FIVE AREAS OF FOCUS FOR DEFINED CONTRIBUTION PLANS

Many answers, but a few questions still remain.

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EXECUTIVE SUMMARY

Growing reliance as a primary retirement savings vehicle, default-driven behavior, and increasing fiduciary scrutiny continue to characterize the defined contribution (DC) environment. Given these trends, we have identified five key areas plan sponsors and their advisors should focus on to achieve the objectives of a DC plan in helping participants meet their retirement liabilities and manage key risks.

While helping participants meet retirement goals is a challenge and can be complex, most fiduciaries know what needs to be done. The answers have become clearer as the industry has focused on understanding the investment math that is needed to get participants to their goals and the behavioral aspects of participant decision making, fiduciary bodies, and public policy makers. Here, we address both what we believe has been answered and the questions that remain to be solved among plan design, public policy, investments, default options, and post-retirement.

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1 PLAN DESIGN:
More strategic, comprehensive, and outcome oriented

Plan design is critical to helping participants meet their retirement liabilities and it drives participant behavior. Since the Pension Protection Act of 2006, default-driven plan design has become prevalent as plans have adopted features such as automatic enrollment, automatic escalation, qualified default investment alternatives and re-enrollment. Automated features embrace the power of inertia and in turn, drive significant improvements in plan wellness and outcomes for participants.

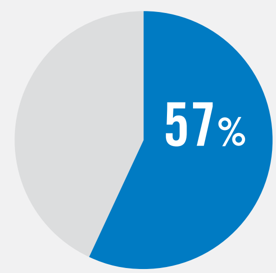
WHAT'S BEEN ANSWERED?

Thorough academic research and plan experience over the last two decades indicate that plan design, more than anything else, drives behavior. Still, only 57.5% of plans auto-enroll[1] and today's most commonly used default savings rate is 3%.[2] Even when combined with employer match, a default rate at that level is going to fall far short of creating sufficient retirement savings for participants. On a positive note, the number of employers enrolling at a rate of 4% or more has seen a significant increase from 39% in 2013 to 52%[3] and 42% of plans are utilizing auto-escalation, up from 31% in 2014.[4] Sponsors should be thinking more strategically about what the right default-driven design is needed to get participants to reach their goals. In our experience, leading plan sponsors are setting a retirement readiness objective for their plans, determining what savings rates combined with employer contributions will get them there, and designing plan features in a way to support meeting these objectives.

WHAT QUESTIONS REMAIN?

How are plan sponsors going to tie retirement savings programs in to their employees' broader financial challenges and needs? Many sponsors are looking to take a more holistic approach to employee financial wellness, including areas such as budgeting and debt management. The belief is that it is not only good for the employees, but also benefits the employer as well when their workforce is less financially stressed and more retirement ready. It is estimated that 57% of employees are somewhat or very stressed about their financial situation (Figure 1),[5] while 30% of employees claim to be distracted by financial issues at work.[6] Additionally, it is estimated that a one-year delay in retirement can cost employers over $50,000 per individual or 1.0-1.5% in workforce costs across an employee population (Figure 2).[7] The question remains how far employers will go in bringing more holistic financial solutions to their current employees and retirees.

Figure 1: Employees who are very or somewhat stressed about their financial situation

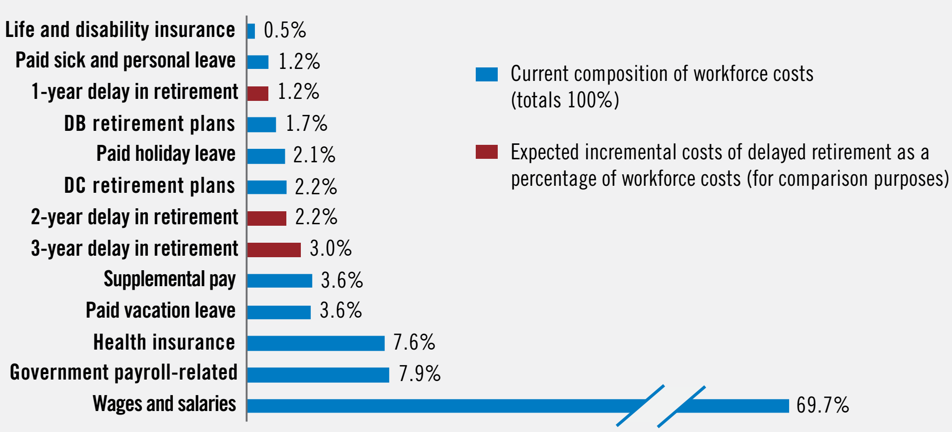


Top reasons for financial stress*

1. Saving for the future (67%)
2. Paying monthly bills (57%)
3. Credit card debt (42%)

* Among respondents who are very or somewhat stressed. Respondents could select more than one reason.
Source: Prudential Financial, Inc. (PFI) 2017 Wellness Study

Figure 2: Composition of Private Sector Workforce Costs, 2016



Notes:
1. DB retirement plans include premiums, administration fees, and dollar amounts placed by employers into pension funds.
2. Supplemental pay includes overtime, shift differentials, and nonproduction bonuses.
3. Government payroll-related includes Social Security, Medicare, Federal and State Unemployment Insurance and Worker's Comp.

Source: Bureau of Labor Statistics, Employer Costs for Employee Compensation – March 2016, Table 5, June 2016. PFI analysis with supporting research by Goldenson Center at University of Connecticut.

2 LEGISLATION, REGULATION, AND LITIGATION:

Opportunities and challenges

Whether it's tax reform, fiduciary rules, class action lawsuits, or a safe harbor for retirement income, what goes on in Washington and the courts has a major impact on plan sponsors' actions related to benefit plans and thus, their employees' ability to meet their financial goals. These effects could be viewed positively (e.g., support for auto features from the Pension Protection Act) or negatively (e.g., reducing tax incentives to save), but such policy decisions are rarely neutral or have a limited effect.

WHAT'S BEEN ANSWERED?

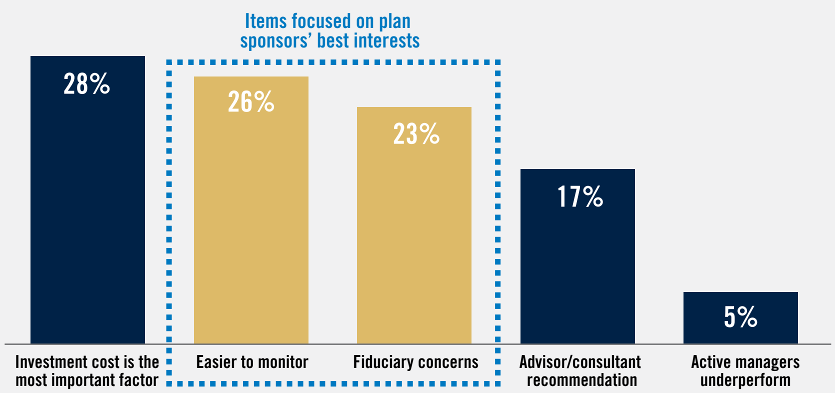
Perceived fiduciary concerns should not dictate that DC plans only offer participants the lowest cost options. Doing so could potentially put participants at risk of failing to meet their goals, arguably creating more legal risk by violating one's fiduciary duty. Since 2006, there have been over 120 class action lawsuits filed related to fees and while many have settled, very few judgements have actually been issued against sponsors. Unfortunately, litigation risk has often deterred sponsors' willingness to implement institutional and innovative investment solutions for their DC plans. This includes adding diversified asset classes or having a thoughtful mix of active and passive. In fact, where plan sponsors have selected a passively-managed option, 26% did so because they are easier for a fiduciary to monitor and 23% did so to alleviate threat of litigation (Figure 3).[8] However, fiduciary obligations require sponsors to do what is in the best interest for participants, and not simply offer basic, passive investment options. Fees are critical but ERISA requires that costs be "reasonable," and not necessarily the lowest.

> **"Fiduciary obligations require sponsors to do what is in the best interest for participants, and not simply offer basic, passive investment options."**

WHAT QUESTIONS REMAIN?

Although the 2017 Tax Cuts and Jobs Act does not alter existing retirement savings incentives by lowering limits or implementing "Rothification" of contributions, how long until Washington looks for other opportunities to tap the retirement system the next time lawmakers need to fill a budget hole? There have been many instances in recent times that when needing to raise revenue, such as funding a highway bill or avoiding a government shutdown, the retirement system has been targeted through such measures as PBGC premium increases, pension funding relief, and Roth conversions. In the most recent tax reform effort, proposals were considered to require all or much of individual contributions to be made on a Roth basis.[9] While Roth contributions have become a more popular option in plans (currently offered by 60% of all plans[10]), it has been primarily offered on a voluntary basis. There are significant unknowns to how individuals would alter their savings behavior if contributions were required to go in on a Roth basis, thus potentially reducing their current take-home pay. Plan sponsors should continue to be aware of these issues and use their voice to remind public policy makers of the importance of tax-advantaged savings to increase retirement readiness.

Figure 3: Reasons Plan Sponsors Go Passive



Source: Cerulli Associates: US Retirement Markets 2017; Large Plan Sponsors

3 INVESTMENTS:

Bringing an institutional approach to the individual investor

To help meet their long-term goals, participants will need their assets invested in well-diversified, institutional quality portfolios. Starting in the second half of the 1990s, DC plan menus began expanding, with a proliferation of name brand and style-specific funds. This led to confusion among participants resulting from too much choice. Additionally, sponsors often did not have a clear understanding of the investment fees being charged. Now, as DC plans have become the primary retirement savings vehicle for most US private sector employees, sponsors are looking to take more of an institutional approach.

WHAT'S BEEN ANSWERED?

Menus should offer more streamlined options while also expanding investment coverage to diversifying asset classes and strategies. Less choice in terms of number of options may initially be viewed as a reduction in benefit to some, however research suggests that both participation rates[11] and decision-making[12] improve in plans with consolidated investment menus. The inclusion of diversifying asset classes within the available choices, such as high yield, emerging markets and real assets, can have multiple benefits, most notably providing participants the opportunity to enhance risk-adjusted performance and protect from risks such as inflation.

> **"Both participation rates[11] and decision-making[12] improve in plans with consolidated investment menus"**

WHAT QUESTIONS REMAIN?

Streamlined menus intuitively make sense, and a move in that direction should meaningfully benefit participant decision-making. But, there are some interesting questions on the best ways to implement while also providing exposure to diversifying asset classes and strategies. Here, we will lay out some of those questions where we are seeing exciting evolution in the industry. High-level questions include: What is the right number of options? Which asset classes should be offered? How do plan sponsors integrate active and passive managers? How do sponsors determine what type of vehicle to select? Other more specific questions include: Should the options be white labeled? Should options diversify across multiple managers? Within a multiple manager structure, what's the most thoughtful way to combine investment styles? What is the best way to incorporate diversifying asset classes such as private real estate or other real assets? Should investment selection be done by the plan sponsor or delegated to a third party? Ultimately, there are no single correct answers as preferences and sponsor resources matter significantly. While there are varying views on how to implement, the basic premise of shifting towards an institutional investment approach remains.

Figure 4: Streamlined menus intuitively make sense, and a move in that direction should meaningfully benefit participant decision-making, but…

1. What are the right number of options?
2. Which asset classes should be offered?
3. How do you integrate active and passive managers?
4. Should the options be white labeled?
5. Should options diversify across multiple managers?

4 THE DEFAULT OPTION:

Optimizing participant outcomes

With the majority of new cash flows going into the plan default option, the success of these strategies is directly tied to the success of participants in meeting their desired long-term outcomes. Strong acceptance of auto-features and re-enrollment following the Pension Protection Act of 2006 have reinforced the importance of the Qualified Default Investment Alternative (QDIA), making it the focus of sponsors and advisors going forward. Today, 50% of 401(k) contributions go into target-date or lifecycle strategies[13] and 75% of 401(k) sponsors use a target-date fund as their QDIA.[14]

WHAT'S BEEN ANSWERED?

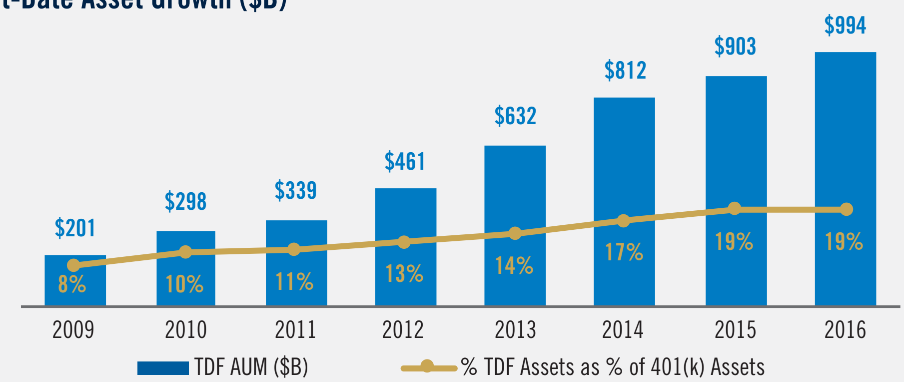
Sponsors should ensure their QDIA is designed explicitly with the objective to provide better retirement outcomes. QDIAs are more than just a simple portfolio to accumulate assets in and decisions regarding their design should be based on how well they help participants meet their liabilities and manage key risks.* Risks shift as people age and the ability to manage these changing risks has been the underlying driver of success for target-date funds. Over time, portfolios should decrease market exposure as participant risk transitions from savings shortfall to drawdown risk near retirement. In retirement, the focus should then turn to protecting against longevity and inflation risks. Similar to how other institutional investors think about meeting their liabilities, broad asset class diversification and a thoughtful blend of active and passive management will be important to the success of QDIAs in managing these risks and balancing a heightened sensitivity to fees. Regardless of the type of QDIA that is selected (e.g., off-the-shelf or custom target-date funds, or managed accounts), sponsors should seek these characteristics in a solution as it will have the greatest impact on outcomes.

WHAT QUESTIONS REMAIN?

Can outcomes be improved even more through greater customization of the QDIA either at the plan (target-date) or individual (managed account) level? Potential benefits of custom target-date strategies include greater control over underlying asset class coverage and manager selection, improved value, and a more targeted glide slope to specific demographics and preferences. While 20.7% of plans surveyed by Callan offer custom target-date funds, the majority of those were very large plans, with over $5 billion in assets.[15] Cost, operational complexity, and legal responsibility continue to be the primary barriers to customization, but many sponsors and providers now have experience on how best to address these.

Alternatively, managed accounts provide participants with customized advice on their specific financial situation by accounting for individual savings behavior, risk tolerance, out-of-plan data (e.g., pension, Social Security, personal savings, etc.), as well as broader familial information. Unfortunately, with individual customization comes the difficulty of benchmarking performance and higher cost, limiting the service's adoption as a QDIA to only 7.4% of plans.[16] While most industry experts agree that more individually-tailored solutions should increase the probability of meeting retirement goals, there will likely need to be an evolution in how sponsors are able to deliver these options in a cost-effective way, including hybrid solutions that combine target-date funds and managed accounts. Plan sponsors should periodically evaluate available options and implement ones that work best for their plan.

Figure 5: Target-Date Asset Growth ($B)



Pensions & Investments: Money Managers Survey, May 2017

*No risk management technique can guarantee the mitigation or elimination of risk in any market environment.

5 POST-RETIREMENT:

Addressing the unique needs of retirees

The focus up to this point in the industry has largely been on helping individuals accumulate sufficient assets to achieve their retirement goals. However, this is solving for only part of the challenge in helping participants attain a secure retirement. Even if individuals successfully get to the start of their retirement years with a sufficient amount of assets, they will be faced with new challenges in meeting their spending needs in retirement.

WHAT'S BEEN ANSWERED?

In retirement, DC plan participants will need help in managing to a unique variety of risks, notably market, inflation, and longevity risks.* Longevity risk (the risk of outliving one's money) is linked to all risks retirement savers experience and thus, the most critical to manage. Individual participants begin with the structural disadvantage of not being able to pool their mortality risks. In addition, growing life expectancies due to healthier lifestyles and advancements in medicine require that investment earnings keep pace. Further, demographers have often underestimated life expectancy. For example, an American born in 1940 was expected to live on average until 63; current life expectancy for that 1940 cohort is now known to be well over 75.[17] These mortality improvements, while positive from a lifestyle perspective, leave participants in a difficult position to manage through these risks on their own. Insurance-related solutions can be of significant help. These products have the ability to pool mortality risk, reduce market volatility, and protect against inflation, but come with unique complexities that need to be carefully considered.

Figure 6: Spectrum of Retirement Income Solutions

In-Plan Solutions: Non-Guaranteed	In-Plan Solutions: Guaranteed	Out-of-Plan Solutions
Annuity Tracking	Deferred Income Annuities	Immediate Income Annuities
Managed Accounts	Guaranteed Lifetime Withdrawal Benefit	Deferred Income Annuities
Managed Payout Funds	Immediate Income Annuities	Qualified Longevity Annuity Contracts
Target-Date Funds		

Source: DCIIA, *Retirement Income Solutions: A Guide for Plan Sponsors*, 2015

WHAT QUESTIONS REMAIN?

How will plan sponsors offer solutions within a DC plan to manage unique retiree risks? Sponsors should help participants solve these challenges, even with expectations that some participants may intend to leave the plan, but doing so will require addressing a variety of questions: Will the solution be offered in-plan or out-of-plan? Should it be guaranteed or not? If in-plan, is the product offered on a standalone basis or part of an existing investment option like a target-date fund? If income is guaranteed, is the rate the guarantee is based on fixed or variable? Is it portable? For insurance-related products, fiduciary and cost concerns continue to weigh on sponsors,[18] but increased protection from regulators around insurer selection will likely lead to greater adoption.

While the process can be overwhelming, sponsors and their advisors should determine the appropriateness of various solutions, particularly given the growing role of DC plans in retirement savings. The reality is that there is likely not a single one-size-fits-all solution, and retirees will need access to a variety of products and services that meet their specific objectives and situation. A good first step sponsors can take is communicating to participants in terms of projected future retirement income, away from the focus on account balances.

CONCLUSION: WHERE DO WE GO FROM HERE?

Up to this point, the DC marketplace has done a great job identifying the low hanging fruit to help drive successful outcomes for participants. As the momentum of plans adopting these baseline best practices grows, plan sponsors must remain committed to implementing these solutions and discovering what next set of steps can move the needle even further. The transition away from reliance on defined benefit retirement plans, the increasing focus of employers on how benefit offerings can enhance workforce productivity, and the growing attention from asset managers and consultants will undoubtedly play key roles in building upon what we already know works and what we know needs further attention.

*No risk management technique can guarantee the mitigation or elimination of risk in any market environment.

END NOTES

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IMPORTANT INFORMATION

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