Retirement Plan Newsletter

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Markets in Review

Since reaching respective all-time highs on February 2025 and December 2024, the S&P 500 Index[1] and the Nasdaq Composite Index[2] both reached correction territory in Q1 2025, indicating a decline of between 10% and 20% from these record levels. A deeper analysis, however, reveals that the Q1 2025 market environment was impacted by both a broad-based selloff and a market rotation, both of which were triggered by concerns about the prospect of slowing economic growth and the impact of proposed tariffs from the new presidential administration.

On the market rotation front, we believe the Q1 2025 market environment is best characterized by a material shift away from growth-oriented and more economically sensitive stocks to value-focused and defensive equities. Perhaps the best example of this performance divergence is the tech-heavy Nasdaq-100 Index[3], which declined by 8.1% in Q1 2025 compared to a comparatively smaller 0.9% loss in the more value-oriented Dow Jones Industrial Average[4]. In addition, while growth and cyclical sectors lagged, defensive and value focused sectors outperformed[5], further demonstrating that the first three months of 2025 were defined by both a broad-based correction and a rotation out of growth and into value.

As a further consequence of this market rotation, market breadth improved considerably, and domestic stock index performance became less reliant on a handful of mega cap technology and technology adjacent stocks. For an example of this trend, consider that after narrowing in Q4 2024, market leadership broadened materially in Q1 2025 as the market-cap weighted S&P 500 Index declined by 4.3% compared to a 0.7% drop in the S&P 500 Equal Weight Index[6], indicating a 359 basis point performance advantage for the broader version of the index, which in turn signals broader market leadership.

The improved market breadth did not extend to small and mid-cap ("SMID") U.S. listed stocks, however, with the SMID-focused Russell 2000 Index[7] declining by 9.5% in Q1 2025. SMID stocks in the U.S. were seen as being more vulnerable to both slowing economic growth and tariff-induced inflation, hampering share price performance in this segment of the market. In addition, a more cautious approach to near-term rate cuts by the Federal Reserve appeared to indicate that rates were destined to remain higher for longer, possibly continuing to pressure highly levered SMID companies via elevated interest expense.

After materially lagging U.S. equities for the last several years, international stocks significantly outperformed their U.S. counterparts in Q1 2025. The MSCI World ex USA Index[8] appreciated by 6.3% in Q1 2025, led to a large extent by European equities. In the Eurozone, a combination of attractive relative valuations, accommodative monetary policy from the European Central Bank, and fiscal stimulus from countries such as Germany propelled the iShares Core MSCI Europe ETF[9] up by 11.4% in Q1 2025.

Emerging market equity performance was only modestly worse than that of developed markets, with the MSCI Emerging Markets Index[10] appreciating by 4.5% in the quarter, driven by robust performance from Chinese equities. A significant rally in Chinese stocks, particularly in technology and AI-related stocks, was sparked by optimism surrounding innovations such as the DeepSeek AI model, which was released in early 2025. This enthusiasm was further buttressed by Beijing's perceived shift to a more supportive policy stance relating to the private sector and technological innovation.

After cutting the federal funds rate by 100 basis points from September 2024 to December 2024, the Federal Open Market Committee of the Federal Reserve System ("the Fed"), opted to stay put at the late January 2025 and mid-March 2025 meetings. In its 3/19/25 press release, although the Fed stated that economic uncertainty has increased and inflation remained elevated, it also highlighted robust growth in economic activity and solid labor market conditions.[11] The Fed's updated Summary of Economic Projections released on 3/19/24 indicated a median expectation among Federal Open Market Committee members of two 25 basis point rate cuts in 2025, down from an expectation of four 25 basis point cuts in September 2024. 30-Day Fed Funds futures prices imply a more aggressive rate cutting path, perhaps in response to more concrete information on tariffs that came to light on 4/2/24. 30-Day Fed Fund futures prices currently suggest an expectation of four 25 basis point rate cuts by year end.[12]

10-year U.S. Treasury yields were on the rise from the beginning of the quarter until 1/13/25, when a year-to-date peak of 4.81% was reached. This initial surge in yields was driven by a combination of strong economic data, shifting expectations about Federal Reserve policy, and heightened inflationary concerns tied to proposed tariffs from the incoming Trump Administration. From mid-January to the end of the quarter, however, growing pessimism about U.S. economic growth resulted in the 10-year U.S. Treasury yield contracting to close at 4.20% on 3/31/25. The protracted decline in Treasury yields resulted in the Bloomberg Aggregate Bond Index[13] increasing by 2.8% in Q1 2025. The biggest gains came from long duration bonds, which tend to be more sensitive to changes in interest rates and interest rate expectations. As a case in point, the iShares 20+ Year Treasury Bond ETF (TLT)[14] appreciated by 4.9% in Q1 2025 compared to a 1.6% increase in the iShares 1-3 Year Treasury Bond ETF (SHY).[15]

On the commodity front, intensifying U.S. sanctions on Russia and Iran, OPEC+ production cuts, and unusually cold weather in the Northern Hemisphere caused the price of Brent Oil to surge by 9.9% from 1/1/25 to 1/14/25. However, Brent Oil prices posted a precipitous decline from mid-January to early March, due to concerns about slowing economic growth and OPEC+ production increases. After bottoming out on 3/4/25, Brent Oil prices increased by 7.8% to close out the quarter on a high note. After taking these movements into account, the price of Brent Oil over the entire quarter was relatively flat.

We look forward to the remainder of 2025 and are hopeful that market volatility will dissipate as the economic outlook and the impact of fiscal policy initiatives become more certain. If the economy is merely slowing and not heading towards a recession, the Fed can continue to keep monetary policy relatively restrictive, combatting sticky inflation without negatively impacting the labor market. Under this scenario, the equity markets could end the year on a high note once economic uncertainty dissipates, bringing the focus back on a relatively solid economic backdrop and strong underlying fundamentals.

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Could Immediate Vesting be a Win-Win for Your Plan?

As a plan sponsor, you may be using vesting schedules to encourage employee retention, but new research from Vanguard reveals that this strategy may not be as effective as you think. In reality, vesting schedules do little to keep employees from leaving – and they might actually be creating unnecessary administrative costs for your company.

What is a vesting schedule? While the funds that an employee contributes to the plan as an employee deferral are always fully vested, you are permitted to establish length-of-service requirements that employees must meet to be fully vested in the employer contribution portion of their account balance. The schedule may be a cliff schedule, such as 100% vested after 3 years, or a graded schedule, such as 20% per year until fully vested after 5 years. If a participant terminates employment before reaching normal retirement age and takes a distribution prior to becoming fully vested, the non-vested portion remains in the plan as a forfeiture. Provisions in the plan document define how forfeitures can be used, with options including using the funds towards certain plan expenses, reducing employer contributions, or adding to employer contributions.

Vanguard's analysis of 4.7 million job separations from 2010-2022 found that vesting schedules do not significantly impact employee retention. In fact:

- 30% of job separations involved forfeited, unvested contributions.
- Employees who hit a key vesting milestone were no less likely to leave than those who hadn't yet reached a milestone.
- Only 33% of participants know whether their plan has a vesting schedule, making it unlikely to influence their decisions.

While forfeitures from unvested contributions can reduce costs, the financial gain is modest, recouping roughly 2.5% of employer contributions. If vesting schedules do not significantly boost retention or cut costs, why keep them?

Switching to immediate vesting could offer stronger benefits for both your employees and your organization.

- **For participants:** Immediate vesting strengthens retirement security by allowing employees to keep the full value of their employer contributions, which is often a substantial portion of their savings. This can improve financial well-being and promote greater engagement with the plan.

- **For plan sponsors:** Immediate vesting simplifies plan administration and reduces compliance risks presented by possible distribution overpayments. It could also help you qualify for safe harbor status, potentially exempting your plan from annual nondiscrimination testing if you opt for a fully vested contribution.

Data from a 2023 Vanguard study indicates that 1 in 4 participants were deferring less than 4%. This not only affects their employee contribution balance but also limits the amount of employer matching contribution they are eligible to receive. For participants with low deferral rates, a discussion with them may help determine the reason behind the election. Maybe the plan has a matching contribution but they forgot or maybe they have questions about how the vesting schedule works for the account balances. Understanding the participants' perceptions of the plan is helpful in knowing where changes would be beneficial.

Vesting schedules are not without merit, but may not be the retention tool they were once thought to be and might come with additional downsides. Immediate vesting, on the other hand, could provide a win-win scenario for both plan sponsors and plan participants. We are always happy to discuss the impact that each can have on your plan.

Vanguard studies:

https://corporate.vanguard.com/content/dam/corp/research/pdf/does_401k_vesting_help_retain_workers.pdf

https://institutional.vanguard.com/content/dam/inst/iig-transformation/insights/pdf/2023/how-americans-can-save-more-for-retirement.pdf

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Planning Ahead for 2026 Catch-Up Contributions

Effective for plan years beginning on or after January 1, 2026, catch-up contributions for certain participants in a 401(k), 403(b), or governmental 457(b) plan could be affected by proposed regulations by the Department of Treasury and Internal Revenue Service. The proposed regulations would require that high-income earners who are aged 50 or older make catch-up contributions as Roth contributions rather than pre-tax contributions. In this case, a high-income earner is defined by prior-year FICA wages exceeding $145,000. This requirement, introduced in the SECURE 2.0 Act in December 2022, was delayed to allow for an administrative transition period. With the rules expected to be finalized in 2025, some review steps now can help minimize any last-minute uncertainty.

Catch-up contributions allow participants who are age 50 or older to contribute above the standard IRS deferral limit, which is $23,500 for 2025. The standard catch-up contribution limit for 2025 is $7,500, with a higher catch-up contribution limit of $11,250 for those aged 60-63. If permitted by the plan document, catch-up contributions can currently be withheld as either pre-tax or Roth deferrals.

Since the regulations are not yet finalized, the important action now is to simply be aware of the possible requirement and consider if the plan and participants will be affected so you can be prepared. Here are a few items to consider:

- Identify which employees will be age 50 or older in 2026. Likewise, determine if they are eligible during the 2026 plan year.

- Review estimated annual 2025 FICA wages for these employees. Income from other employers is not considered in this case; only the income paid by the employer who sponsors the plan is applicable to the $145,000 threshold.

- Does the plan permit Roth deferrals? If not, based on the proposed regulations, the higher-income earners won't be able to make catch-up contributions unless the plan is amended to allow for Roth deferrals.

Understanding which participants may be affected will ensure timely communication as soon as the regulations become final. When 2025 comes to a close, it will be important to gather year-end census data promptly so these participants can make the proper deferral elections for 2026. We can look at these details with you and help plan ahead together.

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How Government Staffing Cuts Could Impact the Plan

Many different Federal agencies affect the operation of retirement plans. First, Congress enacts the laws that govern plans; then, various entities such as the Internal Revenue Service (IRS), Department of Labor (DOL), Pension Benefit Guaranty Corporation (PBGC), and the Employee Benefits Security Administration (EBSA) interpret and carry out those laws.

The most important thing to note is that any recent reduction in workforce experienced by these government agencies will not impact the daily operation of your plan. Instead, because these agencies provide guidance on how to apply retirement plan laws, any future changes to laws that are passed by Congress could take longer to implement.

Additionally, if you need to contact these agencies with a question or to submit information for approval, you will most likely see an increase in wait times. On the other hand, much of the actual processing of forms—such as the Form 5500—is handled electronically and should be unaffected by these events.

If you need anything related to the plan, or if you have any questions, please feel free to reach out to us. We will work with you to resolve any issues.

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Upcoming Compliance Deadlines

May 2025

15th: **Quarterly Benefit Statement -** Deadline for participant-directed plans to supply participants with the quarterly benefit/disclosure statement, including a statement of plan fees and expenses charged to individual plan accounts during the first quarter of 2025.

June 2025

30th: **EACA ADP/ACP Corrections** - Deadline for processing corrective distributions for failed ADP/ACP tests to avoid a 10% excise tax on the employer for plans that have elected to participate in an Eligible Automatic Enrollment Arrangement (EACA).

July 2025

28th: Summary of Material Modifications (SMM) – An SMM is due to participants no later than 210 days after the end of the plan year in which a plan amendment was adopted.

31st: Due date for calendar year-end plans to file **Form 5500** and **Form 8955-SSA** (without extension).

31st: Due date for calendar year-end plans to file **Form 5558** to request an automatic extension of time to file **Form 5500** or **Form 9855-SSA.**

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Sources:

1. The S&P 500 Index is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market.
2. The Nasdaq Composite is a capitalization-weighted index and dominated by technology companies.
3. The Nasdaq-100 Index is U.S. stock market index comprised of the largest 100 non-financial companies listed on the Nasdaq stock exchange. The index is commonly used as proxy for U.S. large cap technology performance.
4. The Dow Jones Industrial Average is a widely followed, price weighted stock market index of 30 prominent companies listed on stock exchanges in the United States.
5. For example, consider that the worst performing S&P 500 sectors in Q1 2025 were the cyclical Consumer Discretionary sector (-11.8%) and the growth-oriented Information Technology (-11.0%). By contrast, the top performing S&P 500 sectors were Energy (+9.9%), Health Care (+6.5%), Utilities (+4.9%), Consumer Staples (+4.4%), Real Estate (+3.6%), and Financials (+3.4%), all of which can be characterized as defensive and/or value sectors.
6. The S&P 500 Equal Weight Index (EWI) is the equal-weight version of the S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight of 0.2% of the index total at each quarterly rebalance.
7. The Russell 2000 Index is a small-cap U.S. stock market index that makes up the smallest 2,000 stocks in the Russell Index. The index is commonly used as proxy for U.S. small cap stock market performance.
8. The MSCI World ex USA Index captures large and mid-cap representation across 22 of 23 Developed Markets countries (excluding the U.S.) and 24 Emerging Markets countries.
9. The iShares Core MSCI Europe ETF tracks the investment results of an index composed of large-, mid- and small-capitalization European equities.
10. The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets countries.
11. https://www.federalreserve.gov/monetarypolicy/files/monetary20250319a1.pdf
12. https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html
13. The Bloomberg U.S. Aggregate Bond Index is a broad-based index that is commonly used as a proxy for the U.S. bond market.
14. The iShares 20+ Year Treasury Bond ETF seeks investment results that correspond generally to the price and yield performance of the long-term sector of the U.S. Treasury market as defined by the Barclays Capital 20+ Year Treasury Index.
15. The iShares 2-3 Year Treasury Bond ETF seeks investment results that correspond generally to the price and yield performance of the short-term sector of the U.S. Treasury market as defined by the Barclays Capital 1-3 Year Treasury Index.