



Empower Profile 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.

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 Profile 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 Profile 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 Profile 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 each of the individual funds within the Profile suite outperformed both their respective benchmarks and their peers except the Empower Aggressive Profile Fund, the most aggressively positioned fund in the group.

The aggressive fund's underperformance was in turn a function of its strategic asset allocation, which places essentially all the fund's assets in equity-oriented investments. That places the fund on a more aggressive footing than its average peer in Morningstar's 85%-plus equity category, which is a disadvantage during periods when equity markets are declining.

Moreover, the stock-based investments we own in all Profile Funds 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 Profile suite given their higher overall allocation to stocks. Regardless, results for even the aggressive Profile fund were still consistent with our expectations.

On an individual basis, noteworthy positions within the portfolios included our investment in the Empower Emerging Markets Equity Fund. 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 investment in the space reflected that weakness and was 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 Profile Funds — particularly those designed to more aggressively pursue growth.

Meanwhile, the Empower T. Rowe Price Mid Cap Growth Fund had a difficult quarter, lagging an already downbeat market for mid-cap equities and finishing the period behind a majority of its peers. With actively managed strategies such as this one, 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 Empower T. Rowe Price Mid Cap Growth, this quarter's setback is easier to stomach considering its very strong year-to-date performance versus its competitors.

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 funds 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 Short-Duration Bond Fund, which successfully navigated one of the most challenging environments imaginable given the category's status as "ground-zero" for the recent market volatility as the Federal Reserve ratchets 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, 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	RATING/ TOTAL # OF FUNDS			RANK/ ² # OF FUNDS
				Overall	3-year	5-year	1-year
Empower Aggressive Profile Instl	MXGTX	5/1/2015	US Fund Allocation--85%+ Equity	★★★★ 188	★★★★ 82	★★★★ 71	(44/188)
Empower Moderate Profile Instl	MXITX	5/1/2015	US Fund Allocation--50% to 70% Equity	★★★★ 753	★★★★ 312	★★★★ 320	(248/753)
Empower Moderately Agg Prfl Instl	MXHRX	5/1/2015	US Fund Allocation--70% to 85% Equity	★★★★ 325	★★★★ 140	★★★★ 133	(92/325)
Empower Moderately Cnsv Pfl Instl	MXJUX	5/1/2015	US Fund Allocation--30% to 50% Equity	★★★★★ 458	★★★★★ 40	★★★★★ 63	(114/458)
Empower Conservative Profile Instl	MXKVX	5/1/2015	US Fund Allocation--15% to 30% Equity	★★★★★ 136	★★★★★ 8	★★★★★ 7	(28/136)

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 Aggressive Profile Instl	MXGTX	5/1/2015	0.80	0.80	-18.92	3.63	4.34	5.80
Empower Moderate Profile Instl	MXITX	5/1/2015	0.57	0.63	-14.55	2.62	3.40	4.31
Empower Moderately Agg Prfl Instl	MXHRX	5/1/2015	0.67	0.70	-16.03	2.98	3.74	4.81
Empower Moderately Cnsv Pfl Instl	MXJUX	5/1/2015	0.48	0.56	-12.98	1.80	2.74	3.53
Empower Conservative Profile Instl	MXKVX	5/1/2015	0.43	0.51	-11.68	0.87	2.05	2.74

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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