EMPOWER INVESTMENTS | Thomas Nun, CFA | Portfolio Strategist

Empower Lifetime Funds Commentary Q3 2022

Delayed departure

If you've tried to get on an airplane this year, chances are pretty good that you've faced a delay, cancellation or some other form of headache. According to the Bureau of Transportation Statistics, airline cancellations are more common now than during any year in a decade, and, if you're willing to ignore COVID-contaminated 2020, on-time arrivals are more rare than they have been in seven years.[1]

It's hard to blame the airlines — after all, they've had to deal with exactly the same issues that more or less all businesses have struggled with amid all the weirdness of a post-pandemic economy: persistent labor shortages, hard-to-find replacement parts and a supply/demand environment still wildly out of whack from the lingering impacts of the pandemic, to name just a few.

But what does any of this have to do with markets and, more specifically, your investments? Well, just like the vast majority of Americans who successfully boarded an airplane this year, stock markets completed a round-trip of their own during the third quarter. Although the S&P 500 Index began the period with six months of deep losses already behind it, for a brief period last quarter it looked as if markets might finally make it off the runway. July's inflation numbers were far better than expected, leading some analysts and economists to conclude that the "ground stop" implemented by the Federal Reserve in the form of aggressive interest rate increases designed to control said inflation might finally be lifted. That allowed the engines of optimism to reignite and, for at least a few weeks, markets were suddenly regaining a whole lot of lost altitude.

But it didn't last long. The Fed wasn't fooled by the brief pause in inflation evident in July's numbers, and instead of pausing its rate-raising campaign, it actually doubled down by boosting the Federal Funds Rate — essentially the only interest rate over which it has explicit control — by an unusually aggressive 0.75%. And it did so not just once but on two separate occasions this quarter (bringing the total number of such increases so far this cycle to an unprecedented three). Moreover, Fed Chairman Jerome Powell and his minions have continued to talk tough from their tower chairs high above the airfield, and after a brief but steep climb, stocks came crashing back to earth By the end of September, stocks were even lower than where they had been at the end of June as optimism that the economy might be spared a damaging recession was replaced by renewed pessimism that the Fed would most likely overshoot the runway and push the U.S. economy into a hard landing after all.

And it wasn't just stocks that felt the pain. As discussed at length in last quarter's commentary, the post-COVID market correction has been unusual for its remarkable breadth. Unlike a more orthodox market decline, this year's stock market rout has been accompanied by an almost equally steep decline in areas of the market that often hold their own during a dive — most notably, bonds and other fixed income-oriented investments. By way of example, the Bloomberg/Barclays U.S. Aggregate Bond Index fell again this quarter and is now down more than 13.5% so far in 2022. That's highly unusual — ordinarily when stocks fall in response to broad macroeconomic trends, investors flee to the safety of bonds. Not so this time.

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On closer inspection, this all makes at least some kind of sense. After all, the reason stocks are falling is fear that higher interest rates might send the U.S. economy into a tailspin. Sure, it's the knock-on effects like declining corporate profits, slower consumer spending and rising unemployment that equity investors are most likely reacting to, but the proximal cause is still dramatically higher interest rates — which just so happens to be exactly the environment that bonds hate the most. As a result, there continue to be very few places to wait out a market rout in 2022.

But if you're like me, you may have seen firsthand that if (when?) you become one of the roughly one-in-four airline travelers who experience a setback to your travel plans, it pays to keep your cool. After all, the miracle of modern air travel means you'll probably still make it to your final destination in one piece and pretty close to on time (even if your luggage doesn't). And remember, your gate agent and flight crew are probably just as frustrated as you are, so take a step back, relax and do your best to keep everything in context. The same applies to your investments, too.

Performance of the Empower Lifetime Funds

With such challenging market conditions, it's likely that even the most carefully diversified investment portfolios will experience losses. That's because the mechanism that makes diversification work in the first place is the tendency of different types of investments to react differently to the same set of economic circumstances. When that relationship breaks down or goes on hiatus for a little while, as it has so far in 2022, it's reasonable — though still frustrating — to expect asset values to decline.

That was true this quarter, a difficult period that saw each fund in the Empower Lifetime series finish lower on an absolute basis. This is of course not the outcome we would choose for your investments, but it's also not entirely unexpected — markets never move in a straight line, even under the best of conditions. It's also not unique to the Lifetime Series: Both our benchmark indices and our peers registered similar declines. In fact, one of the more encouraging aspects of this quarter's setback is that the majority of individual funds within the Lifetime suite outperformed both their respective benchmarks and their peers (with the more conservatively positioned, near-vintage funds held by investors at or nearing retirement outperforming by a fairly comfortable margin).

Among longer-dated funds, typically held by younger investors with longer time horizons, a larger overall exposure to stocks hindered relative results. This stock-heavy orientation is strategic in nature and wholly consistent with the objective of growing our investors' savings over the longer term. Stocks tend to produce higher returns in the long run, but the trade-off is higher volatility in the short run. That makes a relatively high exposure to stocks appropriate for younger investors with a longer horizon because they can afford to wait patiently for markets to recover any short-term losses they may suffer in the here and now.

Moreover, the stock-based investments we own tend to carry a slightly higher exposure to smaller- and value-oriented stocks than our benchmarks and our peers. This, too, is a strategic decision: We believe that these types of stocks provide a slightly better trade-off between risk and reward over an entire market cycle. Unfortunately, though, these exposures have recently flipped from headwind to tailwind and back again as markets search for a new equilibrium in the post-COVID world. This quarter, small-cap and value stocks once again underperformed, and the resulting headwind disproportionately hindered results among the longer-dated funds in the Lifetime suite given their higher overall allocation to stocks. Regardless, results for even the most aggressively positioned Lifetime Funds were still consistent with our expectations.

1 Bureau of Transportation Statistics, transtats.bts.gov.

On an individual basis, noteworthy positions within the portfolios included our emerging market stock investments. While emerging markets play only a small role in our overall allocation, the recent risk-off attitude in markets hit developing markets hard. This was a function of several things, including Russia's unprovoked invasion of neighboring Ukraine earlier this year and the economic fallout it continues to create. Moreover, as is common in periods of market volatility, the U.S. dollar has rallied sharply. That trend, which was only exacerbated by the aggressive rate-tightening campaign undertaken by the Fed this spring, tends to hit developing economies far harder than developed ones. Our investments in the space — the Empower Emerging Markets Equity Fund and the Fidelity Emerging Markets Index Fund — reflected that weakness and were among our biggest laggards on an absolute return basis. While it's never comfortable to endure losses, emerging market stocks remain important as both diversifying assets for our more traditional exposures and a potentially significant source of growth within a number of the Lifetime Funds — particularly those of longer vintages.

Meanwhile, two mid-cap U.S. equity holdings — one on either side of the growth/value spectrum — struggled during the quarter: the Empower Ariel Mid Cap Value Fund and the Empower T. Rowe Price Mid Cap Growth Fund. Both funds lagged an already downbeat market for midcap equities this quarter and finished the period behind a majority of their peers. With actively managed strategies such as these, occasional underperformance can be the price of entry and is perhaps not altogether unexpected unless it persists for a long period of time. In the case of the Empower T. Rowe Price Mid Cap Growth Fund, this quarter's setback is easier to stomach considering its very strong year-to-date performance versus its competitors. In Ariel's case, however, results are a little more disappointing because the strategy has lagged its peer group over longer periods as well. We note that the fund's relatively concentrated strategy can leave it vulnerable to performance swings when markets are exceptionally volatile as they are now and are comfortable being patient for now, but we will continue to monitor performance closely.

On the positive side, several underlying holdings performed exceptionally well during the quarter, including the Empower Short Duration Bond Fund and the Empower Large Cap Growth Fund. Both were among our best-performing holdings from an absolute return perspective, protecting capital admirably in such a difficult environment. Both also easily outperformed their competitors, finishing high in the top quartile of their respective peer groups. We are especially encouraged by the Empower Short Duration Bond Fund, which successfully navigated one of the most challenging environments imaginable given the category's status as "ground-zero" for recent market volatility as the Federal Reserve has ratcheted short-term interest rates higher and higher in a bid to control inflation.

Outlook

The list of issues currently aligned against markets and the global economy itself is a long one. First, some of the most obvious disruptions associated with the pandemic, such as supply chain disruptions and a misaligned labor market, have yet to fully work themselves out. Chief among these is inflation, which has been both worse and more persistent than most observers expected. That includes the Fed, which, toward the end of last year, finally abandoned the fallacy that inflation was temporary and likely to resolve of its own accord. This delay in acknowledging — let alone addressing — inflation left the Fed uncomfortably "behind the curve," forcing the central bank to be more aggressive in hiking interest rates than it might otherwise have had to be, resulting in what now seems to be a frenzied bid to catch up. Now, the Fed is arguably fighting more than just inflation: Its very credibility may be at stake, making it even harder for the Fed to press pause in its rate-boosting campaign even if price pressures relent in the months ahead.

An aggressive Fed bent on defeating inflation and slowing the economy would be challenging enough in its own right, but when you combine it with aggressive tightening by virtually every other central bank around the globe, it becomes all but inevitable that economic growth will slow substantially. That brings with it the threat of economic recession, which, in some areas of the globe, has quite likely already begun. Whether or not the U.S. ever formally crosses the threshold into recessionary territory itself is, in my view, largely academic. The Fed's stated desire to keep pumping the brakes until the economy slows substantially means that many of the ills that usually accompany recessions — namely, declining corporate profits, weaker consumer spending and higher unemployment — are bound to find their way into the data regardless.

Add to all this the geopolitical challenges associated with the ongoing war in Ukraine, and the picture becomes darker still. Under ordinary circumstances I tend to view markets as largely immune to geopolitical developments, but this time may truly be different. At a minimum, both Russia's and Ukraine's statuses as globally significant producers of all sorts of agricultural, mineral and energy-related commodities all but guarantees that the conflict will remain relevant to the inflationary discussion, even if — Providence willing — fears of wider global conflict prove to be mere hyperbole.

But as depressing as all this may sound, there are actually reasons to be optimistic. Markets by their very nature tend to be forward-looking. That could easily mean that all the volatility markets have endured in 2022 is the market's own version of "paying it forward." During past recessionary periods, some of the steepest market losses have been recorded during the months leading up to recession itself, allowing markets to begin recovering in robust fashion months before the economy itself bottoms out.

It's easy for me to imagine that being the case this time as well. While I believe the list of stresses described above likely means we haven't yet seen the end of this difficult period for markets, I'm equally confident that each Fed-sponsored increase in interest rates, every geopolitical setback, and each disappointing earnings report brings us one step closer to the time when true healing can begin. Even more importantly, the flexible and dynamic nature of our economy means that the greatest opportunities are quite often created during the times of greatest stress. That's as good a reason to exercise patience and look forward optimistically as any I can muster.

Morningstar ratings and rankings as of September, 30, 2022

Rating based on risk-adjusted returns and ranking based on total return

Fund name	Ticker	Inception	Category	Overall	RATING/ TOTAL # OF FUNDS 3-year	5-year	RANK/[2] # OF FUNDS 1-year
Empower Lifetime 2015 Instl	MXNYX	5/1/2015	US Fund Target-Date 2015	★★★★ 123	★★★★★ 13	★★★★ 25	(26/123)
Empower Lifetime 2020 Instl	MXAKX	4/28/2016	US Fund Target-Date 2020	★★★★ 156	★★★★ 29	★★★★ 44	(29/156)
Empower Lifetime 2025 Instl	MXQBX	5/1/2015	US Fund Target-Date 2025	★★★★ 224	★★★★ 43	★★★★ 65	(59/224)
Empower Lifetime 2030 Instl	MXAYX	4/28/2016	US Fund Target-Date 2030	★★★ 224	★★★★ 68	★★★ 75	(48/224)
Empower Lifetime 2035 Instl	MXTBX	5/1/2015	US Fund Target-Date 2035	★★★ 217	★★★ 79	★★★ 95	(48/217)
Empower Lifetime 2040 Instl	MXBGX	4/28/2016	US Fund Target-Date 2040	★★★ 218	★★★ 103	★★ 106	(53/218)
Empower Lifetime 2045 Instl	MXWEX	5/1/2015	US Fund Target-Date 2045	★★ 217	★★ 120	★★ 121	(82/217)
Empower Lifetime 2050 Instl	MXBSX	4/28/2016	US Fund Target-Date 2050	★★ 218	★★ 131	★★ 133	(91/218)
Empower Lifetime 2055 Instl	MXZHX	5/1/2015	US Fund Target-Date 2055	★★ 217	★★ 148	★★ 2	(100/217)
Empower Lifetime 2060 Instl	MXGUX	5/1/2019	US Fund Target-Date 2060	★★ 217	★★ 143	N/A	(100/217)

Fund performance as of September, 30, 2022

Fund name	Ticker	Inception	Net expense ratio (%)[3]	Gross expense ratio (%)	1-Year return (%)	3-Year return (%)	5-Year return (%)	Since inception return (%)
Empower Lifetime 2015 Instl	MXNYX	5/1/2015	0.45	0.49	-13.97	1.64	2.89	3.65
Empower Lifetime 2020 Instl	MXAKX	4/28/2016	0.48	0.51	-14.79	1.69	2.97	4.57
Empower Lifetime 2025 Instl	MXQBX	5/1/2015	0.50	0.52	-15.84	1.91	3.20	4.13
Empower Lifetime 2030 Instl	MXAYX	4/28/2016	0.52	0.54	-16.90	2.13	3.42	5.52
Empower Lifetime 2035 Instl	MXTBX	5/1/2015	0.54	0.55	-18.17	2.52	3.70	4.85
Empower Lifetime 2040 Instl	MXBGX	4/28/2016	0.57	0.57	-19.11	2.69	3.80	6.31
Empower Lifetime 2045 Instl	MXWEX	5/1/2015	0.57	0.57	-19.95	2.80	3.81	5.10
Empower Lifetime 2050 Instl	MXBSX	4/28/2016	0.58	0.58	-20.34	2.71	3.71	6.40
Empower Lifetime 2055 Instl	MXZHX	5/1/2015	0.57	0.57	-20.54	2.60	3.59	4.92
Empower Lifetime 2060 Instl	MXGUX	5/1/2019	0.59	0.59	-20.65	2.56		2.52

The date in the name of the target date fund is the assumed date of retirement. The asset allocation becomes more conservative as the fund nears the target retirement date; however, the principal value of the fund is never guaranteed.

2 Morningstar Percentile Rankings are based on the fund's actual rank within its category, total return and the number of funds in that category. The returns assume reinvestment of dividends and/or capital gains, do not include any applicable sales charges or redemption fees, but include 12b-1 fees. Rankings for each share class will vary due to different expenses. The highest (or most favorable) percentile rank is 1, and the lowest (or least favorable) percentile rank is 100. Had sales charges or redemption fees been included, total returns would be lower.
3. The net expense ratio reflects contractual fee waivers or reimbursements that expire on April 30, 2023. Absent waivers or reimbursements, the performance would have been lower.

Performance for institutional class shares before their inception is derived from the historical performance of initial class shares, which has not been adjusted for the lower expenses; had it been, returns would have been higher.

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On August 1, 2022, Empower announced that it is changing the names of various companies within its corporate group to align the names with the Empower brand. For more information regarding the name changes, please visit www.empower.com/name-change.

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