NAGDCA Automation of DC Plans Taskforce
Consideration of DB Features for DC Plans Guide

Background

The Pension Protection Act of 2006 (PPA) provides important safeguards that permit defined contribution (DC) plan sponsors to implement a number of specific defined benefit (DB)-like features. Various studies (see "References" on page 2) have concluded that DC plans underperform DB plans by as much as 1 to 2% per year due to the combined impact of inferior asset allocation by plan participants and higher plan costs. There are many who believe that adopting certain elements of DB plans can significantly improve participant outcomes in DC plans. The protections offered by PPA apply to private plan sponsors under ERISA and can serve as useful plan design guidance to the public sector for this purpose.

NAGDCA established the Automation of DC Plans Task Force in 2008 to study DB-like elements being implemented or considered by DC plans and to provide an analysis for NAGDCA plan sponsors who may be considering implementing any of these features.

Structure of Guide

The Task Force prepared the following document in four sections to address the different elements of the DB-type plan features currently being implemented or considered by DC plans:

1. **Asset Allocation Vehicles: Qualified Default Investment Alternatives Under PPA** **Pages 3 – 5**

   DC plans generally require plan participants to build their own individual portfolios from an investment line up selected by the plan sponsor. The result is a wide range of asset allocation strategies. Many participants take on far too little or far too much market risk for their individual situations. Once in place, inertia sets in and allocations rarely, if ever, change. The result is an extreme dispersion of investment outcomes for participants who have similar employment, salary, age, and other characteristics. The PPA provides a plan sponsor with fiduciary protection against investment losses by participants who are defaulted into a Qualified Default Investment Alternative (QDIA) following a pre-notification period. This section examines the pros and cons of the three QDIAs designated by the Department of Labor: target-risk funds, target-date funds and individually managed accounts.

2. **Diversifying Asset Classes: Incorporating Underrepresented Categories Into DC** **Pages 6 – 9**

   Studies indicate that one of the reasons DC plans underperform DB plans is the underweight positions they carry in certain asset classes that contribute to the stability of DB portfolios (see "References" on page 2.). Labeled as "alternative" investments only a few years ago, these investments are now becoming mainstream. This section will examine several asset classes commonly found in DB portfolios that are now being added to DC plans as part of asset allocation portfolios and sometimes as standalone menu options: real estate, commodities and inflation protected securities.

3. **Retirement Income Vehicles: Guaranteed and Non-Guaranteed, In and Out of Plan** **Pages 10 – 11**

While many of the best elements of traditional DB pensions can be incorporated into DC plans, the one element that has been beyond the reach of DC plan participants is the DB plan's greatest benefit: guaranteed lifetime income. In recent years, new product and service offerings have been introduced to the market as in-plan options, or to assist participants when they begin taking distributions at the point of retirement. This section will review features of new living benefit and traditional deferred annuities as well as rollover platforms and non-guaranteed payout options.

4. **"Auto Everything": Complete Automation of the Participant Experience** **Pages 12 – 17**

DC plans have been built historically on the premise that participants are engaged and qualified to build their own investment portfolios after careful consideration of their individual retirement needs. Recent behavioral research indicates this idealized vision is far from reality. The PPA provides protections under ERISA for private sector DC plan sponsors wishing to exert far more control over participant decision-making and outcomes than has been the practice. This section describes a model for complete automation of DC participation including auto-enrollment, auto-escalation of contributions, implementation of Qualified Default Investment Alternatives (asset allocation defaults) combined with re-enrollment of existing participants into those defaults, and, finally, the integration of insurance guarantees into default funds to provide a lifetime stream of income in retirement.

For each feature, the guide provides a description, a rationale for considering the feature (e.g., research basis) and implementation considerations.

Acknowledgment
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References

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1. Asset Allocation Vehicles: Qualified Default Investment Alternatives Under PPA (Pages 3-5)			
Feature	**Description**	**Rationale for Considering Feature (e.g., research basis, etc.)**	**Implementation Considerations**
Target-Risk Funds	Target-risk funds were the first type of asset allocation product designed to simplify investing for participants to gain significant traction in the defined contribution (DC) plan market. Also known as "lifestyle funds" these funds are typically labeled as "conservative", "moderate" or "aggressive" in terms of their risk exposure. The key advantage of target-risk funds is that they simplify investing for participants by allowing them to (1) select a single fund based on their risk tolerance and other factors, (2) remain confident that their level of risk exposure will not change substantially over time, and (3) benefit from professional asset allocation management. One of the key disadvantages is that participants typically must shift from one target-risk fund to another several times as they get older and as their risk tolerance and other factors change. As compensation to managers for their value-added services (e.g., rebalancing, risk monitoring, review of overall and component fund performance, optimization), fees for managing the target-risk funds are sometimes charged in addition to the expenses charged by the underlying funds.	Studies conducted by the Center for Retirement Research at Boston College, CEM Benchmarking, John Hancock and others have found that the increased use of professional money management (e.g., through the use of target-risk funds and other asset allocation products) within the DC arena would significantly benefit DC plan participants. According to the CEM Benchmarking study, over the eight-year period ending December 2005, DC plans underperformed DB plans by 1.8% per year. (See "References" on page 9.) After 25 years, this 1.8% difference would reduce a DC plan participant's future account value by 34%. The use of target-risk funds allows DC investors to take advantage of professional portfolio management and asset allocation expertise found in DB plans. The most important investment-related trend in the DC industry is the significant increase in the use of asset allocation products, including target-risk funds. Market share increases within target-risk and target-date funds have been particularly significant since 2003, due in large part to the increasing adoption of these funds as default investments within auto enrollment programs. Some industry experts expect that a majority of assets in DC plans will be invested in asset allocation products within the next decade.	An evaluation of the implementation of target-risk funds by plan sponsors should include a consideration of the following: ▪ Should target-date funds and/or managed accounts (see "Target-Date Funds and "Retirement Managed Accounts" sections) be implemented in lieu of or in conjunction with target-risk funds? ▪ Does it make more sense to use an "off the shelf" product or a customized solution which can be adapted to factors such as the demographics of your employee base and the fact that your employees may participate in a DB plan? ▪ If a customized approach is being considered, should the funds comprising the target-risk funds consist of only those funds in the plan lineup? ▪ What is the asset allocation of the funds under consideration as this can vary significantly, particularly in terms of equity exposure? "First generation" target-risk funds have been viewed by some as simplistic as they often invested only in equities, bonds and cash. Should the funds under consideration include additional asset classes currently used in DB pension plans such as real estate and Treasury Inflation-Protected Securities to help participants achieve efficient diversification and hedge inflation? ▪ In terms of style, is there a preference for a passive approach or active management? How extensively should index funds, on account of their lower fee structure, be used? ▪ As this can vary by provider, what is the fee structure of the funds under consideration?

1. Asset Allocation Vehicles: Qualified Default Investment Alternatives Under PPA (Pages 3-5)			
Feature	**Description**	**Rationale for Considering Feature (e.g., research basis, etc.)**	**Implementation Considerations**
Target-Date Funds	Target-date funds followed target-risk funds as the second type of pre-packaged product to gain significant traction in the retirement plan market. Also known as “lifecycle funds”, “targeted-maturity funds” and “age-based funds”, target-date funds operate under the assumption that a single asset allocation (as in target-risk funds) will not be appropriate across the investment life cycle of a plan participant. Target-date funds typically assume participants will begin drawing assets out of their accounts in a certain year. The allocation for each fund is based on a “glide path” which adjusts its asset allocation model more conservatively as it gets closer to the target year. The target year is identified in the name of the fund. For example, if a participant plans to begin drawing assets from his/her account in 2020, he/she would select a fund with “2020” in the name. The funds are designed to take the stress out of investing by automatically allocating assets according to investor ages and expected payment commencement dates. With target-date funds, participants do not have to shift from one fund to another as they get older and as their risk tolerance and other factors change. As compensation to managers for their value-added services (e.g., rebalancing, risk monitoring, review of overall and component fund performance, glide path adherence and optimization), fees for managing the target-date funds are sometimes charged in addition to the expenses charged by the underlying funds.	Studies conducted by the Center for Retirement Research at Boston College, CEM Benchmarking, John Hancock, and others have found that the increased use of professional money management (through the use of target-date funds and other asset allocation products) within the defined contribution (DC) arena would significantly benefit DC plan participants. (See “References” on page 9.) According to the CEM Benchmarking study, due in large part to the professional money management used in the defined benefit (DB) space, over the eight-year period ending December 2005, DC plans underperformed DB plans by 1.8% per year. After 25 years, this 1.8% difference would reduce a DC plan participant’s future account value by 34%. The use of target-date funds allows DC investors to take advantage of professional portfolio management and asset allocation expertise found in DB plans. Furthermore, and in contrast to target-risk funds, the modeling of target-date funds is based on the real world observation that each DC investor is similar to a DB plan with an ultimate termination date. The most important investment-related trend in the DC industry is the significant increase in the use of asset allocation products, including target-date funds. According to data from the Employee Benefits Research Institute (EBRI) and the Investment Company Institute (ICI), target-date funds were available in two-thirds of 401(k) plans in the year-end 2007 EBRI/ICI database which is up from 57 percent in the year-end 2006 EBRI/ICI database. (See “References” on page 9.) Market share increases within target-risk and target-date funds have been particularly significant since 2003, due in large part to the increasing adoption of these funds as default investments within auto enrollment programs. Some industry experts expect that a majority of assets in DC plans will be invested in asset allocation products within the next decade.	An evaluation of the implementation of target-date funds by plan sponsors should include a consideration the following: ▪ Should target-risk funds and/or managed accounts (see “Target-Risk Funds” and “Retirement Managed Accounts” sections) be implemented in lieu of or in conjunction with target-date funds? ▪ Do you want the target-date funds to be your participants’ income solution in retirement or do you want some other vehicle for the purposes of providing retirement income (e.g., income guarantee solution)? ▪ Does it make more sense to use an “off the shelf” product or a customized solution which can be adapted to factors such as the demographics of your employee base and the fact that your employees may participate in a DB plan? ▪ If a customized approach is being considered, should the funds comprising the target-risk funds consist of only those funds in the plan lineup? ▪ What is the asset allocation of the funds under consideration as this can vary significantly, particularly in terms of equity exposure? “First generation” target-date funds have been viewed by some as simplistic as they typically invested only in equities, bonds and cash. Should the funds under consideration include additional asset classes currently used in DB plans such as real estate and Treasury Inflation-Protected Securities to help participants achieve efficient diversification? ▪ In terms of style, is there a preference for a passive approach or active management? How extensively should index funds, on account of their lower fee structure, be used? ▪ As this can vary by provider, what is the fee structure of the funds under consideration?

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Retirement Managed Accounts	Defined Contribution (DC) plans began offering discretionary managed account programs to participants following the Department of Labor's Advisory Opinion to Sun America dated December 14, 2001. Under this opinion, plan providers can offer investment advice to their plan participants, provided that the advice is provided by an independent third party, also known as the "Independent Financial Expert (IFE)." Unlike a typical fund, a retirement managed account is generally defined as a "goals-based" program – striving to help a participant achieve his/her desired retirement income goal with a certain probability of success. The advice recommendation provided to plan account program includes asset allocation and investment advice but can also include savings rate and retirement age advice. In managing a participant to an asset allocation strategy, the portfolio assignment process can differ by IFE with the most basic assignment method using an age based approach, similar to target-date funds, or as sophisticated as accounting for the total economic worth of a participant to provide for a personalized asset allocation strategy. This personalization is a true value-add to a retirement managed account program. As compensation for the additional services they provide participants, managed accounts typically charge higher fees than other forms of asset allocation products (e.g., target-risk funds, target-date funds).	Studies conducted by the Center for Retirement Research at Boston College, CEM Benchmarking, John Hancock, and others have found that the increased use of professional money management (e.g., through the use of managed accounts and other asset allocation products) within the DC arena would significantly benefit DC plan participants. According to the CEM Benchmarking study, due in large part to the professional money management used in the defined benefit (DB) space, over the eight-year period ending December 2005, DC plans underperformed DB plans by 1.8% per year. (See "References" on page 9.) After 25 years, this 1.8% difference would reduce a DC plan participant's future account value by 34%. The most important investment-related trend in the DC industry is the dramatic increase in the use of asset allocation products, including managed accounts. While market share has increased, there is still considerable growth opportunity. Further, managed accounts were selected as a default option under QDIA, making it an acceptable default investment for plan participants. Some industry experts expect that a majority of assets in DC plans will be invested in asset allocation products within the next decade.	An evaluation of the implementation of retirement managed accounts by plan sponsors should include consideration of the following: ▪ Should managed accounts and/or target-date or target-risk (see "Target-Risk Funds" and "Target-Date Funds" sections) be implemented in lieu of or in conjunction with managed accounts? ▪ Does it make more sense to offer participants a program that is "goals-based" to help them achieve their desired retirement goal, rather than just focus on the performance of an asset allocation fund? ▪ Is there a benefit in offering participants a managed account program that can be customized to their unique financial situation and provide personalized advice by factoring in such variables as their salary, deferrals, retirement account balance, external investments, spousal assets, cash flows, Social Security benefits and defined benefit pension benefits? ▪ In terms of style, is there a preference for a passive approach or active management? ▪ As this can vary by provider and their selected IFE, what is the underlying methodology used in the management of participant's retirement assets? ▪ As this can vary by provider, what is the fee structure of the funds under consideration and the advisory fee charged to participants?

2. Diversifying Asset Classes: Incorporating Underrepresented Categories Into DC (Pages 6-9)			
Feature	**Description**	**Rationale for Considering Feature (e.g., research basis, etc.)**	**Implementation Considerations**
Commodities	Commodity investing provides exposure across various sectors including energy, industrial and precious metals, livestock and agriculture. Commodity investing is typically accomplished through investing in futures contracts, with full portfolio collateralization, as opposed to direct ownership of an actual commodity. Full portfolio collateralization is a process where an equal amount of dollar value invested in commodity futures is also invested in a high quality investment such as T-bills or TIPS. This process makes the strategy "non-levered" and typically also provides a modest amount of excess return. Commodity exposure is typically managed against the Dow Jones UBS Commodity Index, although other indexes are available for benchmarking. Fees and expenses for commodity index-based investments are comparable to fees and expenses for equity funds. In addition, as with equity funds, fees and expenses will generally be higher for active versus passive commodity strategies.	Potential benefits of commodity exposure include: ▪ Diversification from traditional asset classes ▪ Inflation protection ▪ Long-term return potential Historically, commodity returns and their risk profile have been comparable to the returns and risk profile of the equity market. However, commodity index returns respond to different economic and market factors than equity returns, potentially providing important diversification benefits. Also, because commodities are hard assets, they represent an important inflation hedge, helping to mitigate the effects of rising food, energy or industrial metal prices, or the effects of a depreciating U.S. dollar. Holding commodities may also provide a way to invest in the strong growth outlook for developing countries such as China and Brazil, which can drive demand for physical commodities higher, potentially resulting in higher inflation.	Plan sponsors can offer commodities in various ways as a(n): 1. Stand alone core investment option 2. Stand alone core investment option balanced with other inflation hedging strategies such as TIPS and REITs (a "diversified real asset" approach) 3. Investment option within a self-directed or mutual fund only brokerage window. Plans offering commodities as an investment option must consider the following: ▪ How large should the commodities allocation be? ▪ What index should define the policy benchmark? ▪ What type of collateral should be used (e.g., T-bills, enhanced cash, TIPS) Allocations in the 2-5% range are typical, however research suggests a higher level may be optimal. As with any other DC investment, plan sponsors may request that their plan administrator limit participant allocations to commodities, if desired. The Dow Jones-UBS Index is often selected due to its diversification and lower volatility. The S&P GSCI is attractive for investors seeking more concentrated exposure to the energy markets. Collateral choice varies across investors based on their risk tolerances and other objectives. For instance, many investors have selected TIPS as collateral to achieve “double real” exposure (inflation hedging from both the commodities futures and the TIPS collateral).

2. Diversifying Asset Classes: Incorporating Underrepresented Categories Into DC (Pages 6-9)			
Feature	**Description**	**Rationale for Considering Feature (e.g., research basis, etc.)**	**Implementation Considerations**
Real Estate	Numerous investment experts, including those in the academic community, view commercial real estate as a fundamental asset class that should be used in all investment portfolios in addition to equities, bonds, and cash. Many defined benefit (DB) plans already invest in real estate for diversification and inflation protection. In defined contribution (DC) plans, real estate investing is typically performed through the use of publicly traded Real Estate Investment Trusts (REITs). REITs are commercial real estate companies that own and operate income producing commercial property such as malls, office buildings, hotels and apartment buildings and are traded on various exchanges, particularly the New York Stock Exchange. Fees and expenses for REIT investments (e.g., REIT mutual funds) are comparable to fees and expenses for other equity funds (e.g., growth stock funds). In addition, as with other equity funds, fees and expenses will generally be higher for active versus passive REIT strategies and generally higher for global versus domestic strategies.	Within the past few years, the DC market has seen a dramatic increase in the use of real estate within asset allocation products such as target-date and target-risk funds for diversification and inflation protection. Evidence of this trend may be found in Callan Associates' 2009 industry survey which found that 73% of the target-date fund managers surveyed had a dedicated real estate allocation in their offerings. (As recently as 2005, a minority of target-date fund managers were investing in real estate.) While some asset allocation products invest in private real estate, most target-date and target-risk fund products provide real estate exposure through the use of publicly traded REITs. This is largely because of the liquidity these REITs provide for purposes such as making benefit payments. Studies conducted by the Center for Retirement Research at Boston College, John Hancock, CEM Benchmarking and others have found that DC plans have underperformed DB plans. (See "Target-Risk Funds" and "Target-Date Funds" sections for more details.) The CEM Benchmarking study found that a key driver of the underperformance was the fact that certain asset classes used in DB plans, such as real estate, are not always made available in DC plans.	In evaluating the real estate asset class, plan sponsors should consider: ▪ Should real estate be made available within the plan's investment offerings to allow participants to achieve efficient diversification? ▪ If real estate is to be made available under the plan, should it be in the form of a standalone real estate investment option and/or as an allocation within an asset allocation vehicle such as a target-date or target-risk fund? ▪ If a real estate allocation is to be included in target-date and/or target-risk funds, what level of allocation should be used to provide a meaningful benefit (e.g., diversification, inflation protection)?

2. Diversifying Asset Classes: Incorporating Underrepresented Categories Into DC (Pages 6-9)			
Feature	**Description**	**Rationale for Considering Feature (e.g., research basis, etc.)**	**Implementation Considerations**
Treasury Inflation-Protected Securities (TIPS)	Treasury Inflation Protected Securities (TIPS) are government bonds that provide a return linked to the rate of U.S. inflation (as measured by the Consumer Price Index (CPI). If held to maturity, TIPS are unique in that they provide a government guaranteed return in excess of inflation, regardless of the level of future inflation. This is called "real return", which represents an increase in an investor's purchasing power. TIPS currently represent approximately 10% of the outstanding marketable debt of the U.S. government. U.S. TIPS represent about 40% of the global inflation linked bond (ILB) market. Fees and expenses for TIPS investments are comparable to fees and expenses for other lower risk fixed income funds. In addition, as with other fixed income funds, fees and expenses will generally be higher for active versus passive TIPS strategies.	An allocation to TIPS helps investors protect and enhance the purchasing power of their investment through exposure to government guaranteed bonds (Treasuries) that have returns indexed to inflation. TIPS are designed to provide investors protection against the risk of rising inflation and can also improve a portfolio's diversification, because other financial assets, such as stocks or bonds, may underperform in periods of higher inflation. Other potential benefits of TIPS include: ▪ Predictable real return (return above inflation) ▪ Low volatility ▪ Diversification relative to other financial assets Recently TIPS have experienced strong flows given increased investor interest due to massive fiscal and monetary stimulus to foster economic growth which could result in significantly higher inflation longer-term. TIPS currently offer inflation protection at very attractive levels.	Plans making allocations to TIPS must consider the following: ▪ How large should the TIPS allocation be? ▪ Should a US or global benchmark be used? ▪ Should an active or passive manager be selected? TIPS allocations are typically in the 2-5% range, though that level has been increasing given growing widespread concern regarding future inflation. As with any other DC investment, plan sponsors may request that their plan administrator limit participant allocations to TIPS, if desired. For most U.S. investors, a U.S. TIPS benchmark is typically selected. The reason is that U.S. investors are exposed to U.S. inflation risk, so TIPS, which are uniquely linked to U.S. CPI, provide the best inflation hedge. However, leading non-U.S. issuers of ILBs such as the UK have economic cycles and inflation rates that are highly correlated to the U.S. so global ILBs also can be used to hedge domestic inflation. Lastly, it is argued that active management of TIPS can provide the most efficient exposure to the asset class. Given the relatively smaller size and newness of the TIPS market, it is still characterized by inconsistent liquidity, non-trivial transaction costs and other structural inefficiencies. Therefore, many professionals believe that passive replication can suffer from inherent performance drag amid this less efficient market and that active management can better navigate these inefficiencies, provide more efficient exposure to the asset class, and also utilize many additional sources to add value while still closely tracking the selected benchmark.

References

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401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007**,** December 2008, EBRI Issue Brief #324, Employee Benefit Research Institute, 2008
http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=4132

3. Retirement Income Vehicles: Guaranteed and Non-Guaranteed, In and Out of Plan (Pages 10-11)			
Product Type	**High-level Description**	**Nature of Income Generated**	**Fee Structure**
Out-of-Plan Rollover Annuity Platforms *Supermarket Approach*	• Maximize income at point of distribution • Choice of insurers • Options include fixed or variable annuities	• Annuitization • Maximizes initial income (no upside potential for fixed annuity)	• Fees embedded in monthly benefit for fixed annuities • Monthly benefit incorporates investment management, longevity, administration, and risk charges
In-Plan Deferred Fixed Annuities	• Buy units of future income during accumulation • Purest “DB in DC”	• Annuitization • Maximizes initial income at time of investment (no upside potential)	• Fees embedded in future income amount • Incorporates investment management, longevity, administration, and risk charges
In-Plan Guaranteed Minimum Income Benefit (GMIB)	• Buy units of minimum future income during accumulation	• Upside potential before retirement • Annuitization or withdrawal benefit	• Accumulation: Explicit guarantee and investment fees; risk charges linked to benefit richness • Upon annuitization, future fees embedded in income amount via actuarial assumptions
In-Plan Guaranteed Minimum Withdrawal Benefit (GMWB)	• Guarantees: – basis for income – stable lifetime withdrawals with upside potential • Participant retains control of account balance • Market value determines account balance	• Income generated is initiated from income base • Investment paradigm (flexibility, upside) • Transfers market and longevity risks to insurer post-retirement • No guarantee of principal; guarantee of income	• Explicit guarantee fee and investment fee throughout accumulation and drawdown • Fee is expressed as percentage of account value or benefit base
Out-of-Plan Rollover Guaranteed Minimum Withdrawal Benefit (GMWB) *Institutional Offering*	• Guarantees: – basis for income – stable lifetime withdrawals with upside potential • Participant retains control of account balance • Market value determines account balance	• Income generated is initiated from income base • Investment paradigm (flexibility, upside) • Transfers market and longevity risks to insurer post-retirement • No guarantee of principal; guarantee of income	• Explicit guarantee fee, mortality and expense fee, and investment fee throughout drawdown • Fee is expressed as percentage of account value or benefit base

3. Retirement Income Vehicles: Guaranteed and Non-Guaranteed, In and Out of Plan (Pages 10-11)			
Product Type	**High-level Description**	**Nature of Income Generated**	**Fee Structure**
Out-of-Plan Non-Guaranteed Options *Managed Payout*	• Provides a drawdown strategy at a designated percentage	• No guarantees of principal or income streams generated	• Part of investment management fee

References

LINK TO WHITE PAPER ON RETIREMENT INCOME
http://www.irirc.com/assets/White%20Paper.pdf

LINK TO RETIREMENT INCOME PRODUCT COMPARISON CHART
http://www.irirc.com/assets/Criteria%20Chart.pdf

LINK TO RETIREMENT INCOME GLOSSARY
http://www.irirc.com/assets/Key%20Terms%20Glossary.pdf

LINKS TO ADDITIONAL RETIREMENT INCOME SUGGESTED READINGS

1.) **"It's Time for Income" (DC Focus)**
http://www.irirc.com/assets/Brown-Mitchell.pdf

2.) **"The Retirement Income Landscape" (Vanguard Center for Retirement Research)**
http://www.irirc.com/assets/Retirement_Income_Landscape.pdf

3.) **"The Security of a Guarantee" (Milliman)**
http://www.irirc.com/assets/Milliman.pdf

4.) **"Managing Longevity Risk – A Paycheck for Life" (UBS)**
http://www.irirc.com/assets/UBS_ManagingLongevityRisk.pdf

5.) **"The Retirement Decision: Current Influences on the Timing of Retirement among Older Workers" (Watson Wyatt)**
http://www.irirc.com/assets/RetTiming_OlderWorkers.pdf

Consideration of Features

4. "Auto Everything": Complete Automation of the Participant Experience (Pages 12-17)			
Feature	**Description**	**Rationale for Considering Feature**	**Implementation Considerations**
Step 1: **Auto Enroll New and Existing Employees**	The Pension Protection Act (PPA) offers plan sponsors governed by ERISA anti-discrimination testing safe harbor protections if they auto-enroll new employees in a defined contribution (DC) plan with specific auto-escalation provisions. Participants may opt out of these enrollment programs at any time. Under PPA, corrective processing procedures may be added to plan documents which allow participants to change their minds during the first 90 days and remove DC contributions without tax penalty. Note: Many elements of DC plan automation rely on protections offered by ERISA. While ERISA does not apply to public sector plans, it is often used by sponsors as a model for the purposes of plan design.	Both academic research (see "References" on page 17) and industry experience indicate that a very high percentage of eligible DC participants want to maximize savings and value auto-enrollment in DC plans. Inertia, coupled with cumbersome enrollment procedures, prevent many from actually joining their plan. Private sector participation rates have been stuck at 75% for several decades. This is a particularly large problem for the over 60% of eligible private sector workers who have no defined benefit program and are totally dependent on their DC plan for their supplemental retirement income. Limited data are available on the use of auto-enrollment in the public sector. However, employee acceptance of auto-enrollment in the private sector is very high: • 90% or more for new employees • 80% or more for existing employees "Active enrollment", an alternative method in which employees are required to make a specific "yes" or "no" decision on enrolling, yields comparable enrollment rates, indicating that participants are not being tricked into enrollment via automation and are receiving their desired outcome.	The PPA specifically preempts state laws against garnishment of wages, which had prevented some private employers from adopting auto-enrollment. This preemption would not apply to public DC plans, which are not generally governed by ERISA. Public DC plans need to follow state employment law. Collective bargaining arrangements often come into play and would need to be considered by public DC plans. While 2-3% is the normal auto-enrollment contribution rate, research indicates significantly higher rates are accepted by private sector participants. Initial rates of 5-6% show no higher opt out experience. Annual auto-enrollment for all employees, even those who have opted out of previous auto-enrollment programs, is employed by some employers to maximize participation rates. The existence of a mandatory DB plan by the plan sponsor and the contribution rate to the plan are considerations in the implementation of an auto-enrollment program.

4. "Auto Everything": Complete Automation of the Participant Experience (Pages 12-17)			
Feature	**Description**	**Rationale for Considering Feature**	**Implementation Considerations**
Step 2: **Auto-Escalate Contributions**	Under the PPA, the anti-discrimination safe harbor for auto-enrollment is only available to private sector DC plans if coupled with specific auto-escalation features: • Participants must be enrolled at a minimum rate of 3% • The plan must provide 100% match on first 1% and a 50% match on the next 5% (or 3.5% total) • Or a non-elective employer contribution of 3% of pay • Contributions must escalate up to 6% in 1% annual increments • Total escalated participant contributions may not exceed 10%	Auto-escalation addresses the concern that DC participants, especially those lacking a defined benefit pension, typically are not saving enough to fund a comfortable retirement. Contribution rates of over 10% are needed to replace a traditional pension and the average DC participant only contributes half that much. Employers are also reluctant to auto-enroll employees at more than a 3% initial rate so auto-escalation can be used to increase contributions to a more desirable rate. Auto-escalation came to prominence through the research of professors Richard Thaler and Shlomo Benartzi, and their Save More Tomorrow or "SMarT" program. The research, conducted in multiple plan sponsors, compared average contribution rates over a five year period for DC participants using (1) regular enrollment, (2) enrollment with personal advice and (3) an initial enrollment at 3% with annual auto-increase of an additional 3%. While both regular and advised enrollment generated higher Year 1 contribution rates, those rates never changed and auto-escalated participants had significantly higher contribution rates at the end of the five years – 13.6% on average versus 5.9% for regular enrollment and 8.8% for advice. Importantly, few abandoned the escalation program during the test period and it was rare for a participant to drop from the plan completely.	The SMarT program concept initially tied the contribution increase to the timing of the annual wage increase so participants would not feel a hit in their paycheck. While the idea makes common sense, experience over many implementations suggests that the timing of the increase is not important. Subsequent experience also indicates that participants can sustain contribution rates above the PPA 10% limit. It is important to note that auto-enrollment without auto-escalation typically leads to contribution rates below those of standard enrollment as participants are unlikely to ever change the typical 2-3% auto-enrollment rate. Best practice is to couple the two, or at a minimum start with a higher initial auto-enrollment rate in the 5-6% range. The existence of a mandatory DB plan by the plan sponsor and the contribution rate to the plan is a consideration in the implementation of auto-enrollment and auto-escalation programs.

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Feature	**Description**	**Rationale for Considering Feature**	**Implementation Considerations**
Step 3: **Default Contributions Into A QDIA Asset Allocation Investment**	The PPA provides safe harbor protection against litigation for investment losses for private sector DC plans using one of three Qualified Default Investment Alternatives (QDIAs) for investing participant assets in the absence of explicit participant direction: 1. Target-date portfolios 2. A risk-based portfolio reflecting the overall risk profile of the plan (i.e., a balanced or specific target-risk fund) 3. Individually managed accounts The options must take into account "the participant's age, target-retirement date…or life expectancy" and contain a mix of both equities and fixed income. Stable value assets may be grandfathered but new contributions will not receive the safe harbor protections.	Plan fiduciaries traditionally adopted stable value or money market funds as defaults under the theory that protecting principal, even if sacrificing appreciation potential, would minimize the risk of litigation. In the preamble to the proposed QDIA regulations, the DOL specifically stated that a stable value or money market fund was an inappropriately conservative long term investment "that over the career of the employee is not likely to generate sufficient savings for a secure retirement." Target-date funds are now by far the most popular DC default. Data from a recent Callan client survey indicate the following breakdown: • Target-date: 59% • Balanced: 13% • Target-risk: 10% • Stable value/MMF: 12% • Managed accounts: 3% • Other: 2%	Private sector plans are not required to adopt the QDIA safe harbor protection and can follow general fiduciary practices to maintain an alternative default investment. Target-date and target-risk portfolios come in three varieties: (1) record keeper proprietary, (2) non-proprietary unaffiliated and (3) customized. Customized portfolios are becoming more popular, especially with large plans. 33% of private sector plans with assets in excess of $1 Billion have adopted customized structures. Smaller plans may find off-the-shelf funds to be the most cost-effective option (see "Target-Date Funds" and "Target-Risk Funds" sections for more details). Open architecture and customization in all formats allow sponsors to select "best of breed" managers for each asset class while tailoring the asset allocation to meet the demographics of their plan. Customization may have unique benefits for public plan participants given their earlier average retirement age relative to the private sector and the continued presence of Defined Benefit plans for most employees, allowing more aggressive investments in supplemental plan defaults. The QDIA protections do not eliminate the need for sponsors to follow standard fiduciary processes in selecting their defaults. QDIAs are not commodities and need to be considered independent of record keeping arrangements, with special attention to underlying asset class management in both off-the-shelf and customized arrangements.

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Feature	**Description**	**Rationale for Considering Feature**	**Implementation Considerations**
Step 4: **Investment Re-election To Maximize QDIA Adoption**	In a step to accelerate adoption of new QDIAs, plan sponsors in the private sector are communicating and aggressively promoting the benefits of these new asset allocation options and requiring participants to "re-elect" their investment choices while at the same time making it clear that all assets and future contributions will be mapped into the appropriate portfolio based on the participant's age if no re-election action is taken. QDIA adoption using this negative consent process ranges from a low of 50% to as high as 80%, compared to the 2-4% adoption achieved from simply adding new QDIAs to the menu. The PPA protects private sector plan fiduciaries during this re-election process by providing guidance on when fiduciaries may map assets in the absence of specific participant direction. Those instances include when there is a • Record keeper change • Elimination of funds • Switch from previous non-QDIA default • Any other time a participant fails to give direction after 30-day notice to do so	Plans implementing QDIAs for the first time are increasingly interested in proactively promoting adoption of these better portfolios. An analysis of legacy portfolios assembled by participants acting on their own reveals an almost random distribution of equity holdings by age – in other words, no logical pattern of portfolio construction taking age or expected retirement date into consideration. This wide variation in equity holdings leads to a great dispersion of portfolio returns. In one study by consultant Ennis Knupp, participant-constructed portfolios underperformed a representative target-date fund approximately 60% of the time during a five-year period of weak returns ending in 2005 (cumulative individual account performance ranged from -60% to +40%). During a better performing three-year period ending that same year, 70% of participant accounts underperformed the target-date portfolios (with a cumulative account range of 0% to +80%). Participants don't retire on plan averages, they retire on the balances in their individual accounts. This wide range of investment performance will lead to widely varying retirement outcomes, which is troubling to many plan fiduciaries who now have the necessary protections to act to bring consistency to member investment performance.	Plan sponsors implementing re-election programs should be prepared for some level of participant complaint as would be expected with any plan change. Sponsors who have gone though this process report the total number and percentage to be quite low. While plans often do re-elections as a standalone event, it may be most convenient to coordinate the re-election with other major plan redesigns, such as a significant change in investment menu options or a change in record keeper. It is important to position this process as a positive activity designed to improve retirement outcomes for the majority of participants. Communicating the benefits of the QDIA should follow a two-track approach. Participants having the skill, time and interest in managing their own portfolios should be directed to the core option menu. Participants who indicate they don't have the skill, time, or interests should be directed to the QDIA as their best solution. Certain asset classes may have to be left out of the re-election process. Stable value portfolios are of special concern right now given the prevalence of market to book value discounts as well as contract termination notification periods, and may need to be excluded. A two-step re-election process can be considered which would address stable value assets at a future date. As with other plan changes, collective bargaining issues need to be considered.

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Step 5: **Default of Accumulated Assets Into Guaranteed Income Vehicles Pre Retirement**	As part of the final QDIA guidelines, the DOL endorsed the use of insurance guarantees within QDIA portfolios. Plan sponsors are interested in embedding annuities and related insurance vehicles within QDIAs to provide a seamless transition from asset accumulation during the working years to guaranteed income distribution during retirement years. By accumulating guaranteed income during the working years, participants can avoid exposure to adverse timing of retirement, as happened to individuals retiring in late 2008. This income stream can be accumulated by allocating a portion of participant’s contributions to purchase insurance products which issue a stream of lifetime payments, generally beginning no earlier than age 62. QDIAs for younger participants may contain no insurance allocations, which would not begin until midlife and then increase as a participant approached retirement.	Academic and public policy communities have long favored annuitization of DC balances at retirement as a way to efficiently pool longevity risk to prevent the social problem of retirees running out of money in old age. The United Kingdom in fact requires that 75% of DC balances be annuitized no later than age 75. As a practical matter, all but the most affluent UK plan members purchase a life annuity immediately upon retirement. Longevity continues to increase for Americans at a rate of one additional year of life expectancy every seven years. For a married couple retiring at age 65, there is a 25% chance that one of them will still be alive at age 97. Retirees must plan for a 30-year retirement but few do so. Given the difficulty of making a decision on how to manage their retirement savings, most enter the distribution phase with no plan. Inertia translates to inaction. Research from AllianceBernstein indicates that while a majority of DC participants trust their employers to do a better job of making investment decisions than they could on their own, an even higher percentage – over 85% – would prefer to have their employer make their retirement income decision for them. The need for annuitized DC income may be somewhat lower for public workers given the high percentage currently covered by a traditional DB plan, though uncertainties over funding and living costs could cause interest to grow.	Plan sponsors who want to encourage broad adoption of retirement income guarantees must consider including them in the default investments. When offered as in-plan options, participant take up rates have been very low – 10% at best. In-plan insurance products come in two basic forms with very different features: <u>Deferred Life Annuities</u> – These are traditional products in which assets are contributed to an insurance company in exchange for a stream of lifetime payments beginning immediately or in the future. The assets are invested in an insurance company’s general account and the annuity rate is based on bond-like returns. The decision to commit assets to these products is largely irrevocable. <u>Lifetime Withdrawal Benefits</u> – These newer insurance products guarantee a participant the right to withdraw a certain percentage of his beginning account value for life with an insurance company stepping in to continue payments if the account is depleted. This insurance can be discontinued at any time and the remaining account value can be withdrawn by the participant. Assets are invested in a balanced stock/bond portfolio in an account segregated from insurance company assets, allowing the withdrawal rate to potentially increase over time based on equity market performance.

Reference

"The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States"

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