NAGDCA

BEST PRACTICES GUIDE TO ADMINISTERING YOUR GOVERNMENTAL DEFINED CONTRIBUTION PLAN

PLAN DESIGN

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OVERVIEW

Plan sponsors are presented with a dizzying array of choices with respect to how to design a defined contribution plan. In this chapter, we will review choices with respect to some of the key services and features that can or should be incorporated into your plan, as well as some considerations for establishing or modifying your plan's investment menu.

I. Participant Services

Hardship & Unforeseeable Emergency Withdrawals – Hardship and emergency withdrawal provisions allow plan participants to withdraw funds for non-retirement uses. While offering these provisions to plan participants may not be considered a best practice on its own merits, it is extremely common to do so. There are certain circumstances where access to retirement funds can make a significant difference in a plan participant's life. These are the precise circumstances that withdrawal provisions are designed to address.

Hardship withdrawal provisions are found in 401(k) and 403(b) plans. To qualify for a hardship withdrawal, a participant must have an "immediate and heavy" financial need that cannot be addressed through other resources, and may only withdraw enough to cover that need (including taxes and penalties). There are some safe harbor reasons for a withdrawal that include:

- Medical expenses
- Costs associated with buying a (principal) residence
- Tuition/educational expenses
- Payments to avoid eviction or foreclosure
- Burial/funeral expenses

Hardship withdrawals are typically needed only when a plan loan will not suffice to satisfy the need. Plans that offer these provisions must develop guidelines in order to determine how requests for hardship withdrawals will be qualified and granted by the plan, which means that a number of detailed procedures must be adopted. These procedures are critical to provide clear standards and methods of documentation in order to process these requests. Early distribution penalties will apply to hardship withdrawals for participants below age 59 ½.

Participants in a 457(b) plan may be given an option to withdraw funds for an "Unforeseeable Emergency." Since the 457(b) is not subject to early withdrawal penalty taxes, this provision carries stricter provisions. An emergency withdrawal must result from:

- An illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse, or the participant's or beneficiary's dependent,
- A loss of the participant's or beneficiary's property due to casualty; or

- Other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or beneficiary.

Determining whether a participant's circumstances merit a hardship or emergency withdrawal can be very subjective. Since the plan sponsor is ultimately responsible for administering these provisions in compliance with applicable laws and regulations, clear and consistent policies and procedures are critical.

Loans – Like hardship withdrawals, loans are another commonly offered feature of defined contribution plans. There are two types of loans which can be offered: general purpose loans, which can be used for any purpose (the terms of which may be up to 5 years) and principal residence purchase loans, the terms of which may be up to 15 years). The participant may borrow up to 50% of his/her vested account balance, or up to $50,000, whichever is less. All interest earnings should go back to the participant's account.

In general, if a plan elects to allow loans, it is considered a best practice to:

- Restrict the number of loans taken (e.g. to one or two at a time, to balance flexibility against administrative burdens)
- Charge a fee for initiating a loan to discourage loan use

If an employer sponsors more than one vendor to provide recordkeeping services, the limits (i.e. the lesser of $50,000 or 50%) are cumulative across all participant accounts. It is the plan sponsor's responsibility to monitor the total amount loaned from all accounts combined. Also, to add to the sponsor's burden, a participant may not borrow more than $50,000 over a rolling 365 day period from all accounts sponsored by the employer.

Loans are an optional service, but one that is comforting to participants seeking to increase their contributions to the plan or who are concerned that they may need access to funds in an emergency. When offered, loans can sometimes be very helpful to participants who face taxes and penalties for a hardship withdrawal, or are burdened with high interest debt. The challenge for plan sponsors is to assess the behavior of their own participant population and, if loans are to be offered, set rules that strike a balance between meeting participant needs and ensuring that the plan is used primarily as a retirement savings vehicle. This may be different for every plan.

As the most common procedure used for loan repayment is payroll deduction, plan sponsors should also prepare for the ongoing administrative responsibility that comes along with a loan provision in your plan.

Plan Sponsors should carefully consider not only whether to offer hardship withdrawals, unforeseeable emergency withdrawals, and loans, but also the structure of those plan services as they can have a significant detrimental effect on participant savings, especially if the defined contribution plan is the primary retirement plan for participants.

Investment Advice – Opinions remain divided with respect to best practices regarding communication, education, and advice. As a general summary, despite extensive efforts for participant education, the empirical record of communication and education campaigns to materially improve the investment decisions (savings rates, participation rates, investment diversification, etc.) of plan participants is quite poor. It may be worth noting that the collective record of automatic plan features, plan design changes, or plan sponsor actions in driving savings and investment actions is far superior.

This merits mention because investment advice is frequently offered to participants along with other plan communication and education efforts. In reality, however, there is a very clear line between education and guidance to plan participants, on one hand, and advice, on the other. For a clear description of the differences, see the NAGDCA publication "Investment Guidance Versus Investment Advice[1]"

One method for providing participants with investment advice is to offer a managed account service via the plan recordkeeper. Frequently, these services are also paired with access to a call center that has trained and licensed financial planners available to answer questions and assist in financial planning and asset allocation decisions.

It is increasingly common to provide access to these services, and recordkeeping firms are focusing more efforts on expanding access to these services. From an investment perspective, initial studies of participant asset allocation results with these services indicate they may improve diversification and reduce total volatility. For a plan sponsor seeking to offer managed account services and access to phone-based financial advisors, the key items to monitor are:

- Fees
- Revenue-sharing transparency when revenue is passed from the advice provider to the recordkeeper
- Appropriateness of the asset-allocation model
- Accuracy of the reflection of DB and Social Security Benefits in asset allocation planning models
- Investment fund selection process transparency when revenue sharing is passed between the fund provider to the advice provider

It is important to monitor fees at all times, but it is especially important to confirm that the fees for these services are considered prudent and appropriate, as they are frequently one of the largest costs of a plan. Similarly, advice services often provide a very large revenue source for recordkeepers, and, as with revenue-sharing, ensuring that revenues are transparently disclosed is essential.

Asset allocation models can be monitored through a number of methods, but one of the most basic and effective is to routinely sample the chosen allocations, and monitor the risk-return

[1] http://www.nagdca.org/content.cfm/id/investment_guidance_versus_investment_advice

relationships, and overall composition of the selected portfolios. Similarly, it is important to ensure that DB plan benefits and social security are reflected appropriately. Many NAGDCA plans, for example, will have members without a social security benefit, or where a DB plan is present for all DC participants, and it is important to reflect these considerations.

Another option for advice is to provide access to investor centers, or a field force of representatives that will conduct one-on-one financial planning sessions. For many plans this provides an excellent benefit. However, it is important that plans carefully weigh whether they will encourage one-on-one field forces to conduct financial planning sessions when cross-selling of other products is permitted, as is often the case. Finally, with all advice solutions, it is important to seek transparency with respect to how participants receive counseling with respect to items like rollovers, financial planning in retirement, and purchases of services like annuities, and any associated compensation received by those providing advice to plan participants.

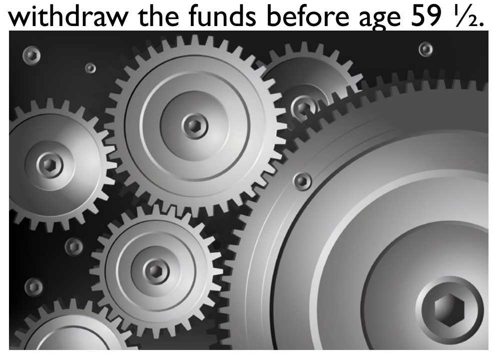
II. Plan Features

In addition to decisions like whether to offer certain services such as advice or loans, plans also get to make several structural decisions, and these decisions often have a very significant impact on the savings decision made by participants. Some common choices are detailed below.

Rollovers – Plan sponsors have wide latitude with respect to permitting rollovers into their plan from other plans. In general, rollovers are commonly permitted into and out of plans, as this permits participants to exercise control over their retirement assets, and to eliminate the frustrations associated with managing multiple retirement accounts. Few plan sponsors restrict rollovers, particularly plan sponsors managing larger plans, as their institutional fees and investment choices typically make them very competitive vis-a-vis more retail pricing frequently offered in plans from smaller employers or Individual Retirement Accounts.

When choosing what types of assets may roll into the plan, it is important to be aware of certain issues that may arise from this design option. For example, if you allow after-tax money to roll into a tax-deferred plan, the record keeper must separately account for the tax basis on those funds. Also, if you allow 401(k) or 403(b) money to roll into a 457(b) plan, the record keeper must once again maintain separate recordkeeping for those funds, because that money continues to maintain the characteristic of a 401(k) or 403(b) Plan (i.e. distributions remain subject to the 10% early distribution penalty tax). A participant may not be aware of this distinction and may end up paying a 10% penalty if they withdraw the funds before age 59 ½.

The new laws allowing "Roth" funds to be rolled into or out of a retirement plan have added a new complexity to record keeping and participant education, particularly with their unique distribution rules and tax treatment.



Roth Options – For most governmental plans, it is now possible to offer access to a Roth version of the same plan. Because these options permit otherwise effectively identical use of the plan, but with an additional option that can help a portion of plan participants to better manage their tax burden in retirement, it is considered a best practice to offer a Roth option when available from the recordkeeper.

With the addition of a Roth feature, a participant may choose between tax deferred savings, and tax-free accumulation (on after-tax contributions). In the past, the only Roth option a participant had was a Roth IRA. Recently, the term "Designated Roth" was assigned to the use of a Roth component within 401(k), 403(b), and 457(b) plans. This distinction is important, because the IRS regulations have different rules and reporting requirements for a Roth IRA vs. a Designated Roth plan. The plan sponsor must understand these differences when designing and communicating the plan's provisions, and the employer's payroll department must also understand the distinction for reporting purposes. When reading tax information, participants may also be confused by the difference in tax reporting requirements.

Automatic Plan Features – In the ERISA marketplace, fiduciary safe harbor protections for plan sponsors that adopted automatic enrollment and automatic contribution escalation features in their plans have led to a very significant increase in plan sponsors utilizing these features. A large volume of research from various recordkeepers, academics, and institutions like the EBRI (Employee Benefit Research Institute) has conclusively demonstrated a few key facts about automatic plan features:

1. When plans adopt automatic enrollment, participation is notably higher than when they don't, often by 10-20%.
2. When plans adopt a default investment, like a target date fund, and automatically enroll participants, the majority of assets invested in these options remain there.
3. When plans automatically enroll plan participants at a given contribution level – most commonly 3% - contribution rates tend to remain close to that level.
4. When plans adopt automatic enrollment and automatic escalation in combination, participation rates remain high, and contribution levels also rise to significantly higher levels than when only automatic enrollment is adopted.

The conclusions from the experiences in both ERISA and non-ERISA plans lead to a relatively clear set of conclusions. For plan sponsors seeking to increase plan participation, no change to the plan will be as effective as automatic enrollment. However, adopting automatic enrollment without automatic contribution escalation results in artificially low contribution rates. As a result, when possible, it is best to adopt the two in combination. If only automatic enrollment is available, then adopting a higher initial contribution rate is generally preferable. Employers interested in automatic enrollment should also carefully review state laws and, if applicable, collective bargaining agreements that may affect implementation.

An alternative to automatic enrollment is active choice which simply requires new employees to make a choice to opt-in or opt-out of the plan. It is also possible to adopt quick enrollment procedures, where participants can sign up and use the default in just a few minutes.

Some employers are taking a step beyond automatic enrollment and re-enrolling existing employees as an effective way to increase plan participation.

Employer Match – Historically, governmental employers generally did not make matching contributions to defined contribution plans because the employer's contributions went to fund a defined benefit plan. With the increased use of hybrid retirement programs within the government sector (a benefit that combines both defined benefit and defined contribution components) employer matching contributions are becoming more common. Also, even if the defined contribution plan is not intended as a primary retirement source of income, there are reasons for implementing a matching program:

- There is a higher rate of participation by employees who are required to make a contribution in order to receive the match
- A match gives the participant an incentive to be more engaged in their savings plans
- The match may be used as a retention tool (see vesting below)
- A match allows an employer to provide additional future income to an employee without inflating other benefit costs which may be connected to wages
- Employer contributions may be FICA tax free to both the employee and employer

When contemplating a matching plan, plan sponsors need to consider certain plan design issues. Where an employer is participating in Social Security and pays FICA taxes, all contributions to the 457(b) plan are subject to FICA taxation – whether contributions are employee or employer matching contributions. These contributions are reported on the employee's W-2 as Social Security wages. For this reason, most employers prefer to make matching contributions to qualified 401(a) or 403(b) plans.

Often employers use their matching plans as a retention tool by attaching a vesting period. Employers may use the same vesting period as required by their defined benefit, to keep their benefit structure consistent. For ERISA plans, there are minimum requirements for vesting periods and the use of forfeited assets. Generally, forfeited assets are required to stay in the plan for the benefit of plan participants. However, this can include an offset for fees and employer contributions.

<u>III. Investment Menu Design</u>

Plan sponsors designing an investment menu face many challenges. First and foremost are the requirements that face a plan fiduciary, such as quality of each investment, fees, appropriateness, and offering a sufficient array of choices. But, there are many other items that affect menu construction. Participants with favorite funds will push for access to their preferred choices. Recordkeepers will often market their proprietary funds, or offer fee discounts for their use. Advocates of greater choice will push for expansion of the lineup. In this section of the guide we'll provide some best practices for plan sponsors dealing with these many competing challenges.

Investment Policy Statements – IRS rules require that all plans now maintain a written plan document that sets out the rules of operation for defined contribution plans. Interestingly, the requirements for plan fiduciaries and investment committees with respect to the processes followed when making investment decisions on behalf of public plans are less restrictive. While not required by law, the DOL has issued formal guidance indicating that the use of an investment policy statement (IPS) is consistent with fulfilling the duty of prudent plan management, and the IPS is normally a critical document in plan audits by the DOL. Thus, despite the different requirements facing public plans, in order to achieve a high quality investment management process, and to maintain documentation of the due diligence undertaken by those responsible for the plan, an investment policy statement is critical.

The benefits of adopting an investment policy statement are many, and include:

- Setting guidelines for the selection and oversight of investment managers
- Setting guidelines for monitoring regular variations in investment performance
- Setting benchmarks for performance
- Setting benchmarks for comparison of investment option fees
- Setting restrictions on investment choices to suit plan risk tolerance (e.g., whether to permit funds that engage in securities lending)
- Providing a routine process for new Board/Committee members to learn and follow
- Setting out the responsibilities of the various parties serving the plan
- Providing protection for plan fiduciaries after investment decisions are made through demonstrating that a prudent consistent process was followed

To achieve these benefits however, the IPS must be a document that is routinely reviewed for accuracy, and that is followed by those governing the plan.

There are many sources that can help plan sponsors identify what to include in an IPS, including various professional societies like the CFA institute, or investment consultants. In general however, defined contribution plan investment policy statements have the following sections and features:

- **Executive Summary/Purpose of the IPS** – This section lays out the plan(s) for which the IPS applies, and how it is to be applied.
- **Roles/Responsibilities** – This section typically includes sections for:
  - Staff
  - Board/Committee Members
  - Advisor/Consultant
  - Investment Managers

Sometimes sections are also included for administrators, such as record keepers or fund custodians.

- **Asset Classes and Monitoring Standards** – This section is in many ways the most critical. Here, the policy will specify which asset classes are to be offered in the plan, and which, if any, will be explicitly disallowed. In addition, this section will typically include standards for selection and monitoring, such as the specified benchmark for performance comparison, return targets, tracking error targets and ranges, and standards for investment management fees.

- **Watch List/Fund Replacement Policy** – While not all plans will adopt a watch list for funds that may need replacement, it is very important that the IPS set out standards for when a fund should be considered for replacement, and if there are any automatic standards for replacement. Similarly, it is important that a careful balance is struck between maintaining a routine and well-regulated procedure, on one hand, and being too rigid, on the other. Processes that require terminating a manager whenever they underperform, for example, will simply require plans to terminate managers at the wrong time, ensuring poor performance for participants.

Core Investment Menu - In recent years there have been many advances in the behavioral finance literature that have significantly changed the way that many plans approach building their investment menus. Previously, many plan sponsors believed that offering a very wide array of investment choices is the best approach. This line of thinking is often rooted in beliefs about the importance of freedom of choice, or concern that participants would have insufficiently specific options to execute their desired investment strategy.

Today, however, the industry is unambiguously moving toward a streamlined model for investment menu design. There are a number of reasons for this change.

First a number of studies[2] have shown that, while a small minority of plan participants take advantage of expansive investment menus, a much larger portion of participants suffer from a phenomenon called "decision paralysis." In other words, complex investment menus with many options are beneficial to a minority of participants who are active investors, while it can serve to scare off a generally larger portion of your participant base that become confused in sifting through all the options.

Researchers have found that not only do expansive lineups discourage participation, but large investment menus also are correlated with lower contribution levels, and sub-optimal investment allocations.

Another interesting fact is that some recordkeepers[3] have tracked the average number of investment choices used by plan participants over the years. For more than a decade, the average number of investment options used by plan participants has remained approximately

[2] When Choice is Demotivating: Can One Desire Too Much of a Good Thing? Iyengar, S. S., & Lepper, M. Journal of Personality and Social Psychology, 79, 995-1006. (2000)
[3] See, Vanguard, Fidelity, and Aon Hewitt.

three funds. This fact has led many plan sponsors to consider the question, "Am I comfortable offering this fund if it ends up as one of only three funds in a participant portfolio?"

In addition to simplifying the participant experience, limited fund lineups have several other benefits, including:

- Reducing the oversight and due diligence burden on plan sponsors
- Potentially reducing fees through pooling of assets[4]
- Making selection of asset classes simpler

As a result of all these facts, the investment menu that most resembles a "consensus best practice" today includes the following features:

1. A tier of one or more pre-diversified "QDIA[5]" investments, such as risk-based funds, target date funds, balanced funds, or a managed account service.
2. A tier of a few "core" funds for participants to construct portfolios.

An optional "third tier" is sometimes included. This tier often includes a self-directed brokerage fund, or more narrowly focused investment selections.

When selecting funds for the second tier, a range of approaches are used, but the most common elements are to offer the following asset classes:

- Domestic (US) equities
- Foreign and/or International equities
- Domestic intermediate core fixed income
- Capital preservation

Domestic Equity – For US stocks, plans take a variety of approaches, and for good reason – there are thousands of investment choices out there, and many are high quality. In general, however, plan sponsors offering US stock choices will include a blend of actively and passively managed choices, and offer choices that include strategies that represent a range of average market capitalizations.

Market Capitalizations – Market capitalizations refers to the size of the individual stocks that would be considered part of a particular category. The broad categories in domestic equities include Large-Cap, Mid-Cap, and Small-Cap.

Active vs. Passive – The term "passive" indicates that an investment fund's holding are meant to replicate the performance of a specific stock market index (e.g. the S&P 500 Index). The term "active" means an investment manager has full discretion over how the fund is invested, and is attempting to outperform an index which is considered a benchmark for the active manager's

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[4] When investments are consolidated into relatively few funds, it is often possible to gain access to cheaper versions of the same mutual fund, or to access breakpoints in separate accounts and collective trust funds. Thus, with the same sized plan, plans with fewer options can often achieve lower fees.

[5] The term QDIA refers to a "qualified default investment alternative" under ERISA. Certain safe harbors have been established for plan sponsors defaulting participant assets into these funds. More detail on these options will be provided in a subsequent section.

performance. In general, the success rate for active managers in outperforming benchmark indices is poor. Further, the success rate is lower with larger capitalization stocks and higher with smaller-capitalization stocks. Since the management costs of actively managed funds are higher than for passively managed funds, plan sponsors should closely evaluate this issue when designing their menus.

Growth vs. Value – The term "growth" in relation to fund management means the investment manager is focused on stocks with high growth potential. The term "value" means the manager is focused on funds which are attractively priced relative to their future potential. Growth vs. value is a prism through which a plan sponsor can choose or not choose to structure fund choices for participants. Funds that combine both growth and value components are typically referred to as "Blend", or "core" funds.

Foreign and/or International Equity[6] – As with US stock funds, the foreign and/or international fund category offers its own considerable diversity. Foreign/International stocks can also be broken out by different capitalization ranges. However, unlike US stock funds, there are additional categories such as exposure to different currencies, regional economies, and degrees of economic development. In addition, for many years now, the most rapidly growing economies of the world have been in so-called "emerging" and "frontier" markets.

Broadly speaking, it is considered a best practice to offer access to international equity funds with exposure to:

- Developed markets, such as those represented in the MSCI EAFE index,
- International developed small and mid-cap equities, and
- Emerging market equities, preferably both developed and small and mid-cap, such as those represented in the MSCI ACW index

There are a number of ways to approach offering exposure to these key asset classes. It is possible to offer a fund representing each asset class. It is also possible to select from a handful of global equity funds to provide exposure to all of these. However, the best practice that encourages maximum diversification for participants is likely to offer one or two funds that are benchmarked to or represent a broadly diversified global equity index, such as the MSCI All-Country World excluding the US Investable Market Index, or MSCI ACW IMI, for 'short'. While the acronyms may be unwieldy, funds benchmarked to this index and its peers will provide access to international developed large and mid-cap equities, as well as large and mid-cap emerging markets stocks, all in a single fund.

[6] Funds that hold principally or entirely stocks of non-US entities are normally referred to as foreign or international equities. Funds that invest significantly in both US and overseas stocks are commonly referred to as "global equity" funds.

BEST PRACTICE ALERT – The biggest challenge in designing an investment menu is balancing the benefits of simplicity with the benefits of diversification. You'll be more successful at this if you anchor your investment decision-making in the average participant's experience of the investment menu. "Those in the know" (e.g. investment professionals, consultants, even plan sponsor staff) will have a variety of prisms through which they define the investment landscape. But your participants' perspectives are the most important, because it's their interpretation of the choices you provide that will drive the choices they make. If your participants don't really speak the language of "growth vs. value," "inflation-protection," or "passive vs. active," then it's unlikely that they will make decisions built around those concepts.

If you're not sure what your participant perspectives are, you can conduct surveys and focus groups to find out. If you find that too much complexity is confusing them, create simplicity in your menu by, for example, looking for established funds which blend different investment approaches (e.g. both a growth and value approach) or creating custom funds which do the same (e.g. blending passive and active fund managers) .

Many if not most of your participants are only willing to engage with investor education at a minimal level. This means it's not what they "should" know that matters, it's how they interpret the choices you set before them. By focusing on this, you provide them a tailwind, not a headwind, for positive outcomes.

Many plans have opted to follow this route because these very broadly diversified funds still provide the core exposures while being less volatile than the individual components – such as emerging markets – would be as standalone investments.

Domestic Intermediate Fixed Income (Bonds) – As with the other asset classes, there are a range of options for providing access to fixed income. By far the most common type of fixed income option offered to US DC plan participants is a so-called "core fixed income" option. These funds usually have characteristics like average yield, maturity, credit quality, issue type, and duration similar to the Barclay's Capital US Aggregate Bond Index.

Usually, fixed income funds are offered in a lineup to provide a counterbalance and diversifier to the equity markets. As a result, while good returns are sought from fixed income, it is often the case that these funds are managed with a more conservative return goal than many equity funds. Because of this fact, additional fixed income sectors such as high yield, long duration, bank loan funds, or mortgage funds are offered far less frequently in defined contribution plans. As with other asset classes, it is possible, and often beneficial, to expand the scope of sources of return for participants, provided that doing so does not result in offering many narrowly focused, volatile investment options. Thus, the theme of broadly diversified funds with many component exposures to different sub-asset classes has continued to gain influence. Pairing a passive with an active approach can be used for this asset class as well.

In addition to intermediate fixed income, a significant portion of plan sponsors also offer a low-duration fixed income fund, with a shorter duration and average maturity than the intermediate funds. These funds can provide a good diversifier, and often a lower-risk option for conservative investors. However, because of their low-duration, these funds can often create problems for plan sponsors offering a stable value fund[7].

Capital Preservation – There are several options for capital preservation, though a few are far more common than others. The two most common options for capital preservation are money market mutual funds or some variation of stable value funds. There are several key differences between the two, but both serve the purpose of providing plan participants with a stable fund with low risk.

Money market funds are, in many ways, among the most conservative of the common capital preservation options. Tightly regulated options, they have several restrictions on credit quality, average maturity, and other risks taken on by the funds. Because they normally take on less interest rate risk – duration – and less credit quality risk than most stable value funds, the returns of money market funds are typically lower than stable value funds[8]. In very low-interest rate environments such as in the years 2009 to 2013, the returns can be literally zero.

In contrast, stable value funds typically offer a higher rate of return than money market funds. These funds come in a number of structures, including collective investment trusts, separately managed accounts, guaranteed income contracts, and fixed annuities/general account products from insurance companies. In each case, the investments supporting the fund typically include interest rate sensitivity and average maturity much higher than is the case for money market funds, and there is often an allocation to fixed income sectors not present in money market funds. These funds use a variety of insurance products to smooth returns, reducing volatility for participants. Either a money market or a stable value fund is offered by the majority of plans. While some plans offer both, many avoid doing so to avoid imposing equity wash rules[9].

After money market funds or stable value funds, plan sponsors have pursued a range of other capital preservation options, including FDIC-insured savings funds, certificates of deposit, and low-duration fixed income. Each of these can serve as an effective option as well, but the choices are far more limited, and each involves unique operational and administrative challenges.

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[7] Many stable value funds and fixed annuities include in their contracts a protection against so-called "competing funds". While the definition of these funds varies from provider to provider, and case to case, in general they are understood to mean high quality fixed income funds with a duration of less than 3 or 4 years. As a result, for plans with a stable value fund, offering a low-duration bond fund can mean that the plan will need to impose an "equity wash" provision. Equity wash provisions require that assets invested in the stable value fund must be invested in something other than a competing fund for 90 days or more before being reinvested in a competing fund.
[8] There are some exceptions that have negatively impacted the stability of money market funds during the recent financial crisis. Money market funds often make use of repurchase agreements, or "repos", which can involve some counterparty risk.
[9] Please see the prior footnote for an explanation of these rules.

Non-Traditional Assets Classes – Because defined contribution plans are beginning to replace defined benefit plans in the private sector, there has been some interest in incorporating asset classes into defined contribution that were usually the domain of large institutional portfolios. These asset classes include:

- Inflation protected securities (most commonly known as TIPS)
- Real Estate
- Commodities
- International fixed income

Since defined contribution plans are generally valued and the balance is displayed to the account owner on a daily basis, some of these assets did not easily lend themselves to daily valuation and liquidity. To overcome this obstacle, real estate investment trusts (REITS) and commodity futures have been used as a surrogate for the actual assets in order to capture the diversifying effect of that asset class. Most plans use these products in a pre-diversified asset allocation fund (see below), but there are new funds being developed as standalone options, generally for an inflation protection component in a participant's portfolio.

Pre-Diversified Funds – While a great deal of effort and energy is devoted to selecting and monitoring individual mutual funds, recent trends show that many participants are seeking an easy to use pre-packaged "diversified" investment option. These options include risk-based funds, balanced funds, and target date funds. Because these options provide participants with a range of advantages not available from other choices – and because they have been endorsed in the ERISA market as defaults – these funds have grown to the point that across the marketplace they are receiving 50% or more of new fund flows[10]. The key benefits that all of these options offer are:

- A single option that offers a fully diversified portfolio
- Automatic rebalancing

In addition, some options offer additional benefits, such as:

- A risk-return profile that changes with the participant's age
- Automatic risk profile adjustment along a glidepath from target date funds
- Selection of a portfolio by age, rather than an unknown risk tolerance when defaults or mapping is conducted
- Can be customized to reflect the demographics and savings patterns of employees
- Can utilize other asset classes not usually used as core options; such as inflation protected securities, real estate, international bonds, and even commodities.

In addition, managed account products can also be offered, allowing participants the opportunity to have a professional management service create a customized portfolio from a broad range of investment options. While this type of option provides greater individuality and flexibility, it is important to note that in many cases the fees for these services can be significant.

[10] See the Callan DC Index™ http://www.callan.com/research/dcindex/

Selecting one or more pre-diversified option does introduce some complexity at the plan sponsor level, while reducing plan complexity for participants utilizing these options. For example, a participant in a plan that offers target date funds or a suite of risk-based portfolios can select a single fund and receive a professionally managed, diversified portfolio, rather than needing to construct one on their own. However, plan sponsors offering these funds face a variety of questions, such as:

- Is the risk/return profile of the risk-based funds appropriate to participant needs?
- Does the target date fund glidepath suite meet the needs of my participant population?
- If there are performance issues with a target date fund suite, how do you evaluate performance across 10-12 funds, instead of one at a time, with most core menu options?

Plan sponsors should seek out which, if any, of these options best suits their plan participants. Often, it is best to look at a list of funds outside of those offered solely by your plan's recordkeeper or administrator. Frequently it is very helpful to engage a third-party independent investment consultant to assist with these questions as well. Governments – especially those in the mid- to small range – should strongly consider engaging a third-party independent investment consultant to assist with these questions as well. A reputable consultant will educate a Plan Board/Committee on their plan responsibilities, including an understanding of all fund and plan-related fees. Usually, a plan sponsor will more than make up the cost of the consultant fee by the savings realized when going to bid. Further, a consultant adds an additional layer of protection from a fiduciary standpoint[11].

While providing oversight to these options can be complex, pre-diversified options are becoming the primary destination for new investment in public defined contribution plans, and their use has been shown to significantly improve participant asset allocations. As a result, it is considered a consensus best practice in the industry to focus significant attention – both from plan communication and investment perspectives – on the pre-diversified option as a centerpiece of the modern defined contribution plan.

Self-Directed Brokerage – Self-directed brokerage windows, or SDBA's, as they are also called, are present in many DC plans. Through these windows it is possible to gain access to investment options that are not reviewed or approved by plan fiduciaries, but that may suit the specific investment needs of individual plan participants. Typically, the fees for these windows are borne by participants in the form of annual account fees, and/or transaction level fees.

From a pure investment perspective, it is not clear that adding a brokerage window will help participants achieve superior returns, both due to participant trading behavior in these windows, and to the higher fees associated with using them. Additionally, because most brokerage windows require that plan participants first move assets from the core menu to a money market fund inside the window before making trades, brokerage windows also frequently result in the imposition of an equity wash provision for plans offering stable value funds.

[11] Like that of a recordkeeper, the contract of a consultant should be sent out for bid approximately every five years.

Lastly, some brokerage windows also can make changing recordkeeping firms somewhat challenging. Should a plan offer a brokerage window and then change to a new recordkeeper years later that does not offer the same brokerage window, it is possible that a portion of the assets in the window would require liquidation in order to complete the transaction, which can upset participants if it takes significant time to liquidate the assets.

There are some benefits of brokerage windows, however. Some plan participants use them to gain access to investments outside of the core plan menu that may be a component of a holistic financial strategy across a household, developed using a financial planner. In other cases, participants are executing a similarly specific strategy. And, of course, it is also helpful to allow participants to have significant freedom of choice in the window, rather than facing pressure to significantly expand the core investment menu to cater to specific investment needs.

Other Considerations

Account Structure – Historically, defined contribution plans have used "retail shares" of nationally recognized mutual funds. These mutual funds, along with their various share classes, have ticker symbols available on numerous financial tracking services. Retail shares of a mutual fund often have a higher cost than the institutional share class of the same fund, or a similar strategy offered in a separately managed account or collective trust fund. As fund assets increase, funds in the plan often become eligible for a lower-cost share class, or an alternative vehicle that reduces the fees ultimately paid by participants (although most "large" defined contribution plans use institutional share class mutual funds, the vast majority of medium to smaller plans use higher cost retail shares). However, it is imperative that plan sponsors that use any retail shares understand the fee structures paid on such funds.

Following are typical fees associated with many mutual funds:

12b-1 fees – The annual marketing or distribution fee on a mutual fund.

Sub-TA fees – "Sub-transfer agent" fees are paid by a fund company to intermediaries. These are ostensibly for maintaining the financial records for each individual investor account so that the mutual fund company need not maintain such records, but in practice are often used to provide revenue-sharing credits for recordkeepers and others. Importantly, while 12b-1 fees are disclosed by prospectus, Sub-TA fees are not.

Management fees – A fee paid to the investment team for running a mutual fund, including the buy/sell decisions and for research and support services.

The actual person or entity receiving the above-mentioned fees is often not obvious. Such fees may ultimately be negotiated and used by plan sponsors to offset plan expenses provided that such use is in the best interest of the plan participants. A qualified consultant or advisor should have a complete understanding of such fees and educate the plan sponsor Board/Committee.

In addition to mutual fund fees, there are several other options frequently seen in governmental plans that can provide significant hidden revenue. Two of the most common include:

Spread Revenue in a General-Account-Backed Fixed Annuity – When plans opt to offer a "fixed fund" for capital preservation that is structured as a fixed annuity, backed by an insurance company's general account, it is often the case that no fees are disclosed as a part of the investment. This does not mean that they do not generate revenue. Instead, revenues are earned by the insurance company by reinvesting the assets invested with them, and retaining the difference between what their investment portfolio earns, and what is guaranteed to plan participants. This difference is referred to as the "spread", and it can often be one of the largest sources of compensation for plan recordkeepers.

Managed Account Fees – Often plans that adopt managed account services find that 10-20% of participants opt in to use the service, and fees often range from 30-60 basis points on assets. For plan sponsors using an external managed account provider, some portion of this revenue is normally shared with the plan recordkeeper. Plans seeking maximum fee transparency are encouraged to request reporting on these fees.

As governmental plan assets continue to grow plan sponsors will have increased negotiating power over the types of assets and fund share classes held within the plan. With increased asset size often comes access to cheaper, more institutionally-oriented vehicles, such as:

- Separate accounts
- Commingled collective trusts
- Institutional mutual funds

Fee Transparency – Fee transparency has become a hot topic in the media and regulatory circles in recent years. Passively managed portfolios (index funds) can be had for a very low fee structure relative to an actively managed portfolio which potentially might offer a higher return. When choosing the account structure and fund options, it is important to understand your fiduciary role to create a program with a fee structure that could be considered "reasonable." However, neither the lowest fees nor the highest fees are necessarily the only gauge to use when selecting plan funds.

When hiring active investment managers, or choosing an actively managed mutual fund, it is critical that the plan sponsor periodically shops around (potentially via an RFP) for a reasonable fee structure, for the type of investments desired, and uses a selection process that is defendable.
