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Inflation Op-Ed by Hal S. Scott

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The Secure Act 2.0 that passed the House on March 29 by an overwhelming 414-5 bipartisan majority makes desirable changes in retirement plans by permitting automatic enrollment, increased contributions and later required minimum distributions. Given inflation at 7.9%, the highest rate since January of 1982, it could be significantly improved by allowing retirement plans to invest in individual treasury securities.

Research shows that in times of high unexpected inflation, risk aversion increases. For those most concerned with the protection of their investment principal, those nearing retirement, treasuries with negligible default and low market risk, compared to equities, may often be the right choice. But the ability of retirees to make this shift is severely restricted.

Investment choices provided by non-profits are limited by Section 403(b) of the Internal Revenue Code, a 1974 amendment to the Employment and Retirement Security Act (ERISA). Over 10% of the workforce, 12.3 million workers, are in the U.S. non-profit sector. Of the total private defined contribution retirement plans of $11.0 trillion, as of December 31, 2021, $1.3 trillion was in non-profit 403(b) plans. The 1974 amendment expanded investment options, enjoying no tax on earnings, beyond annuities, to include mutual funds, but did not permit investment in individual securities. A similar restriction applies to federal employees under 457 plans. The rationale for this ERISA limitation makes sense in principle, since a major purpose of that Act is the protection of employees against undue speculation and concentration of risk through imposing a fiduciary duty obligation on employers.

As a result, employees of non-profits or the federal government seeking to protect their principal by investing in treasuries can only do so through investing in treasury bond funds—they cannot buy individual treasuries. But investments in bond funds exposes these investors to loss of principal since, given inflation, such funds may sell at a discount from the par value of the underlying treasuries. Why? These bond funds do not hold all their treasuries to maturity because they must buy and sell treasuries to reflect new investments or redemptions, and to keep the fund's portfolio at a promised constant maturity. Thus, a three-year bond fund would need to replace or offset three-year underlying treasuries as they mature. This risk is reflected in the fact the iShare 1-3 year treasury fund is down -3.37% in 2022, according to Morningstar.

Investors in individual treasuries could avoid this risk by just holding the treasuries to maturity. And they could choose the maturity they desired by laddering different maturities in their portfolios. Apart from inflationary concerns, employees might also prefer individual treasuries to avoid management fees, admirably low but still present.

For-profit employees are in a potentially better position. Their retirement defined contribution investment options are governed by Section 401k of the Internal Revenue Code enacted in 1978. 401k investments constituted $7.70 trillion as of December 31, 2021. Under this provision, employers offer their employees certain designated investment options which could include individual securities, including treasuries. But to my knowledge, they do not do so, probably out of concern with liability under ERISA for breach of fiduciary duty.

But employees in 401k plans can also invest in a wider range of investments, including individual securities, through "brokerage windows." However, according to a December 2021 Department of Labor report, only 23.2% of all retirement plans and only 40% of plans with more than 5,000 participants, offer such windows. And a Vanguard study of the plans it administers, shows that only 20%

of such plans offer windows with access to any individual securities. Such limited access also probably reflects concern with potential liability under ERISA, given some lower court decisions extending the fiduciary duty to brokerage windows.

Both non-profit and profit employees can buy Treasury Inflation-Protected Securities (TIPS), through TIPS funds. But TIPS are only available in a minimum of 5-year maturities. If one thinks inflation is a shorter-term problem, this length of protection is unnecessary, but it is still priced into the cost of TIPS. Further, TIPS will only perform better than treasuries if the stated CPI (to which protection is geared) is higher than what the market anticipates. Any investor can use her own self-provided retirement accounts like IRAs, which totaled $13.9 trillion as of December 31, 2021, to invest in individual treasuries, but these investments do not enjoy the employer-provided retirement account tax advantage.

I am not recommending that individuals purchase individual treasury securities as part of their retirement funds, only that they should have the option to do so. Obviously, inflation protection had not been a concern since the early 1980s. So, there was no reason to worry about the inability of investors to invest in individual treasuries. Now there is.

For retirement plans of non-profits and the federal government, this requires an amendment to the Internal Revenue Code permitting the option of investing in individual treasury securities—restrictions on investing in other individual securities should remain. This modification can be done through a Senate amendment to the Secure Act 2.0., now pending in the Senate. That Act should also provide a safe harbor from ERISA liability for all employers offering individual treasury options, either directly or through brokerage windows.

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