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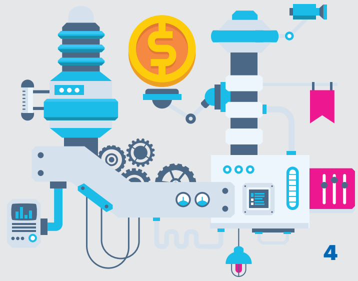
401(k) Investment Lineup



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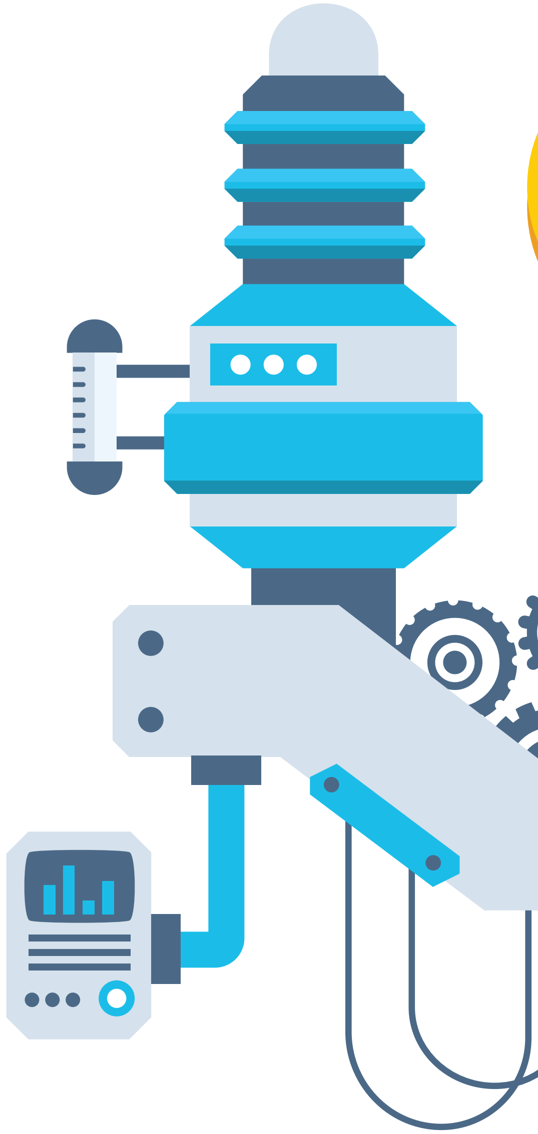
PLAN SPONSORS CONTINUE TO WORK WITH MANAGERS, RECORDKEEPERS AND CONSULTANTS TO DEVISE FUND OPTIONS AND USE AUTO FEATURES IN NEW AND SUCCESSFUL WAYS

Innovation Bolsters the 401(k) Lineup



As defined contribution plans continue their inexorable rise as the primary retirement vehicle for U.S. workers, plan sponsors are refining the all-important investment lineup and other plan features to produce better outcomes for participants.

"Plan sponsors should construct a lineup that aligns to both participant behavior and perspectives, especially around the selection and monitoring of the QDIA," says Diane Gallagher, Vice President and Manager, DCIO Practice Management at American Century Investments. "Now that we've had decades of experience with DC plans, we know what participants' tendencies are and how comfortable they are making decisions. So it's incumbent on the sponsor to structure a lineup that gives participants the best chance of success."

Plan sponsors also need to use all the tools at their disposal. "It's the 10-year anniversary of the Pension Protection Act," says Toni Brown, Senior Vice President, Defined Contribution, Retirement Strategy Group at Capital Group. "Auto-enrollment and the QDIA have been absolute homeruns, particularly in getting participants out of capital preservation options as the default. We still need to work with sponsors to encourage them to use auto-escalation and to conduct investment re-enrollments."

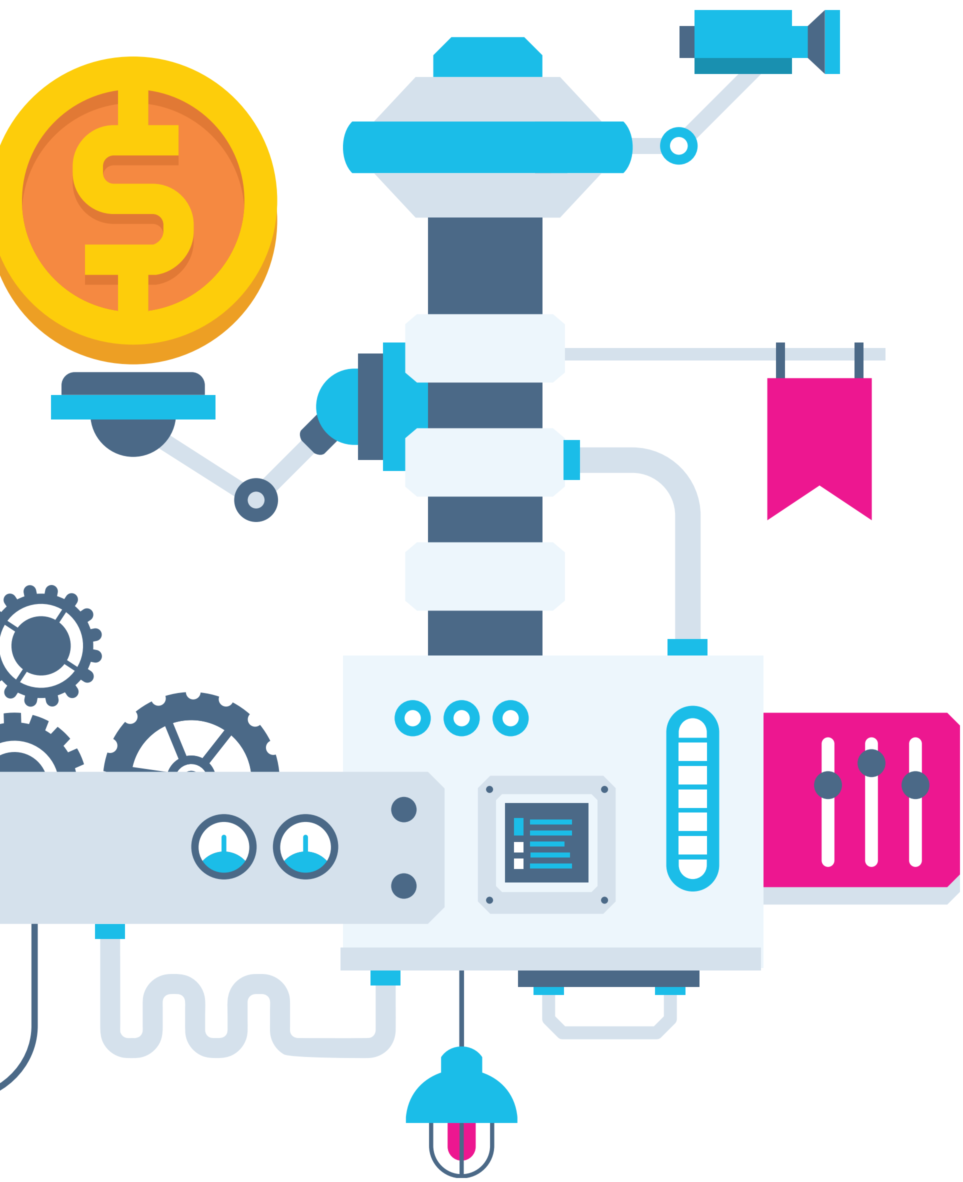
It's true that there is still more work to be done. "Many plan sponsors are working hard to create the best possible plan for their participants," says Jonathan Hubbard, Director, Institutional DC Platforms at MFS Investment Management. "However, there are many challenges in today's DC landscape, including rapidly shifting investment and regulatory environments. With so many different aspects of plans to manage, one of the big challenges plan sponsors face is determining how to allocate their time and resources to areas that are going to be the most impactful in providing positive retirement outcomes for plan participants."

Choice architecture

"The industry is going through another transformative period as it relates to the 401(k) investment lineup," says Christopher Daley, Head of Defined Contribution Institutional Sales at JP Morgan Asset Management. "Plan sponsors are focusing on the factors that matter: The way participants are interacting with the plan and the types of decisions they ultimately make. The industry has provided plan sponsors with clarity on those points. It's helping plan sponsors to reframe the choice architecture in lineups to make them more understandable for those participants that want to do it themselves."

"Sponsors of all sizes have been streamlining the lineup to different extents," says William Ryan, Associate Partner at Aon Hewitt Investment Consulting. "Larger plans may be moving from 18 to 25 options down to under 10, while mid- and small-sized plans are trying to get from hundreds of options to under 20."

Of course, it's always important to understand that DC plans involve two



levels of decision making. "Plan sponsors are faced with the job of having to consider a range of competing factors when designing an investment lineup," says Daniel Oldroyd, Head of Target-Date Strategies at JP Morgan Asset Management. "They want to provide investment choices that have the best possible range of outcomes, yet at the same time they have to remember that they aren't making that final investment decision – their employee is."

However, plan sponsors have a wealth of experience to draw on when making refinements to their plans. "We find that when changes are made in the 401(k) investment lineup, the improvement in a participant's potential outcome from those solutions should outweigh the feedback that sponsors are getting," says Aon Hewitt's Ryan. "For sponsors, the unknown is always the hardest part because it includes the potential for negative pushback from participants. We've only seen minimum amounts of pushback or feedback from participants when changes are made."

So where can plan sponsors make the most impact? "There are a number of factors that impact a participant's investment experience," says Kristen Colvin, Director, Consultant Relations at MFS Investment Management. "For example, asset allocation is incredibly important and outcomes are also impacted by the implementation of investment strategies – active and passive are two obvious examples. Perhaps we should also be focused on building portfolios that maximize the benefits of compounding. Compounding of returns is one of the most valuable features of investing in a DC plan; low and negative returns inhibit the benefit of compounding. We should consider building portfolios that can provide a smoother ride for participants, limit losses in challenging market environments and minimize the impact of sequencing risk at or near retirement. "

Fewer options

Perhaps the best-known example driving investment lineup construction today is the paralyzing effect of too much choice. "It's well-documented that a lineup with few options is more beneficial for the participant," says Capital Group's Brown. "That means a QDIA, and three or four other options. So this is much more similar to what DC plans were in the 1970s and 1980s than what they became later. The biggest challenge for sponsors is to have the motivation and the courage to make a change to this kind of lineup."

It can be difficult for plan sponsors to see how best to meet this challenge. "We believe that it is important for plan sponsors to simplify their core menu without giving up diversification," says JP Morgan Asset Management's Oldroyd. "A few years ago we wrote a paper proposing a very streamlined menu: a default option, usually a target-date fund; a diversified equity option; a diversified fixed income option; and a cash alternatives option, often stable value. We did this to get clients thinking about reducing the number of options they offer. Many sponsors have taken steps towards simplifying."

A few years ago, some plan sponsors were flying in the face of the streamlin-

continues on page 6

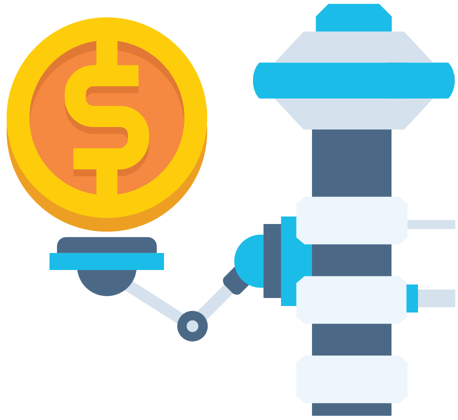
ing rhetoric by offering full suites of both passive and active choices. "We're seeing fewer plans adopting mirror active and passive lineups," says American Century's Gallagher. "Rather, as they simplify their lineups, they look for asset classes where passive is appropriate and others that should be actively managed. But they remain committed to participants having choices within the lineup."

One reason that sponsors were looking at adding more passive options after the financial crisis was fees. "The industry has done a great job of demonstrating the negative impact that fees have on retirement outcomes," says MFS' Colvin. "It is simple math. We know that, all else equal, fees have a negative impact on retirement outcomes. What the industry has not focused on nearly enough is the positive impact that alpha can have on outcomes. The impact of incremental amounts of alpha over a participants working life can actually outweigh the impact of higher fees. We believe that participants should have the opportunity to experience long-term growth in excess of the market."

An important area of focus for plan sponsors is their fixed income options. "We don't expect the next 30 years to be the same as the last 30 years in the fixed income markets," says MFS' Colvin. "So DC plans need to help protect participants against what will likely be a multitude of challenges within their bond exposures. Liquidity and interest rate risks are apparent both in core options and target-dates."

The final piece of the lineup puzzle is the conservative option. "Money market reform is forcing plan sponsors to revisit their capital preservation option," says MFS' Colvin. "Most plan participants are being defaulted into a diversified option such as a target-date, so I don't think we are talking about a large percentage of plan assets invested in capital preservation options going forward."

IT'S INCUMBENT ON THE SPONSOR TO STRUCTURE A LINEUP THAT GIVES PARTICIPANTS THE BEST CHANCE OF SUCCESS



Stable value here to stay

However, capital preservation options have been and probably will continue to be part of the 401(k) lineup for the foreseeable future. "Our trends data for 2015 shows that 74% of plans still offer stable value in their core lineup," says Aon Hewitt's Ryan. "Anecdotally, we are hearing more plan sponsors having the conversation around the possibility of using stable value funds as an alternative to money market funds with the pending money market reform in 2016. However, the reason that a stable value fund gets introduced is the return profile and the stability. But we won't know until the end of 2016 whether plan sponsors are actually changing their capital preservation options."

"Stable value has had a place in the DC space from the very beginning," says JP Morgan Asset Management's Daley. "The concept of providing participants with a backstop through insurance company general accounts has worked well over the years. Relative to other principal preservation options, stable value does a good job of providing excess return in a safe way. It makes the most sense when participants are nearing the end of their career, and need an anchor to balance volatility."

Of course, plan sponsors need to be mindful of more short-term influences as well. "In the past five years, we've had relatively stable markets," says MFS' Hubbard. "But more recent upticks in volatility which started in August of last year and recently increased in frequency has been a real wake-up call to investors about their equity portfolios and target date portfolios. We've seen the introduction of low volatility strategies to mitigate some of that volatility."

Volatility is not the only risk that participants face. "It's about looking at risk management in a dynamic way," says JP Morgan Asset Management's Daley. "DC plans carry all sorts of risk. A younger participant who puts all their money in stable value is actually taking lots of risk – including the risk that they will outlive their savings, or longevity risk. There's also accumulation risk, or failing to save enough, which isn't discussed as much as it should be. If a participant is being conservative, then they should be putting away as much money as they can."

One important way to help participants manage risk is to provide a limited number of options that offer built-in asset allocation. Target-date funds are probably the key example of this phenomenon (see page 12). But there can be others within the core lineup. "Some of the very large plan sponsors are looking at creating a single diversified option with multiple managers underneath," says American Century's Gallagher. "So it's a single solution that participants see, allowing plan sponsors to consolidate and simplify the lineup."

These solutions are often known as white-label funds. "White labeling is becoming more prevalent because plans are getting bigger," says Capital Group's Brown. "A larger plan can do it in a cost-effective manner. The other hurdles, such as pushback from the recordkeeper or custodian bank, are lessening as well. It can be complicated to create a multi-manager white-label fund because of the need to set and manage asset allocation, so some plan sponsor just set up a single manager white-label fund. Some plan sponsors don't have the expertise to manage a multi-manager fund."

Eliminate brand bias

"Larger plan sponsors have more flexibility than ever to create options that eliminate brand bias, provide diversification and avoid overlap," says JP Morgan Asset Management's Daley. "We need to work on ways for smaller plan sponsors to be able to access some of these benefits. Customization may deliver some benefits to smaller plans as well if we can make that option more scalable."

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A target-date portfolio's target date is the approximate year when investors plan to retire or start withdrawing their money. The principal value of the investment is not guaranteed at any time, including at the target date.

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The Sharpe Ratio is a risk-adjusted measure developed by William F. Sharpe, calculated using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe Ratio, the better the fund's historical risk-adjusted performance. Sharpe Ratios shown for portfolios with 10 years of history. Fund name, 10-year rank/number of funds in category: In Retirement, 18/87 funds; 2025 Portfolio, 1/42 funds; 2035 Portfolio, 1/42 funds; 2045 Portfolio, 1/30 funds.

It's not just in the equity category that white-label is shining. "We've seen lots of innovation in white-labeled fixed income strategies," says MFS' Colvin. "It's meant the ability to offer a truly diversified portfolio that has exposure to asset classes such as credit, high yield, emerging market debt and global bonds."

But it is more usual to see white-label funds as an opportunity to combine a variety of types of management. "As plans are streamlining, they may choose to combine active and passive management in a single white-label option," says Capital Group's Brown. "For instance, if you were creating a global equity option, you might think that the non-U.S. and small cap could be managed actively, while the U.S. large-cap portion could be managed both actively and passively. In that case, the passive component could be used as the liquidity buffer."

There is also a nascent move to provide solution-driven white-label options, also sometimes known as objective labels. "Some plan sponsors have added a diversified real asset strategy to the core menu - REITs, commodities and other inflation-hedging asset classes are often included within these types of strategies," says MFS' Colvin. "Plan sponsors have been questioning whether CPI is the best benchmark for this type of option and because inflation has been so low for so long, it is unclear how some of these instruments will actually behave during periods of high inflation. Another consideration when building a real asset or inflation-hedging portfolio could be to consider a share-of-wallet approach. Essentially building a portfolio that is more reflective of where participants actually spend their money in retirement. Higher healthcare costs are an example."

Beyond the inflation-hedging option that has been around for awhile, other plan sponsors are discussing a more complete overhaul of the core lineup. "We are seeing several clients that are implementing fund options with objectives labels – growth, income, inflation sensitive and capital preservation," says Aon Hewitt's Ryan. "At Aon Hewitt, we believe that these are investment solutions that are easier for participants to understand, and give them tools to construct better solutions. Once the plan size is larger than $100 million or $200 million in assets, then a plan can start developing objective-labeled funds."

"We do see some discussion of calling funds by different names in order to make them even more helpful for participants," says Capital Group's Brown. "I see a little bit of bringing back labels that we saw decades ago like income, growth, and income and growth. It's like a retread! I'm encouraged, though, because this discussion could lead to better solutions for participants."

A further idea, arising out of the re-emergence of volatility, is an option that seeks to dampen the effects of this risk. "Some of the conversations we've been having with sponsors lately involve building defensive equity strategies," says MFS' Colvin. "That could involve potentially pairing a low volatility strategy alongside a passive strategy within a white-labeled equity portfolio. In this case there would be the potential for diversification benefits, lower fees, and the ability to cut off some the left-tail risk of the overall portfolio."

The alternatives question

DC plans don't change quickly. But new topics of conversation do arise. Today's most common debate surrounds the use of alternative asset classes – hedge funds, private equity, real estate, commodities and others. "Alternatives are more likely to be part of a packaged solution like a custom target-date fund or used within an off-the-shelf target-date solution," says American Century's Gallagher. "The need for participant education and fees will likely preclude most alternatives from being a single solution within the core for most plans. The target-date fund is probably the right spot for alternatives."

Few managers or plan sponsors advocate for the use of standalone alternative options. "Alternatives in DC plans are reasonable within diversified options and target-date funds," says Capital Group's Brown. "Those that seem appropriate are the three illiquid alternative asset classes: real estate, hedge funds and private equity. Each offers different benefits."

"The use of alternatives starts with the comfort level of the sponsor, consultant and service provider," says Aon Hewitt's Ryan. "The initial indication is that certain alternatives that are more liquid and those that provide daily values are being more quickly adopted. Examples would be risk parity, hedge funds and daily valued private real estate. It's also possible to incorporate private-equity infrastructure. We are seeing those conversations picking up."

"From our perspective, alternatives are best used within a carefully constructed, professionally managed asset allocation portfolio," says JP Morgan Asset Management's Oldroyd. "That's where we are seeing them used today. When you put alternatives in as an additional core menu option, two things happen. It goes against the streamlining that is otherwise happening. Secondly, you see very little usage of the option by participants, probably because they are confused as to how and when to use them."

Some in the industry advocate the use of more liquid alternatives or ones that are daily valued. "Liquid alternatives concern me," says Capital Group's Brown. "Once you introduce liquid versions of otherwise illiquid investments, some of the benefits you would have gotten have been watered down. They won't provide as much diversification and they won't give the same illiquidity premium."

Liquidity isn't the only potential long-term problem with alternatives. Most are designed to be bought and held for a long time, thereby making them complicated to incorporate even into diversified asset allocation options. "When adding alternatives into a DC plan, even as part of a managed option, you need to be aware of the J-curve effect," says Capital Group's Brown. "With private equity funds, you spend the first seven years funding the portfolio, so receiving no return until after year eight. For a DC plan that has significant employee turnover, it may be difficult to spread that risk across participants. It is possible to buy a private equity portfolio in the secondary market and then feather in the primary investments over time, thereby managing the J-curve effect."

Auto features take over

DC plan sponsors are well aware that all of the specific questions about the makeup of the investment lineup are worthless if a participant has little to invest. So one of the major areas of focus today is on getting employees into the 401(k) plan and then making sure that their savings rate is appropriate. "The first priority for plan sponsors has to be savings and savings rates, so it's not surprising that we are

BRINGING THE BENEFITS OF DEFINED BENEFIT INTO DEFINED CONTRIBUTION PLANS

While defined benefit plans are becoming a smaller proportion of retirement assets in the U.S., the returns from these plans continue to outperform those of defined contribution plans. The reasons for this are many and varied – and some would say it isn't fair to compare them. Others think that the comparison is useful.

"DB plans are a good point of reference for DC plans," says Toni Brown, Senior Vice President, Defined Contribution, Retirement Strategy Group at Capital Group. "In a DB plan, the plan sponsor has control of the asset allocation and is able to maintain it over time. It's that asset allocation that drives the difference in returns between DB and DC, not necessarily the use of alternatives."

"It's fair to compare the returns of DB and DC plans in the sense that we need to understand how the higher returns of the DB plan are being generated," says Christopher Daley, Head of Defined Contribution Institutional Sales at JP Morgan Asset Management. "The fact that DB returns are different should be no surprise to anyone given the way the investment decisions are made. The trick is to apply some of the DB concepts to the DC plan where participants may not be familiar with certain asset classes or ways of looking to protect on the downside."

It is true that there are many differences between DB and DC plans. "Although both DB and DC plans are retirement vehicles, their structures are inherently different, even in their decision-making frameworks," says Diane Gallagher, Vice President and Manager, DCIO Practice Management at American Century Investments. "In the DB plan, professional investors are making those decisions to provide a guaranteed defined benefit – to provide consistent income. On the DC side, all those decisions are made by participants – the vast majority of whom are not professional investors. So you aren't comparing apples to apples."

The risks evolve differently across the two types of plans. "There are many well-documented studies that highlight how DB plans have outperformed DC plans," says Kristen Colvin, Director, Consultant Relations at MFS Investment Management. "Much of that data has been interpreted to conclude that the exposure to alternative asset classes has driven the outperformance of DB versus DC. DB plans have the opportunity to fully recognize the illiquidity premium of alternative asset classes such as private equity, direct real estate and hedge funds."

The goal of both DC and DB plans is to provide funds in retirement, however this is accomplished. So it might be best to consider the comparison in terms of outcomes. "The right measurement of success for a DC plan isn't savings rates, but retirement income adequacy," says William Ryan, Associate Partner at Aon Hewitt Investment Consulting. "This may be the textbook difference between DB and DC, and why the objectives have been different. As DC continues to shift from being a supplemental savings plan to being the primary retirement vehicle, the optics on measuring the success of the plan needs to change. Plan sponsors need to understand that the contribution rate and investment mix are the levers in the equation that provide retirement income. By setting an income bogey, a sponsor can build a plan that allows participants to hit their long-term objective."

Long investment horizon

"The comparison between DB and DC becomes less meaningful today and for the past 10 years, though, because the plans have different objectives and will have very different asset allocations," says Capital Group's Brown. "For instance, DB plans have more fixed income than they used to. So that makes comparing averages problematic. At the same time, we encourage DC participants with a 40-year investment horizon to be heavily invested in equities."

"DB plans pool risks at the plan level versus the individual level," says Jonathan Hubbard, Director, Institutional DC Platforms at MFS Investment Management. "Cash flows are different where you have the periodic cash flows in DB plans versus the more consistent cash flows in DC plans. Even though DC investors may be saving for the long term, the plan needs to have the liquidity for several reasons including the need to provide for daily pricing, account valuation and transparency purposes, among others"

"The investment committee structure has typically been highly investment focused on the DB side versus the DC side where investment focus and plan design often become intertwined," continues Hubbard. "The reality is that the DB plan is tied to the financial statements of the corporate sponsor. The DC plan doesn't have the same direct tie, but it's critical to recognize that both plan types are designed to benefit the participants.

"The investment committee structure has typically been more robust on the DB side versus the DC side," continues Hubbard. "The reality is that the DB plan is tied to the financial statements of the corporate sponsor. The DC plan doesn't have such a close tie. Finally, the larger scale of many DB plans means they often have the ability to get better pricing schedules, though that may change as DC plans become larger."

seeing a huge increase in the use of default options, specifically with auto-enrollment," says American Century's Gallagher. "It's important to remember that there is no investment solution that remedies poor savings."

"The implementation of auto features for those who don't have the time or wherewithal to focus on making their own investment decisions, not just once but over time, is helping to improve outcomes," says JP Morgan Asset Management's Daley. "It's not fair to put the challenge of retirement investing in front of the average American worker without the right tools. Those include target-date funds, auto-enrollment, re-enrollment and auto-escalation, many of which are being adopted."

"You still have the vast majority of plans

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defaulting participants into the plan at a rate of 3% or less," says MFS' Hubbard. "You still have many plans using auto escalation as an opt-in versus an opt-out feature. Over the accumulation period we need to make sure that we are encouraging participants to generate balances that are healthy enough to have something to distribute and a more paternalistic use of auto features is one way to support increased contribution levels."

"The academic and participant research shows that employees value access to a DC plan, and that it is an important part of their compensation and benefits," says American Century's Gallagher. "Most working Americans know that they are responsible for their own financial security and recognize that a DC plan is the most effective vehicle to work toward that security. Our research shows that. But equally, they want plan sponsors to provide bumpers or guardrails in the plan. Our research is very compelling: 70% of participants believe that employers should automatically enroll people at a 6% savings rate to start and automatically increase that rate."

This feeling is showing in practice. "We are beginning to see a more aggressive use of both auto-enrollment and auto-escalation," says Capital Group's Brown. "Rather than just enrolling at 3%, starting at 6%. Then instead of auto-escalating at 1% per year, taking 10 years to get to 10% or 15%, implementing at a more meaningful 3% escalation. Again, to those who implement in this way, they get very little pushback."

Others suggest a more gradual escalation. "Just to provoke thoughts on auto-escalation, we suggest a 1% to 2% escalation rate without a cap," says Aon Hewitt's Ryan. "By that we mean letting it escalate until the limit that a person can contribute to 401(k) for a calendar year. It may take 10 to 15 years to reach that number, but it does encourage and signal to participants that savings is important."

"Conducting a re-enrollment can help both new and existing participants get on an appropriate path," says JP Morgan Asset Management's Daley. "A re-enrollment uses participant inertia to help delegators who could benefit from being invested in a professionally managed QDIA. At the same time those participants who prefer to make their own investment decisions can continue to do so."

Setting guardrails

Another area that is getting more attention is re-enrollment, which in the past may have been considered too complicated and expensive for many plans. "Reducing the lineup should go hand in hand with an investment re-enrollment," says Capital Group's Brown. "That way you can also get as many participants as possible into the QDIA and allow others to make better decisions for themselves in the new, reduced lineup."

"In addition to participants having overwhelming support for being defaulted into higher rates, our research also showed 70% of participants support a plan investment re-enrollment," says American Century's Gallagher. "That means both the current account balance and future contributions are defaulted into the QDIA. What participants are saying is, 'This is really important. It's something I know I should do, but I'm not getting there on my own. If you set up bumpers or guardrails, I will stay within them.' I think this is incredibly powerful. The plan sponsor's objective is to provide a vehicle through which their employees can achieve retirement security, and they have all the tools in the toolbox to help them be successful in retirement."

This approach can lead to better plan health. "It can also make sense to re-enroll everyone every three years to try and pull back in some of those who may have opted out," says Capital Group's Brown. "It's not cheap, necessarily. But I think plan sponsors understand the value of helping American workers save so they are able to retire. The cost up front is far less than the cost potentially at the end if people aren't able to retire."

Another lever in the plan participation toolbox is the company match. "Sponsors we talk to are really thinking about what that right total contribution rate is: 8%, 10% or 15%," says Aon Hewitt's Ryan. "We would say the total contribution split between employer and employee needs be closer to 15%. That can mean stretching the match, so that it isn't simply dollar for dollar, but 4% match across 8%. We know that there is a retirement savings gap that needs to be filled and that employees won't fill this hole without employer guidance or increases in savings automation."

"When I first started in this industry, we heavily promoted the company match in all plan materials," says American Century's Gallagher. "It was an important feature – and continues to be an important feature. But it doesn't dramatically affect participation rates. Certainly not like it did in the early days of 401(k) plans. We saw that in 2008 when a number of plans either suspended or changed their match formula. We did not see participants opt out of participating."

"You are seeing companies looking to stretch the match," says American Century's Gallagher. "This is particularly true of plans that are implementing auto-enrollment. In this case, participation might go from 60% to 90%, a significant increase. A plan in that situation might stretch the match. Rather than matching 50% up to 6%, they might choose to match 25% up to 12%. In this case, the company match cost ends up pretty neutral, but it can dramatically affect both participation and savings rates."

All this push on participation can skew the data on savings rates. "The data we have going back to 2001 shows that although participation rates are rising, contribution rates are lower," says JP Morgan Asset Management's Oldroyd. "That's because auto-enrollment typically hasn't come with auto-escalation. In smaller plans, the company match is very important, though. We do see companies stretching the match."

However, it's important to remember that almost anything that plan sponsors can do to encourage additional retirement savings is probably a good thing. "DC plans are well-known to be driven by inertia," says Aon Hewitt's Ryan. "So that inertia is best harnessed effectively through auto-enrollment. Auto-escalation will be the next phase."

DC plans still face challenges. "DB may be easier for a participant to understand," says JP Morgan Asset Management's Daley. "By definition, you know the outcome as an employee, and since it's managed for you, no investment selection process exists to add confusion. In DC, you can control your level of contribution, and your selection from the investment lineup – or decision to be defaulted into the QDIA. The rest is unknown. The big trick is being able to more accurately define what the plan is trying to accomplish as an outcome, and what both participants and plan sponsors need to do to reach this goal."•

How Target-Date Funds Have Come to Dominate

Target-date funds are the all-weather, all-participant solution for retirement savings. That's the clear message that is coming from plan sponsors and participants alike. It's an interesting transformation for a solution thought to have a narrow usage. "Target-date funds are good for everybody," says Toni Brown, Senior Vice President, Defined Contribution, Retirement Strategy Group at Capital Group. "Originally it was thought that they were just good for the uninformed participant who might not have time to manage their own investments. What the last 10 years has shown is that even those who are able to manage their own investments often don't do so. So target-date funds really are good for everyone."

What's interesting is to track the development of this dominant solution. "It's been 10 years since the Pension Protection Act (PPA)," says Daniel Oldroyd, Head of Target-Date Strategies at JP Morgan Asset Management. "With the PPA came the Qualified Default Investment Alternative (QDIA). Most plan sponsors put in a target-date fund as the QDIA and we've seen enormous growth in the industry as a result. That first wave was dominated by recordkeepers with proprietary funds to offer. Since then sponsors have continued to evaluate whether a target-date fund is the best default option. Some consider target-risk or managed accounts, but for the most part we see sponsors wondering whether they should test the target-date market. It may have been a while since they explored the market. The handful of providers with three-year track records that were in the market 10 years ago has grown to 40 or so."

"I see plan sponsors taking more of an interest in fully understanding their target-date funds," says Capital Group's Brown. "That can mean getting bids to see what other funds are available and how they may differ from what you have, or just meeting more people or exploring custom options. Not all investment committees have the time to do this, but as more assets are going into the target-date, it is becoming more of a focus. It's an important aspect of being a fiduciary."

It's a good moment for plan sponsors to review their choice, whether it is target-date or another. "Because default funds have become such a large component of overall plan assets, plans are allocating more time and resources to making sure that it is the best fit for their plan," says Jonathan Hubbard, Director, Institutional DC Platforms at MFS Investment Management.

In most cases, this means choosing target-date funds. "Industry data is compelling; participants use target-date funds more than target-risk funds," says Diane Gallagher, Vice President and Manager, DCIO Practice Management at American Century Investments. "At one time, participants would put one-third of their account into each sort of target-risk fund in order to cover all their bases, which isn't ideal. Target-date funds, on the other hand, are much more self-explanatory and simple, so easier for participants to use appropriately. Another downside with target-risk is that participants don't adjust their risk over time appropriately, which is another issue that the target-date fund solves for in the glidepath. So it isn't surprising that some 80% of DC plan flows will go into target-date funds in the next few years."

Annual reviews

The percentage is already creeping up. "We are seeing about 68% of all new participants' dollars going into the QDIA," says William Ryan, Associate Partner at Aon Hewitt Investment Consulting. "Of that money, 90% is going into the target-date fund, with the rest into a target-risk, managed account, or balanced fund. Target-date funds have really separated themselves from the other choices in terms of the QDIA option."

"Plan sponsors are paying as much attention to the choice of target-date provider as they once did in a recordkeeping search," says American Century's Gallagher. "The due diligence process is pretty locked down. They know it's an important decision and much more scrutiny – appropriately so – is being attached to it."

That scrutiny doesn't stop when a target-date fund is chosen. "With our clients, we have an annual review on the QDIA," says Aon Hewitt's Ryan. "That's

With the majority of new assets flowing into this DC QDIA, target-date funds are becoming ever more sophisticated

because of the size and importance of this asset class to participants. Sponsors need to make sure that the QDIA is still meeting their objectives. ”

Others are more specific about the schedule. “Clearly the target-date needs to be monitored on a regular basis,” says Capital Group’s Brown. “And we are seeing plans reviewing it fully on a three-yearly basis.”

In recent years, some plan sponsors have taken target-date a step further, investigating and sometimes implementing customized versions. “We are seeing sponsors continuing to investigate custom,” says JP Morgan Asset Management’s Oldroyd. “It can be for a variety of reasons. They may feel they have a unique plan in terms of demographics. Or they want to have the ability to control the underlying managers. And with the release of the DOL tips, all sponsors want to ensure they are doing their fiduciary duty.”

“The DOL target-date fund guidance in 2013 may have accelerated the custom target-date conversion,” says Aon Hewitt’s Ryan. “Mega- and large-plan sponsors have been the natural first adopters because of their size and scale. Advancements in technology are allowing service providers to provide custom solutions now to plans with as little as $50 million to $100 million in assets in the target-date fund. There’s a benefit for mid- and small-sized plans to take advantage of the road paved by the larger plans over the past few years.”

Others agree. “Custom target-date is a relatively easy option to implement efficiently with $500 million and above in assets,” says JP Morgan Asset Management’s Oldroyd. “As recordkeepers and custodians have embraced the concept and built out the infrastructure, it’s now possible even at $50 million in assets.”

Whether custom or off-the-shelf, the driver for many target-date decisions is the glidepath. “Because of the level of flows into target-date funds, there is more scrutiny in terms of selection and monitoring,” says American Century’s Gallagher. “When an organization looks at glidepath decisions, it’s important to consider beyond to-versus-through to what their participants are actually doing with their accounts when they leave or retire. The DOL tips for monitoring and selecting target-date funds that came out in February 2013 provide a structure for that process. So we see more organizations working with their consultants to ensure that they are using that framework.”

The right questions

“Trying to find the right glidepath involves asking the right questions,” says JP Morgan Asset Management’s Oldroyd. “Sponsors need to define what they’re trying to achieve with their target-date fund. Do they want an approach that is designed to get participants to the point of retirement? Do they want participants to stay in the plan after retirement? Have they examined the behavior of their participants in the plan?”

Knowing the desired outcome is also important. “You are looking for a reasonable income replacement ratio from a glidepath,” says Capital Group’s Brown. “But that depends on many factors: what level were participants auto-enrolled at, does it escalate, what salary growth patterns do employees have? All of these will impact the result from a particular glidepath.”

“There are numerous flavors of glidepaths and these change every year based on the assumptions and innovations at the investment manager,” says Aon Hewitt’s Ryan. “These changes may not correlate with what’s happening at the plan sponsor. So though they may have picked the right glidepath at the time, when the committee reviews it three or five years later, is it the right glidepath? The answer can involve how the glidepath has changed, whether it still matches the benefit structure at the company, whether it allows the plan sponsor to control fees, and whether it involves active or passive management. Sometimes the committee may feel it can build a better portfolio by having open architecture and incorporate core managers to better meet the plan’s objective in the target-date.”

Some managers provide tools to aid the conversation about the most appropriate glidepath. “We have a tool that maps

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Plan sponsors are considering ways to keep retirees in the DC plan or otherwise make the distribution of income more effective

The Challenge of Retirement

Accumulation has been the name of the 401(k) game for years. That hasn't changed. After all, without an adequate savings pot, there's little point in discussing the retirement distribution mechanism.

But with the success of the many accumulation levers – from auto features to Qualified Default Investment Alternatives (QDIAs) – some participants have been building up significant retirement nest eggs. So necessarily, plan sponsors and the defined contribution industry have been turning their sights on how to best distribute these pension pots.

"We've been seeing, and we'll continue to see, innovation in the distribution element of 401(k)s," says Diane Gallagher, Vice President and Manager, DCIO Practice Management at American Century Investments. "So whether that is through drawdown tools, online marketplaces, annuities, income solutions or other tools, plan sponsors are starting to take a serious look at these, particularly if they are interested in keeping participants in the plan through retirement. Or they may be interested in providing a service through which a participant can do this on their own."

"Retirement income is the hottest conversation today and its connection to financial well-being," says William Ryan, Associate Partner at Aon Hewitt Investment Consulting. "We at Aon Hewitt believe that the private wealth account balance for the average full career employee should be roughly 11 times final pay in order to retire at age 65. Overall, that should be 15 times, when DB plans, Social Security and other income are factored in. That can become an equation that a plan sponsor can use to determine how many of those over 50 are on pace to reach that level at their current savings rate, and how many of those between 40 and 50, and so forth."

"There are lots of different options for the distribution phase being tested today," says Daniel Oldroyd, Head of Target-Date Strategies at JP Morgan Asset Management. "But plan sponsors have been hesitant to adopt any of these. It's understandable because you don't want to experiment with participant nest eggs. The biggest concerns have been liquidity, lockup and a general lack of understanding, particularly around some of the guaranteed income options. We are seeing more of a focus on distribution-focused investment options, but these are often no different than a target-date fund."

The perfect answer?

"Many super-smart people have been trying to figure out the perfect answer to the distribution question," says Toni Brown, Senior Vice President, Defined Contribution, Retirement Strategy Group at Capital Group. "They haven't found that answer, which leads me to believe that the best answer may be something simpler, liquid and appropriate for people in retirement. It might mean a target-date fund that's meant to be managed into retirement, that expects participants to stay in the plan and is really thoughtful on how that fund is managed during the critical drawdown period."

"What I am seeing is the start of an undercurrent of plan sponsors wanting to keep retirees in the plan," continues Brown. "It's the fees that make this important. Being able to continue to get institutional fees in retirement will be a huge advantage to retirees. All most plans need to do is to change their plan documents to allow retirees to stay in the plan. If a plan has a thoughtfully designed target-date, as well as other options that are really intended for retirement, then this could work very well."

Others see the landscape more broadly. "We think that de-cumulation will be more of a process than a product," says Jonathan Hubbard, Director, Institutional DC Platforms at MFS Investment Management. "Everyone is going to be in different circumstances in terms of their assets invested in their DC plan at retirement given the number of job changes that individuals make. Participant account balances in their DC plan may be just one sliver of their assets with the rest in the IRA market. The IRA market already dwarfs the DC market in terms of assets. So for a plan to design one sort of distribution option based on an individual's account balance that is just one component of their overall assets – that's not a complete picture of that individual's situation. Plans will need a holistic approach to de-cumulation."

Although retirement income has been on sponsor's minds for a number of years, the solutions

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have not yet seen widespread take-up. "The next phase of the DC discussion will be around how participants can support their retirement in a safe and effective way," says Christopher Daley, Head of Defined Contribution Institutional Sales at JP Morgan Asset Management. "At the moment, everyone is self-insuring against retirement risk, which is a bit of a scary thing. The question can't be answered on your own. One of the first solutions is to find ways to keep participants in the company plan - at the very least that will allow them to take advantage of group pricing from an institutionally priced vehicle."

The behavior of participants generally, and retirees specifically, is important here. "A fundamental question when choosing the glidepath is the to-versus-through discussion," says American Century's Gallagher. "Is the plan objective to get participants to retirement? The latest data I saw shows that 83% of participants exit the plan within three years of departing the company. That would support a 'to' decision. But it's also important to think about the objectives of the plan."

Safe harbor

"It always comes back to the objective," continues Gallagher. "Does the plan sponsor want to provide a lifetime solution? If so, then they are going to look at all of the distribution options much more carefully. But they are also looking for safe harbors and guidance that might come along with those options. This can include issues such as the portability of annuities and what their responsibility as plan sponsors might be regarding putting those into the plan. Everyone is keeping an eye on innovation here and making sure that a variety of solutions are available."

There are some barriers to implementing this variety of solutions. "We think there is an opportunity to add income solutions into 401(k) plans," says Aon

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FEES BECOME MORE TRANSPARENT, LEADING TO CLARITY FOR PARTICIPANTS

When the Department of Labor introduced new fee-disclosure rules several years ago, plan sponsors braced themselves for a raft of questions from participants. Few arrived. It turned out that few participants read or tried to understand their defined contribution statements, proving yet again that inertia continues to drive the DC experience.

However, the exercise had long-term effects. Plan sponsors benchmarking investment managers and providers took the opportunity to unravel some long-term and complex fee arrangements. The result is that fees are much clearer and plans are utilizing more institutional-type arrangements to keep costs down.

"The biggest shift we have seen in fees is away from revenue-sharing to zero-dollar revenue share classes, and away from mutual funds to collective trusts," says Daniel Oldroyd, Head of Target-Date Strategies at JP Morgan Asset Management. "I expect to see more of that in the future."

"The fee-disclosure rules brought transparency to the way asset management fees and revenue sharing are distributed," says Christopher Daley, Head of Defined Contribution Institutional Sales at JP Morgan Asset Management.

"We've seen an increase in the use of zero-revenue share mutual funds, collective investment trusts and separate accounts," says Jonathan Hubbard, Director, Institutional DC Platforms at MFS Investment Management. "As plans achieve scale they are able to move to lower cost investment vehicles and source the same investment strategies."

Associated costs

"There's been an improvement in explaining to participants what fees are associated with the 401(k)," says William Ryan, Associate Partner at Aon Hewitt Investment Consulting. "In the past, they may have perceived some services as free, when there is actually an associated cost. So they need to understand what percentage of the fee they now see is allocated to the investments they choose, or the services they are provided. Sponsors are being more proactive regarding the yearly fee disclosure. This can include videos, websites and other innovations to communicate."

"Sponsors have become more comfortable with breaking out of bundled fee arrangements," says Aon Hewitt's Ryan. "They are paying more attention to the services included, which has dramatically increased over the last couple of years. The downstream effect of this is that sponsors are now completely aware of all the incremental costs and what that means to participants. So the transparency is becoming part of a feedback loop."

"There was a perception that the 401(k) plan was free," says Aon Hewitt's Ryan. "So first you have to introduce the idea to participants that there is a cost, and then you can break down the costs. So part one is education about the costs, and part two is how those costs are allocated."

"Plan sponsors are making individual decisions about the providers they use, the managers of their default fund and other services," says Diane Gallagher, Vice President and Manager, DCIO Practice Management at American Century Investments. "These are individual decisions that are then rolled up. At one time, they were based on bundles or some sort of relationship pricing. These decisions are part of the fee-disclosure discussions and also are alluded to in the DOL's tips. It's leading to very careful decision making."

"The fee-disclosure rules have led to separating decisions that were once bundled together," says American Century's Gallagher. "We're seeing plans doing a sequential decision-making process; first, the recordkeeper is selected and then their default manager. They aren't making these decisions simultaneously, even if the provider ends up being the same for both. Plan sponsors are being more deliberate in separating those decisions and working with their consultant through the process."

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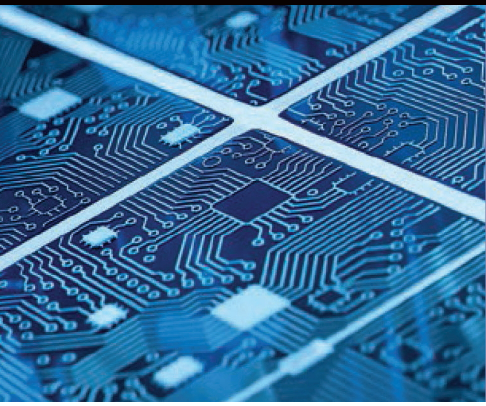

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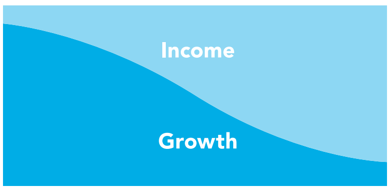

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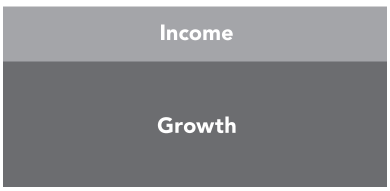

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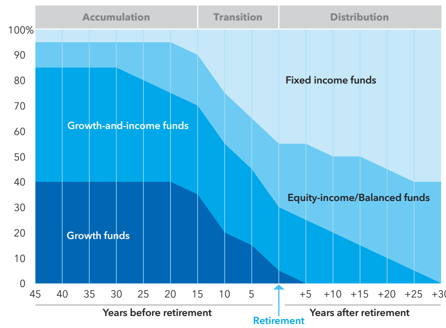

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[1] Relative to their Morningstar indexes since the Series launched in 2007; as of December 31, 2014. [2] Based on Class R-6 share results for rolling periods through December 31, 2014. Periods covered are the shorter of the fund's lifetime or since the comparable Lipper index inception date. [3] Based on Class R-6 net expense ratios as disclosed in the most recent prospectuses available from Morningstar at the time of production. Morningstar averages include the Morningstar Retirement, Large fee level group, No-Load and Institutional share class categories. The Morningstar Retirement, Large fee level group is composed of target date funds classified by Morningstar as Retirement share class type.

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Hewitt's Ryan. "The flavor or the tool will depend on how well it fits into a sponsor's benefit structure. It could be a deferred annuity, an immediate annuity or a managed payout solution. It's one thing to implement the solution and put it on a platform. It's another thing to make it functional as an income distribution mechanism. It's not always easy for recordkeepers to create a monthly distribution. There are kinks currently being worked out."

"De-cumulation is not a challenge unique to the U.S. DC market. There are many countries outside the U.S. that are engaging in a similar dialogue," says Kristen Colvin, Director, Consultant Relations at MFS Investment Management. "We don't think that there is a silver bullet that will solve the de-cumulation challenge, it will likely be a combination of many types of solutions."

"There are different ways to think about whether to keep participants in the plan post-retirement," says MFS' Hubbard. "If you keep them in then you have more oversight, you can keep fees low and you can be more paternalistic. If you push them out, then you may be sending them into the unknown. However, there are many talented investment advisers out there able to help individuals manage those assets."

"In a perfect world, there would be a gate on specific retiree, distribution or annuity options so that only retirees could access some of these options," says Capital Group's Brown. "It would be very useful if plan sponsors could receive some guidance or authorization from regulators about how this would work. It would be very meaningful."

"If you ask me what keeps plan sponsors up at night, it's that their participants walk into retirement without enough savings," says Christopher Daley, Head of Defined Contribution Institutional Sales at JP Morgan Asset Management. "Plan sponsors and the rest of the DC industry have moved a lot further towards the goal of retirement adequacy in the last 10 years."•

HOW FUNDS DOMINATE, from on page 13

portfolio compositions and glidepaths of actual funds into quadrants by asset class diversification and equity exposure," says JP Morgan Asset Management's Oldroyd. "Some quadrants are more populated than others. But there are definitely enough managers in each quadrant for us to say with a good amount of confidence that a plan sponsor can find a glidepath that works for their plan."

Others believe that even as glidepaths have proliferated, there isn't as much choice as one might think. "Without thinking about any specific groups of participants, but about target-date funds as a whole, what appears to be happening is that glidepaths are becoming more similar," says Capital Group's Brown. "We all understand the importance of asset allocation – we know that a very large percentage of the return of a DB plan is attributable to asset allocation."

"So doing a fair amount of modeling on the glidepaths, you'll see you can't easily differentiate," continues Brown. "But what you can't see in that exercise is how the manager implements that glidepath. So although it's important to understand the high-level stock-bond split, you have to spend a lot of time understanding how the glidepath is implemented: through active or passive management, where the risk controls are and the kind of management used."

In particular, it is important that plan sponsors remember that the glidepath, by definition, is an active decision, however it is implemented in the underlying funds. "Plan sponsors should consider both active and passive strategies," says JP Morgan Asset Management's Oldroyd. "When it comes to target-date funds, though, we suggest thinking about the overall objective of the fund series before having the active-passive discussion."

Not either-or

"We often describe the active-passive debate as somewhat binary," says Christopher Daley, Head of Defined Contribution Institutional Sales at JP Morgan Asset Management. "Both play an important role in DC plans. It is important to contain costs and get efficiently priced options into the plan, because cost does affect outcomes. But that's not the end of the debate. Within target-date funds, for instance, managers often operate both a fee budget and a risk budget. So rather than simply choosing all active or all passive, the manager will spend those budgets where it makes the most sense. So portfolios often include both. It's not an either-or; it's about marrying the two."

Other plan sponsors want to leverage existing relationships with money managers. "If you think of the plan holistically, some sponsors may see an advantage in having the target-date fund use the same funds as in the core," says Aon Hewitt's Ryan. "This might mean a custom target-date fund that uses the 10 to 15 managers in the sponsor's toolkit to build an open architecture target-date that blends active and passive management. This is a solution that is beginning to happen, not just in large plans, but also in small- and medium-sized plans."

The industry is also looking at ways to address the needs of different cohorts of employees within the same employer. "There is typically one primary determinant of which target date fund a participant is defaulted into, their age, but there have been thoughts in the industry to push toward more customization for different cohorts," says MFS' Hubbard. "There are several considerations beyond age that may impact optimal asset allocations, glide paths and underlying investment strategies. You can also think of it in terms of account balance, risk tolerance, contribution levels and even additional benefits. If a workforce has a number of different cohorts of employees – one with full DB benefits, one with limited accumulated DB benefits that are no longer accruing and one with no DB benefits, for instance – it can be challenging to create a one-size-fits-all DC plan menu. Managed accounts may be best for one cohort, while the default target-date fund may be better for others."

"Through the increased use of auto features, some participants are seeing their balances build up," says MFS' Hubbard. "They may be more engaged. And managed account providers have done a very good job of training plan sponsors about how to include managed accounts within their lineups. We expect that you will see both target-date and managed accounts in many lineups."•


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