). Barclays U.S. Aggregate Bond Index tracks domestic investment grade bonds (including corporate, government, and mortgage-backed securities). Citigroup 3-Month U.S. Treasury Bill Index tracks short-term U.S. government debt instruments. All referenced indices are unmanaged and not available for direct investment. Past performance is not a guarantee of future results.

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