

## 2009 ISSUE BROCHURE

# IS “YOUR MATTRESS” A VALID RETIREMENT SAVINGS OPTION?

## The Implications of Financial Turbulence for Plan Sponsors

As a result of the recent financial turbulence and market volatility, Plan Sponsors may feel inundated with questions and concerns from participants about losses within their accounts. Active participants may question the value of continuing contributions, and retired participants may withdraw assets to place in “safer” money market or savings accounts. The standard responses about staying the course, diversification, asset allocation, rebalancing and dollar-cost averaging may ring false in frightened participants’ ears. These suggestions might be better received if Plan Sponsors are able to also offer effective tools AND if Plan Sponsors have an effective, easy to understand plan design.

This brochure reviews two of the more common investment options and the implications of these investment options for both the participant and the Plan Sponsor. The brochure ends with a general discussion of participant risk – what it is and what it isn’t. The intent is to help Plan Sponsors understand, design and implement plans with investment options designed to help participants feel more secure during times of uncertainty.

tremendously. Therefore, a target date fund is not a target date fund; it’s not a one-design-fits-all. Unfortunately, some Plan Sponsors have added target date funds without identifying and communicating the advantages, disadvantages and expected outcomes. Consequently, what a participant thinks they are receiving might not be what the Plan Sponsor is offering.

Diversity in target date fund design is especially significant in close-to-retirement funds. Different assumptions related to outcomes and to the meaning of the 2010 date (end of the glide path vs. point on the glide path) have a significant impact on the funds’ returns. The 2008 annual returns of the 2010 Target Date funds are a vivid reminder of the magnitude of those differences. Depending on the investment manager, a 2010 target date fund delivered a return of anywhere from -3.61%, or -41.32%. The consequences of selecting a fund without understanding its design principles can be life-changing for a participant.

### TARGET DATE FUNDS

Target date (lifecycle) funds were first introduced in 1993. During the past few years, mainly as a result of the Pension Protection Act (PPA), which made them a valid auto-enrollment default, target date funds have grown rapidly in number and in size and are now a mainstream investment option for many defined contribution plans. Plans may have added target date funds as one of many investment options, without fully considering the implications and varying outcomes depending upon different circumstances, including participant use and market conditions.

The recent financial turbulence has highlighted many different implications between participants and Plan Sponsors that previously may not have been considered. The design of target date funds varies



## Implications for Participants

Participants' decisions to use a target date fund should be no different now than they were before. Participants often choose to invest in target date funds because they do not have the time or inclination to become more involved in investment decision-making. They should nevertheless take time to understand the structure of the target date funds that are offered and select the fund best suited to their anticipated circumstances and retirement needs.

Many target date fund managers assume they will be managing participants' assets in the target date fund for 20 to 30 years after retirement. Others assume that participants will withdraw a lump sum at or around the time of retirement. Although in both cases the same date is used to name the fund (i.e., 2030, 2020, 2010), the time horizon – and therefore the allocation to higher-risk assets – is likely to be higher in the first case. Participants need to be fully aware of those underlying assumptions so they can make an informed decision and avoid surprises in retirement.

In an ideal world, participants would also consider their risk tolerance and additional investments outside of the defined contribution plan, either of which might suggest a more or less aggressive target date fund. If participants did not consider these when selecting a target date fund, they may be disappointed with their selection, especially given the possible impact of market volatility on account balances. Because of the current economy, participants who had anticipated retiring in the near future might be rethinking their plans. If so, participants should reassess which target date fund is most appropriate.

Unfortunately, these thought processes tend to be contrary to the idea that target date funds are easy and “decision-free” for the participant. This is how and why the Plan Sponsor's implications and design responsibilities become essential.

## Implications for Plan Sponsors

In any market environment, Plan Sponsors should do their homework to understand and match the structure of the target date funds to the demographics of their plan participants. No single solution is best for every Plan Sponsor, but there are common issues to be considered:

### I. Role of the defined contribution plan

- a. Is the defined contribution plan a supplemental plan to a defined benefit plan, or
- b. Is it the only retirement plan for the participants?
- c. If it is a supplemental plan, what is the likelihood that market conditions could ever result in a re-evaluation of the Plan Sponsor's long-term commitment to maintaining a defined benefit plan?

The answer to these questions could lead to

different desired structures, such as a more aggressive or more conservative asset mix.

### 2. Glidepath

- a. What is the average age of retirement for participants?
  - i. Most target date funds are based on a retirement age of sixty-five, which is older than the age that many public sector employees retire. The earlier the retirement age, the longer the retirement savings have to last.
- b. How do participants take distributions upon retirement?
  - i. As previously mentioned, participants who plan to take a full or partial lump sum after retiring may want to reconsider whether a target date fund with significant equity exposure is appropriate.
  - ii. On the other hand, participants who plan to take a stream of income should consider appropriate equity exposure.
- c. What is the outcome that the Plan Sponsor believes needs to be accomplished by the fund, and how is it measured?
  - i. Probability of achieving a certain real income replacement ratio?
  - ii. Median expected retirement savings?
  - iii. Range of expected returns?
  - iv. Probability of running out of money by a certain age?
  - v. Other?
- d. How is the asset mix weighted along the glide path to increase the probability of meeting the fund's objective?

### 3. Underlying investment mix

- a. What are participants' reactions to market volatility? For most participants, the recent market downturn is the worst they have experienced.
- b. Is the investment mix designed to reduce volatility? Ideally, Plan Sponsors want participants to use a target date fund as the sole investment option and to use it over the course of their careers.
- c. Will negative reaction to market volatility encourage participants to transfer assets out of more volatile funds? If so, do your target date funds include asset classes such as TIPS, REITs or commodities to reduce volatility?
- d. How is your target date fund designed to respond to unexpected inflation? Is it properly diversified and does it include meaningful proportions of inflation-hedging assets?

### 4. Active/Passive

- a. Given that a target date fund is composed of a number of underlying funds, are the underlying asset classes actively or passively managed?
- b. Is the glide path actively or passively managed?
- c. Are you, as the Plan Sponsor, confident that various actively managed funds will meet or

exceed their respective benchmarks in the future?

- i. If not, will underperformance encourage some participants to move assets out of the target date funds?
- ii. Is the additional cost of active management paying off?

#### 5. Custom or off the shelf?

- a. Considering the demographics, plan size, fees, and Plan Sponsor's ability to monitor investment managers, does it make sense to create a customized version of target date fund or use an existing off-the-shelf product?

#### 6. Communications

- a. Plan Sponsors should take steps to effectively communicate with and educate participants about target date funds to set proper expectation, and to encourage proper use of the funds.

For further information regarding target date funds, see the *NAGDCA Guide to Lifestyle/Lifecycle Funds for Asset Allocation*.

## STABLE VALUE FUNDS

Stable value funds, whether general account, guaranteed investment contracts (GICs), or synthetic GICs, are designed to deliver objectives of principal stability and relatively steady yields. Until recently, stable value funds were considered relatively benign investment options with very little risk. While the objectives of stable value funds remain the same, the recent upheaval of the financial markets and the impact on finance and insurance-related firms has dramatically changed the stable value landscape, creating a more challenging and uncertain environment.

From the perspective of some participants, some of the underlying fixed income securities that were once thought to be extremely secure are now viewed with skepticism. For example, given the recent problems with Alt-A and subprime mortgage securities, many once-confident stable value investors are now fearful of all mortgage-related securities and, in turn, are questioning the relative safety of stable value funds that hold any mortgages.

From the Plan Sponsor perspective, recent events have resulted in a greater need for due diligence and more "looking under the hood" to determine what underlying assets might be at risk of increased price volatility.

Additionally, market conditions have resulted in the market values for most stable value funds falling below the funds' book value. This means that Plan Sponsors should not only monitor the funds' investments, but must also monitor the stability of the wrap providers and their willingness to retain and/or expand their book

of business. One troubling result of the market dislocations of the past 18 months for stable value funds holding synthetic GICs is the supply constriction in the wrap market. Several significant wrap providers have exited the market, and the remaining wrap providers have become more risk averse and either are unwilling to write new contracts or are doing so with higher fees and more restrictive contract provisions.

In the current environment, it is more important than ever for Plan Sponsors to discuss anticipated changes in their overall stable value investment portfolio with their stable value wrap providers – prior to making any changes. Previously, Plan Sponsors may have had flexibility to determine or establish investment guidelines or portfolio holdings for the stable value fund. As the market-to-book ratios have changed and wrap providers are absorbing more risk, some, if not all, of that flexibility has vanished.

Wrap providers are also sensitive to any changes in other investment options or plan features that could directly or indirectly affect participants' decisions to invest in a stable value fund. For example, adding new fund options or a self-directed brokerage account, or implementing automatic enrollment and using target date funds as a default option, could cause wrap providers to consider increasing their fees, changing contract terms, or terminating their contracts. In some cases, wrap providers may not be willing to amend contracts or continue to wrap a portfolio, depending on the changes that are planned. This is not to say that a Plan Sponsor should not consider changes because of the possible implications with wrap providers. Plan Sponsors should ultimately do what is in the best interest of participants. However, coordinated discussions with the investment managers and wrap providers are necessary to maintain understanding and confidence that the stable value fund will remain secure and available.

Finally, crediting rates for the stable value funds are also declining as a result of the current market environment and are likely to continue declining in the near future. In order to maintain their wrap providers, Plan Sponsors might consider other strategies that could affect crediting rates and lessen risk, such as:

1. reducing the crediting rate to improve the market-to-book ratio
2. holding larger cash equivalents to provide liquidity
3. reducing the general level of risk in the fund's fixed income investments

Overall, stable value funds still provide relative value and meet their key objectives despite these challenging times. However, Plan Sponsors and their investment consultants are encouraged to expand their due diligence efforts, make sure they understand the risks inherent with stable value funds, and increase communication with participants to alleviate concerns.

## RISK IN THE FRAMEWORK OF A DEFINED CONTRIBUTION PLAN

A retirement planning strategy is a combination of the following:

1. contribution rate levels
2. investment strategy

The greatest risks to the defined contribution participant are: 1) the possibility of running out of money in retirement, 2) having to reduce significantly his or her standard of living, and 3) reentering the workforce. When planning for retirement, defined contribution participants need retirement planning strategies which ensure they save enough money they can support their lifestyle throughout retirement. It is important that Plan Sponsors design plans that allow the participants to achieve that goal. Plan Sponsors also need to ensure that participants understand the intent of the plan and their own retirement income needs. Too often, participants underestimate their retirement income needs and the potential income one single plan may realistically be able to provide. Participants need to know if their defined contribution plan is a primary or a supplemental plan – if it is their main retirement savings plan or just a way to save extra money – and from that point, how it will coordinate with other plans, savings and assets.

For a participant, running out of money in retirement does not mean a low probability of running out of money by the age of 87 – which is the current average life expectancy for a person who reaches retirement. This is an extremely difficult concept and thought process for most participants to grasp and apply, but it is very important in the context of understanding expectations and planning appropriately. The average life expectancy means that 50% of the people are expected to live to that age and 50% are expected to live longer. Nevertheless, no one should consider it appropriate to have a 50% probability of running out of money by age 87. Some participants may be comfortable with the prospects of having a 5% probability of running out of money at the age of 90; others will only be comfortable with a 1% probability of running out of money at that age. Exactly how much risk is appropriate and acceptable varies among participants.

There is a difference between risk of the investment strategy and risk of the retirement planning strategy. Although counter-intuitive to many participants, a low risk investment portfolio, combined with a low contribution rate, is not low-risk retirement planning – another difficult concept for participants to grasp. Participants using that combination are highly likely to outlive their retirement savings. With a low level of contributions, a riskier portfolio with potentially greater returns might reduce the probability of outliving savings somewhat, but it still unlikely to achieve the participants' goal for retirement income.

## Risk of investment strategy

Typically, most people look at investment risk as the volatility (standard deviation) of investment returns. Quite often this measure is also narrowed down to looking solely at equity market returns. This is an incomplete measure of risk. An important factor that needs to be considered is inflation. Even with 3% inflation, \$209 nominal in 25 years is needed to support the spending equivalent to \$100 today. If a defined contribution plan participant encounters 8-12% inflation for 4 years, his/her purchasing power decreases by one-third. Defined contribution participants need to accumulate and preserve real dollars because their liabilities in retirement are denominated in real dollars. They need to prepare and preserve their purchasing power. Unless their individual portfolios are already constructed to favorably respond to inflation risk, the result can be catastrophic.

For example, once inflation risk is taken into consideration, stable value funds, money market, or the other “mattress” options are not low-risk assets. Treasury Inflation Protected Securities (TIPS) are a risk-free or minimum-risk asset. TIPS are issued by the U.S. government and make interest and principal payments in inflation-adjusted dollars.

The Plan Sponsor must design a plan that provides their participants with the ability to manage the risk of outliving their savings. This includes provide investment options with an adequate emphasis on real returns (inflation-adjusted returns), not just on nominal returns. This is especially important for default investment options, since the Plan Sponsor portrays them as having an appropriate level of risk for most participants.

In conclusion, current market conditions have participants worrying, rightfully so, about the security of the retirement investments, and, consequently, making the wrong decisions when trying to protect themselves. The decisions occur due primarily to fear and misunderstanding. It is incumbent upon Plan Sponsors to fully understand their participants and their participants' needs, and to design plans that provide the helpful investments and tools – in all economic conditions.

Neither NAGDCA, nor its employees or agents, nor members of its Executive Board, provide tax, financial, accounting or legal advice. This memorandum should not be construed as tax, financial, accounting or legal advice; it is provided solely for informational purposes. NAGDCA members, both government and industry, are urged to consult with their own attorneys and/or tax advisors about the issues addressed herein.

Copyright 2009 NAGDCA