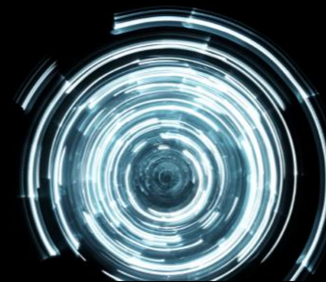
Harmonizing DB and DC investment approaches

Russell Investments Research / Viewpoint



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Russell Investments published the first version of this paper in 2013. The retirement landscape has shifted since then, requiring a fresh look at the topic of harmonizing defined benefit (DB) and defined contribution (DC) investment approaches. The trend to use an outsourced chief investment officer (OCIO) is on the upswing and moving "up market" as CFOs, investment committees and retirement plan sponsors are increasingly realizing the benefits of outsourcing. The updated version of this paper asks plan sponsors a new fundamental question: *If you are a plan sponsor that has outsourced, or has considered outsourcing your organization's DB plan, why would you not do the same for the DC plan?* Harmonizing DB and DC investment approaches can deliver economies of scale and help simplify and aggregate responsibilities, while demonstrating fiduciaries' strong adherence to best practice governance disciplines.

Aligning actions with investment beliefs

While an organization's DB and DC retirement plans typically share the same investment committee members, these plans don't always share a consistent investment approach. DC plans have embraced the simplistic and low-cost appeal of passive management undoubtedly spurred on by the increased focus on fees following regulatory scrutiny and a related spike in class-action lawsuits. Yet the same plan sponsors that accept this basic DC plan approach often adopt a completely different institutional approach in their DB plans.

Fiduciaries should seek to align the management of both their DB and DC plans with their investment beliefs.[i] Some committees opt to create a statement of investment beliefs to document their overarching beliefs, while others simply allow their actions to imply what the underlying belief set is. Where plan sponsors identify inconsistency between implied beliefs and their actual beliefs, we would encourage a discussion around whether there are justifiable reasons for such inconsistency to continue.

As we look across the industry, some of the most apparent contradictions of investment beliefs relate to inconsistent decisions being made across DB and DC plans, most often in such areas as the types of investments, choice of investment vehicles and governance processes. Plan sponsors who are taking inconsistent approaches to managing their DB versus DC plans should have defensible reasons for doing so; otherwise, they should consider harmonizing their approaches.

Harmonization doesn't require that DB and DC plans be managed in exactly the same way — in unison — but that plan sponsors should at least look to apply a consistent set of investment beliefs and, where practical, to directionally align their investment approaches across both DB and DC plans.

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Why is this important?

Plenty of evidence shows that outcomes for DC participants have trailed those of DB plans, mainly due to high fees, lack of portfolio diversification and poor market timing by participants[ii]. A more harmonized approach may lead to improvement in DC plan outcomes. A harmonized approach also signals to employees that the organization is applying a consistent framework for selecting the types of investments and services that are most likely to meet the objectives of both the company and its employees.

Applying different investment policies and standards to the two types of plans can also suggest inattentive or inconsistent governance practices, which opens fiduciaries to questions about their oversight and policies. We expect at least some of the outcomes in the lawsuits that have been filed on behalf of participants in recent years would have been different if the fiduciaries had applied a more disciplined institutional approach, such as that typically applied in the management of DB plans.

Finally, many DB plans have refocused the management of the plans' pension assets away from an "asset only" approach and to an approach that considers both the assets and the specific liabilities of the pension plan, as well as the financial situation of the plan sponsor. A harmonized approach would move beyond the benchmark-centric measurement of most DC plans, in which success is based on the funds in the plan outperforming a benchmark, and apply the same liability-driven philosophy to DC plan participants.

1. Governance process

Governance is the first area where we have observed differences in approach between DB and DC plans. How a plan sponsor oversees the plan, makes investment decisions, defines the investment policy and works with vendors are all part of the governance process.

Exhibit 1 highlights a few questions designed to start a dialogue among fiduciaries for evaluating the consistency of their governance approaches across DB and DC plans.

Exhibit 1: Balancing governance practices

QUESTION	DB	DC
How much time is spent in investment committee meetings?		
Who is providing investment advice?		
How are managers selected and monitored?		
Do you outsource the investment function?		
Are investment decisions benefitting participants or plan fiduciaries?		

As they examine their governance practices, plan sponsor fiduciaries should determine whether there is reasonable alignment in how they allocate their investment committee time between DB and DC; identify the source and quality of the investment advice they get and determine how they make their own decisions. We observe that many plan sponsors will spend significant time and internal and external resources on managing their DB plans, yet will not bring those same resources to bear on the DC plan, nor dedicate an adequate amount of committee meeting time to DC.

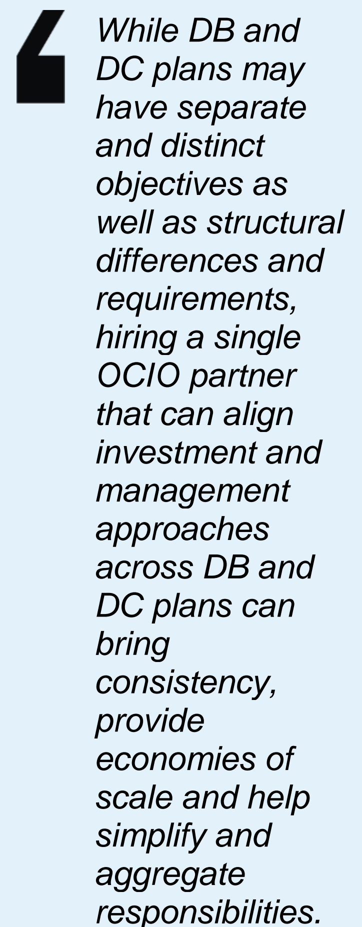
A critical aspect of governance is determining which fiduciary responsibilities the Committee will retain and which it will delegate to staff or a third party outsourcing provider. The role of outsourcing has grown rapidly among DB plans, but the DC plan is sometimes carved out of the outsourcing arrangement and managed internally or under a traditional 3(21) consulting model. This model can lead to missed opportunities for DC plans. In fact, many of the same benefits to outsourcing a DB plan are applicable to a DC plan:

- Reduce fiduciary burden on the plan sponsor by contractually delegating fiduciary duties
- Simplify and aggregate plan management responsibilities
- Potential to lower cost and increase operational efficiencies
- Mitigate litigation and compliance risk
- Spend more time on strategic decisions; spend less time on operations and monitoring vendors
- Increase decision speed
- Enhance the investment program and keep pace with continually evolving markets

Layered over the benefits of outsourcing are the structural headwinds facing DC plans. DC plans are entering a prolonged period of net outflows in 2020 with the mass retirement of the baby-boomer generation, making the potential cost savings delivered by the OCIO model even more attractive. Also, the transition from DB to DC as the primary retirement benefit has left workers with retirement risks that didn't exist in the DB system, namely contribution, longevity risk and behavioral risk. Outsource providers are perhaps best positioned to enhance DC retirement programs to better meet the needs of the vast majority of American workers who are underfunded for their impending retirement.

Another benefit to outsourcing is that it preserves the historical performance track record when investment managers are swapped out. Under the traditional consulting model, it is standard practice for the new manager's track record to replace the previous manager's track record for reporting purposes, essentially papering over the historical performance that participants actually experienced. With outsourcing, every manager change is captured in the performance track record of the funds, along with every basis point of transaction and implementation cost, so the committee is presented with the actual performance results experienced by participants rather than the historical performance results of a single investment manager that has not been in the plan over the entire performance period (ex-transaction costs incurred swapping out the managers).

While DB and DC plans may have separate and distinct objectives as well as structural differences and requirements, hiring a single OCIO partner that can align investment and management approaches across DB and DC plans can bring consistency, provide economies of scale and help simplify and aggregate responsibilities.



The Investment Policy Statement

The Investment Policy Statement (IPS) is an important component of the governance process because it outlines the objectives and policies for the plans and generally outlines the investment option structure and underlying philosophy. Plan fiduciaries are responsible for ensuring that the plans are managed in accordance with their IPS, and therefore we recommend that the IPS provides meaningful guidance to the plan fiduciaries, without imposing an obligation to act in any particular way. That said, plan fiduciaries should review the IPS for the DB and DC plans to determine whether the differences are justifiable. Some common areas of inconsistency are:

- Real assets – Allowed in DB plan but not DC plan
- Non-U.S. equity benchmark – Contains emerging markets in DB plan but not in DC plan
- Fixed Income – Out of benchmark exposures permitted in DB plan but not in DC plan
- Performance objectives – Longer time horizons for DB plan
- Delegation of investment management functions – Allowed in DB plan but not in DC plan

We encourage DC plans to also adopt the DB mindset when establishing plan objectives. A common objective for a DB plan is to provide funds for the satisfaction of participant benefit payments (i.e., outcome focused), while a common objective for a DC plan is to provide an appropriate range of asset classes and investment options that will reasonably span the risk/return spectrum (i.e.,not outcome focused). To harmonize DB and DC plan objectives, establish income replacement as the DC plan’s primary objective and consider including language in the DC plan’s IPS that states the ultimate goal of the DC plan is to provide a means for participants to fund a retirement income stream. Develop a Target Income Replacement (TRI) goal for the plan and measure participant progress toward the TRI with periodic replacement income studies. Determine participant replacement income studies conducted by your DC plan recordkeeper, consultant or fiduciary provider.

2. Types of investments

Virtually every DB plan uses multiple investment managers. It is widely accepted that no single organization offers proprietary solutions that are best in class across all asset categories and the bundled approach significantly increases manager risk should anything happen to that manager. Further, even within asset classes, there is typically a meaningful benefit to manager diversification. Managers have different styles (e.g., value, growth); their individual approaches may go in and out of favor with the markets; and sometimes, managers just don't meet expectations. However, unlike most DB plans, DC plan menus are often populated with many products offered by their recordkeepers, or with asset class options comprised of solo managers.

Exhibit 2 provides an illustration of potential manager outcomes. For example, a single active manager and a combination of multiple managers may be expected to have the same average outcome. However, the multiple-manager structure has a narrower distribution of results, and is typically viewed as more favorable, with less uncertainty and tail risk.

Exhibit 2: Investment approaches matter - Expected distribution of returns

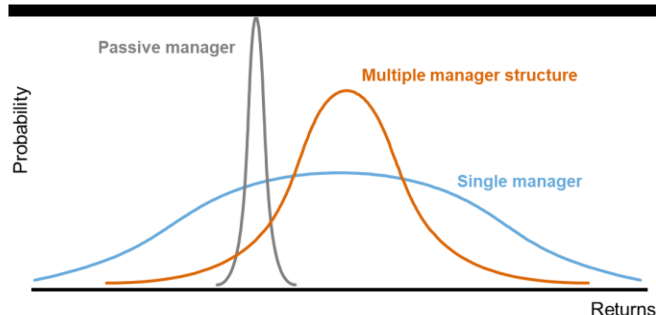


Image shown for illustrative purposes only and is not meant to represent any actual results.

DC plans that fit the single-manager profile should be clear about why they are using this approach. Specifically, why expose DC plan participants to idiosyncratic single-manager risks, particularly if the plan sponsor is diversifying across multiple managers in its DB plan?

In addition to the reliance on single managers in many DC plans, we have also observed some plan sponsors adopting passive management on a blanket basis. We appreciate fee sensitivity with regard to DC plans, but there seems also to be a notion that passive management is a safer fiduciary option. To be clear: Employee Retirement Income Security Act (ERISA) has no requirement to use the lowest-cost option — it simply mandates that fiduciaries act in the best interests of plan participants, follow prudent investor standards and ensure that fees are reasonable.

Exhibit 2 also illustrates that while a passive option offers a much narrower distribution of outcomes relative to a benchmark, it also provides no opportunity to outperform. Of course, not all asset classes offer the same opportunities. Indeed, a stronger case can be made for active management in some asset classes[iii] and less so in others (even if one can access superior manager research capabilities). In practice, we see many DB plans showing greater differentiation toward active management across asset classes, based on their investment beliefs and their respective investment merits, rather than dogmatically opting for passive management across the board, as some DC plans have done.

In contrast to their DB plan approach, some plan sponsors may have simply adopted a no-frills, low-cost passive approach in DC plans because the latter represents "participant money." However, both DB and DC plan asset pools ultimately exist for the benefit of participants, irrespective of which group suffers the ramifications of shortfalls. Further, we note that DC participants typically aren't investment experts; most are really looking to their plan sponsor fiduciaries to provide prudent, appropriate investment options that give them the best chance of meeting their retirement income needs.

Regardless of a plan sponsor's investment beliefs around these types of issues, it is worth considering whether it is adopting a somewhat similar approach across both DB and DC plans, consistent with such beliefs, or at least being clear on a defensible basis otherwise.

3. Choice of investment vehicles

Plan sponsors also have choice in how to implement investment exposures within their DB and DC plans. They may take an institutional approach using separate accounts and certain commingled funds (e.g., collective investment trusts), or they can adopt a more retail approach using mutual funds. As highlighted in Exhibit 3, each investment vehicle has unique characteristics.

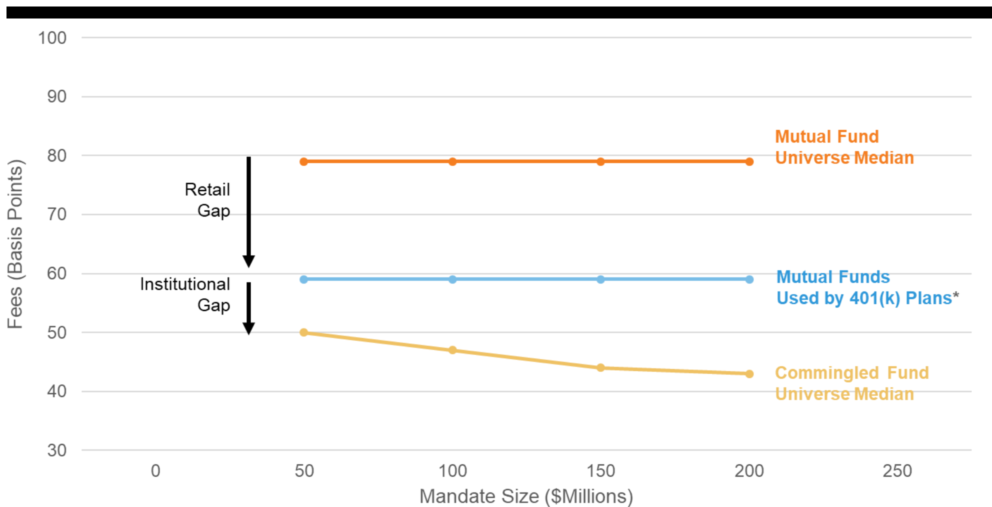
Exhibit 3: Consider investment vehicle characteristics

CHARACTERISTIC	SEPARATE ACCOUNTS	COMMINGLED FUNDS	MUTUAL FUNDS
Guideline flexibility	✓		
Negotiable fees	✓	✓	
Handle limited scale		✓	✓
Brand recognition			✓

Plans with the scale and resources to negotiate fees might want to avoid mutual funds. In contrast, those with lower levels of assets might find it difficult to use separate accounts.

In practice, we see that many plan sponsors favor separate accounts or equivalent institutional commingled funds in their DB plans, yet they continue to use mutual funds in their DC plans. Mutual funds may have wide appeal for brand recognition, but does this characteristic really provide a greater chance of meeting the plan's ultimate goal of providing retirement income for participants? These decisions are important. They can have a material impact on fees, as demonstrated in Exhibit 4, which illustrates typical U.S. equity fees. Mutual funds usually entail higher fees, even for DC plans, where fees tend to be a little more cost-effective than in the mutual fund universe as a whole. Note that the management fee line is flat across all mandate sizes, because mutual funds must charge the same fee for all investors in the fund, or at least those in the same share class.

Exhibit 4: Product structure and fees matter – U.S. equity fees



Source: Investment Company Institute, 2018 Fact Book (Domestic Stock, Asset-Weighted Average). eVestment, LLC, March 2019 (US Large Cap Core Equity) unless otherwise noted

Separate accounts and institutional commingled funds typically offer plan sponsors a way to reduce costs. Aside from general negotiability, tiered pricing schedules also offer the potential for even lower fees as assets with a provider grow. This may be achieved via the aggregation of equivalent mandates across DB and DC plans with common providers, or simply through the organic growth of the assets over time.

Fees matter. Indeed, consider the active/passive discussion earlier in this paper. The prospects of outperforming on a net-of-fee basis in, say, U.S. equities, are not as appealing if

the fee is 90 basis points a year — especially relative to a scenario where the fee may be half that.

At the end of the day, plan sponsors should consider their approaches to choosing investment vehicles for both their DB and their DC plans and seek alignment between them unless they have a defensible reason to do otherwise. We realize that plan sponsors may have taken different approaches in their DC plans because of the historical prevalence of the bundled fee model, even though it is a model that is increasingly unwinding in the current drive toward increased transparency and fee disclosures.

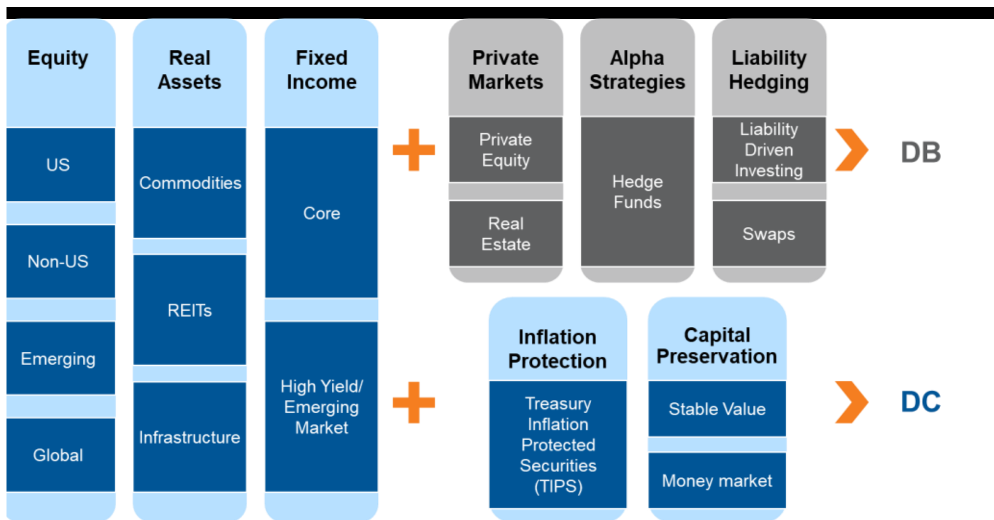
Nevertheless, if we look at the largest DC target date fund providers in terms of assets, it's not surprising to see that most of them are also recordkeepers. Plan sponsors using such solutions should assure themselves that they are exposing their participants to best-in-class investment options, and not simply assuming that strong administrative skills translate to equivalent investment capabilities. Further, no single organization's proprietary products are best at everything. In fact, a 2013 Department of Labor tip sheet explicitly suggested that plan sponsors should evaluate non-proprietary and custom target date options.[iv]

A harmonized perspective

While DB and DC plans may have separate and distinct objectives that necessitate certain structural differences and requirements, they can and should be guided by consistent investment beliefs and principles. Further, there is potential to leverage common asset class exposures across plan types, while allowing unique exposures to persist.

The asset classes grouped at left in Exhibit 5 often play a common role in both DB and DC plans, where the approaches could be similar, if not the same, across plans.

Exhibit 5: A harmonized perspective to DB and DC plan investing



For example, the U.S. equity option offered to participants within a DC plan could be broadly consistent with the U.S. equity asset-class structure embedded within a DB plan – and potentially even use the same investment vehicles, bundled and offered as a single multiple-manager option to DC plan participants. Let's at least identify the overlapping needs and do what we can to harmonize our investment approaches in those areas. Such harmonization would include seeking more consistency across plans as to the use of multiple managers, the blend of active and passive and the type of investment vehicles used.

Again, the approaches taken across DB and DC plans do not need to be in unison. But what is the basis for doing something completely different?

Concluding thoughts to move forward

As you think about your organization's DB and DC plans, we encourage you to commit to consistency in your governance approach and investment philosophy across plans, and to ensure that any inconsistencies are justifiable, particularly from the perspective of achieving ultimate goals. This applies to outsourcing decisions as well. If you explore the OCIO model, consider a single trusted OCIO partner for both types of plans. With the DC plan representing the future of retirement at most organizations, commit to giving the DC plan the attention and resources it deserves (e.g., internal or external), just as we have been doing in DB plans for decades. Finally, look for opportunities to leverage scale, and apply your best thinking across plans in accordance with your investment beliefs. Harmonizing your investment approach across plans may lead to improved outcomes and a more defensible fiduciary position.

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[i] K. Turner (2012), "Is your fund consistent with your beliefs?" Russell Investments Research
[ii] Source: Center for Retirement Research, https://crr.bc.edu/briefs/investment-returns-defined-benefit-vs-defined-contribution-plans/
[iii] D. Gardner (2012, 2017), "Active or passive management in defined contribution plans? It doesn't have to be either/or." Russell Investments Research
[iv] U.S. Department of Labor (2013), "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries." Available at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf

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