8 for 2018

8 ideas designed to improve your DC plan in 2018

Defined contribution (DC) plan sponsors face increasingly complex issues. Russell Investments has developed a priority list of eight ideas and actions to help plan sponsors guide their participants toward better decision making as they save for retirement.

Laying the groundwork

1. Ensure adequate savings

Retirement plan participants often do not save enough for many reasons, including job changes, not taking full advantage of the employer's match, or simply a lack of education about what savings rate is required to sustain one's standard of living in retirement. Professional guidance suggests that participants require retirement contributions of 15%-17% annually over their working careers (from all sources) to accumulate sufficient assets for retirement.[1] However, including both employer and employee contributions, the average participant's total contribution rate is 9.5%,[2] which is about two-thirds of what experts recommend.

Automatic contribution escalation can dramatically increase total savings by about 200% of final salary,[3] but this takes time. More precisely, it takes seven years to move from an employee contribution level of 3% to 10% under typical escalation and default contribution levels, and because the average participant changes jobs every four years,[4] they may never reach that figure. The effect of job changes alone could lead to a final accumulation at retirement that is more than 40% *less* than a full-career employee[5] even if each plan has automatic escalation, which one-third of plans still do not offer.[6]

Ensuring optimal savings by employees is critical because contributions (employer + employee) are the most powerful and direct determinant of retirement success. Without taking investments into account, going from 10% to 11% contribution rate has the potential to improve the retirement outcome by 10%. Retirement income accumulation depends on the amount of total contributions into the participant's account, as well as how much it grows. The expected growth of each contributed dollar depends on the investment strategy it follows and how many years of compounding it will experience.

Plan sponsors should encourage higher savings rates through simple steps, such as **including an "opt-out" automatic contribution escalation feature** and **increasing the escalation schedule beyond 1% per year**. At the very least, contributions should be escalated to levels that take advantage of the full employer match. Automatic enrollment of new participants at higher rates, or asking participants to remember their contribution level from a prior employer's plan, are other tactics. A **contribution re-enrollment**, can be a powerful tool to assist participants in hitting the 15-17% recommended annual retirement contribution rate discussed above. See below for more information on re-enrollments. Plan sponsors can offer participants **online tools that simulate the impact of increasing their savings rate** on future retirement income levels. Finally, plans should **consider implementing a 'stretch match'** (i.e. matching a lower percentage of contributions but up to a higher rate). After all, participants often cite the employer match as the most powerful motivator for setting their contribution rate.[7]

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2. Evaluate the default option

The qualified default investment alternative (QDIA) concept has been a central element of the corporate defined contribution scene since it was first introduced in the Pension Protection Act of 2006. QDIAs have received 50% of participant contributions, and that figure is projected to grow to 85% by 2022.[8] As a result, the QDIA is expected to become the largest option in many plans over the next three years.[9]

Significant attention should be paid to whether the current default option remains suitable for participants or if other options may better suit their needs. The default solution choice, and periodic re-evaluation, should be considered a critical duty of plan sponsors.

There are three primary forms that a QDIA can take (balanced funds, managed accounts, and target date funds), and each has its own strengths in different circumstances. For example, balanced funds are generally the simplest approach; managed accounts are the most customizable; and target date funds (age-based options that automatically de-risk over time) are widely seen as the closest thing available to a "one-size-fits-all" solution. A hybrid QDIA approach combines these options and is discussed in the next section. Russell Investments has demonstrated that with increased customization, first at the plan level, then at the individual level, participants are able to provide higher levels of retirement income adequacy with a higher degree of certainty.

With nearly 40 target date fund providers in 2016,[10] the marketplace offers many target date default options from which to choose. While all glide paths assign a higher allocation to growth assets the further the investors are from retirement, allocations across providers may differ by as much as 40% for investors nearing or in retirement. The range of expected income replacement rates can vary widely among target date funds so it is important to consider the overall objectives of your defined contribution plan when reviewing the default solution choice.

It is equally important to consider risk in the evaluation process. Market corrections are unpredictable and high equity exposures increase the distribution of outcomes. Negative market returns near the point of retirement have an outsized impact on sustainability of withdrawals.[11]

To help plan sponsors evaluate their default option, Russell Investments has published an article on seven tenets of institutional quality target date fund solutions titled "*Russell Investments' beliefs in building institutional-quality target date solutions*" and several pieces on QDIA selection and evaluation can be found on Russellinvestments.com.

3. Conduct a re-enrollment

Evidence is mounting that the self-directed, do-it-yourself approach to DC plan investing often results in poorly constructed participant portfolios and lower-than-optimal savings rates. Participant inertia, naïve diversification, and a bias toward the status quo can be attributed to what we believe is sub-optimal behavior.

Fortunately, there is an easy fix. A re-enrollment consisting of a re-election of investment choices and savings rates can help participants get back on track to saving adequately and investing appropriately. A QDIA re-enrollment can help meet the needs of the majority while still maintaining flexibility for self-directed members who can opt out at any time. A contribution re-enrollment, as mentioned previously, follows the same process only for contribution rates.

While such a process may seem daunting at first, our own experience has shown that re-enrollments are straight-forward, with the plan's recordkeeper doing much of the heavy lifting.[12] With a QDIA re-enrollment, all participants are asked to re-select their investments, typically through a special website established by the recordkeeper. If they wish to maintain their current elections, or select new ones, they can do so within a certain timeframe, generally about three months. Communication materials inform participants that if they fail to act after a reasonable notice period, their existing plan balance and future contributions will be mapped to the QDIA on a certain date. Plus, if done correctly (mainly satisfying certain participant notice requirements), fiduciaries are provided safe harbor protection under the Pension Protection Act of 2006. The glide path manager can help structure both the required and supplemental participant communications.

4. Streamline the core menu

Russell Investments recommends simplifying core menus because offering too many investment choices may lead to participant confusion and place greater fiduciary burdens on plan sponsors. The average number of investment options is approximately 18,[13] while Russell Investments recommends 6 to 8. Although the average number of plan investments has decreased over time, many plan sponsors are still offering too many options. According to Deloitte's 2017 DC Benchmarking Survey, only 55% of plan sponsors have simplified the investment options.

While there is no magic number, decisions about the right number of investment options should be centered around the number of investment decisions you wish to ask your participants to make. The average DC plan core menu requires plan participants make at least five major investment decisions: Stocks vs. bonds, capitalization (large vs. small), investment style (growth vs. value), regional exposure (U.S. vs. Non-U.S.), and active management (active vs. passive). Rather than offering narrow investment choices and forcing participants to become experts on siloed asset classes, we believe the same amount of diversification can be offered to participants with a relatively smaller core menu made up of multiple-managers in each investment option. A multi-manager approach can help improve the consistency of excess returns with less volatility than single-manager portfolios in the same asset class.[14]

An eye toward the future

5. Develop a framework to evaluate managed account solutions

As utilization of managed account solutions continues to grow, plan sponsors and their consultants are developing more robust frameworks for evaluating different solutions. At Russell Investments, our framework is straightforward and objective. Ideally, the following four components should be carefully assessed:

1. INPUTS: Include capital market assumptions, participant data, and treatment of asset classes. Not all providers have robust processes for measurement and treatment of these inputs, but as the saying goes, "garbage in-garbage out."
2. OUTPUTS: Include portfolio construction, participant customization, and the resulting asset allocation that participants receive. Again, these characteristics can vary significantly by provider and a robust scoring methodology on these metrics can help plan sponsors evaluate the capabilities of each provider.
3. MEASUREMENT OF RESULTS: Include how participants are informed of their progress toward a successful retirement, but also how the plan sponsor can verify that participants are deriving value from the managed account solution. The GAO, in its study of managed accounts, clearly identified this as a weakness among current managed account providers.[15] We believe that both plan sponsor and participant reporting should focus on progress toward a stated retirement goal.
4. FEES: Managed accounts can be expensive, and we believe that additional fee transparency is needed for plan sponsors to make an educated decision about whether to offer managed accounts to participants. Fees typically include two components: a payment to the recordkeeper for data transfer, access and/or exclusivity, and the cost of managing portfolios. Plan sponsors should understand both components and push for transparency whenever possible.

6. Bringing it all together: Uniting pre- and post-retirement solutions

The transition from saving to spending is still clunky for many participants. Target date funds can serve the accumulation needs of pre-retirees and help manage account balance volatility for post-retirees, but participants are largely on their own when it comes to drawing down the accumulated assets. Both guaranteed and non-guaranteed products exist to help participants with their decumulation phase, but the integration of pre-retirement and post-retirement solutions remains elusive.

The solution may lie within managed accounts, which possess more capabilities to combine pre-retirement accumulation and post-retirement spending support in one seamless and integrated solution, essentially taking participants from "cradle to grave" in a single solution.

Because of a participant's natural interaction with managed account solutions, the communication and transition can be a seamless process, allowing participants to "turn on" retirement spending support as they near retirement. Managed accounts can solve for outside assets and automate the process of aggregating all the participant's assets pegged for retirement in one place, whether in-plan or out-of-plan, across all tax treatments, and can also offer social security claiming strategies as well as tax efficient drawdown strategies.

The next phase for managed accounts is continuity between the in-plan and out-of-plan environments. Russell Investments supports efforts by both regulators and plan sponsors to retain a greater percentage of participant assets in the qualified plan environment post-retirement. That said, currently, a majority of participants roll out of their employer-sponsored plan into an IRA, as evidenced by the fact that 75% of retirement assets reside in IRA/Keogh accounts while only 25% reside in employer sponsored plans for individuals age 65 and older.[16] This underscores the need for future post-retirement solutions for participants regardless of whether they remain in an employer plan or roll into an IRA in retirement.

7. Hybrid QDIA: A natural evolution of default investing

A hybrid QDIA represents a natural evolution of QDIA investing, drawing from the strengths of each approach to serve the differing needs of participants in different life stages. This approach combines the simplicity of asset allocation funds (balanced funds and/or TDFs) with the adaptability of professionally managed accounts when it's needed most: in the late-career phase and into retirement.

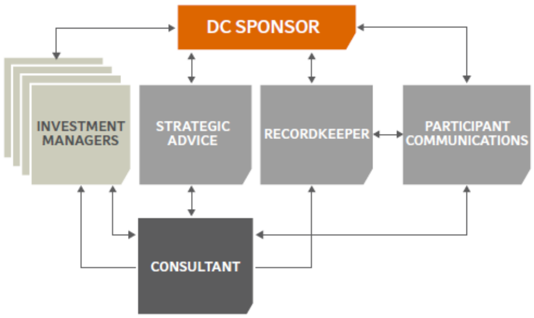
As mentioned earlier, the default investment is evolving to adapt to a simple reality: target date funds are constructed with a 'typical' participant in mind, but in reality, there are very few 'typical' participants. Managed accounts help address this issue by incorporating additional data, such as savings rates, salary, and outside accounts, and can be useful for those participants who desire a higher degree of personalization or who have substantial assets outside the DC plan or DB plan benefits. While managed accounts can offer benefits like financial planning guidance to employees, typically, those who see the most benefit from a managed account are mid to late career participants, while younger participants are usually well-served by a target date fund.

A hybrid QDIA offers many aspects of the best of both worlds. A hybrid QDIA involves a plan sponsor designating more than one QDIA option for the plan, and defaulting participants into one of the designated QDIAs depending on their age and financial circumstances. For example, younger participants with more homogeneous retirement objectives (primarily accumulation), may be defaulted into a target date fund or risk-based fund, while older participants, with more complex and distinct retirement objectives, may be defaulted into a managed account. Additionally, defaulted participants are transitioned to a managed account platform using a rules-based approach when the participant draws closer to retirement and their financial situation may become more complex.

Exhibit 1: Traditional versus outsourcing model

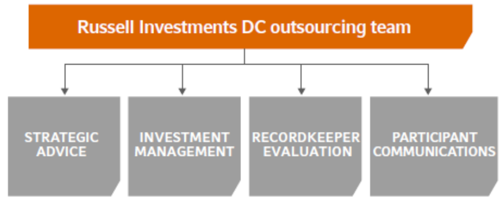
Traditional DC plan model

Multiple relationships, multiple fees, plan sponsor responsible for everything



DC Fiduciary outsourcing model

Single relationship with clear accountability and direction



Are managed accounts alone a suitable default option? Yes. A properly structured managed account solution, we believe, is potentially the most powerful of the QDIA types in terms of tying the asset allocation to the participant's specific goals and circumstances, and the use of managed accounts has benefits for participants of all ages. For example, managed accounts provide personized saving and planning advice, and appear to be associated with a higher level of engagement from the plan participant.

8. Defined contribution outsourcing

Many plan fiduciaries struggle to keep up with changing DC regulatory requirements, fiduciary concerns about compliance and litigation, and oversight of investment managers, recordkeepers, trustees and custodians (and the fees they charge). The traditional approach to managing a DC plan involves multiple relationships with multiple fees, with the plan sponsor ultimately responsible for every decision, which can be a major drain on their limited resources.

In an attempt to simplify, some plan sponsors hire a bundled provider for investments and plan administration, which from the outside looks to be a simple approach; however, this often can be fraught with problems as evidenced by recent class action lawsuits against plan sponsors. The primary issues highlighted by recent litigation are excessive fees, revenue sharing arrangements, choice of share classes in the fund lineup, and choice of investment vehicle. As a result, we believe that the traditional model of DC plan management may no longer be as effective in today's more challenging fiduciary environment. For example, many investment committees still use a quarterly meeting cycle to monitor the plans and most DC plan oversight committees are spending too much valuable time managing and monitoring vendors. This model can lead to slow and onerous decision making.

Most plan sponsors already delegate some plan management responsibilities, such as legal review and plan administration, to third parties. This year, consider delegating additional plan management functions to a third-party expert co-fiduciary. Delegation allows the investment committee to focus on higher impact decisions, such as plan design and facilitating adequate savings behavior by participants, rather than on administrative functions and vendor management that takes up valuable committee time and resources. Outsourcing for a DC plan can take many forms, from limited scope duties such as investment manager selection and monitoring, to full plan management, compliance and administration. Remember, under ERISA it is not necessary for plan sponsors to perform every fiduciary function themselves, but rather to ensure that every function is performed according to fiduciary standards.

Exhibit 2: SAMPLE 8 for 2018 checklist

IDEA	ACTION
✓ **1. Ensure optimal savings**	Action: Remember previous employer match rate for new employees, increase default deferral rate, auto-escalate contributions in greater than 1% annual increments, consider a contribution re-enrollment
✓ **2. Evaluate the default**	Action: Review current QDIA provider and marketplace
✓ **3. Conduct a re-enrollment**	Action: Re-enroll all participants into the plan's QDIA
✓ **4. Streamline the menu**	Action: Consider reducing the plan's menu to 6-8 options
✓ **5. Framework for managed accounts**	Action: Consider a hybrid QDIA in conjunction with default option evaluation
✓ **6. Harmonize pre- and post-retirement solutions**	Action: Review managed accounts if your plan offers them and maintain ongoing discussions with your recordkeeper on alternatives
✓ **7. Consider hybrid QDIA**	Action: Stay abreast of emerging products that integrate pre- and post-retirement solutions for both in-plan and out-of-plan accounts
✓ **8. Outsource additional plan management responsibilities**	Action: Consider delegating additional plan management responsibilities to a qualified provider

[1] Sources: Aon Hewitt The Real Deal 2015, (12% - 15%); Vanguard How America Saves 2016, (14%); Employee Benefit Research Institute (15%)

[2] Vanguard How America Saves 2016

[3] Assuming typical defaults of employer of match 50 cents for each dollar contributed by the participant up to 6% and automatic contribution escalation of 1% per year up to a 10% cap. Source: PSCA 59th Annual Survey

[4] Source: Bureau of Labor Statistics

[5] Assuming typical defaults of employer of match 50 cents for each dollar contributed by the participant up to 6% and automatic contribution escalation of 1% per year up to a 10% cap. Source: PSCA 59th Annual Survey

[6] Source: Deloitte Defined Contribution Benchmarking Survey 2017

[7] Source: PlanSponsor."Employer Match a Powerful Motivator for 401k Participation"

[8] Source: Cerulli Retirement Markets Q4 2016

[9] Source: Cerulli Retirement Markets Q4 2016

[10] Morningstar Direct

[11] Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. There is no guarantee that any stated results will occur.

[12] Source: Verdeyen, H. (2016 March) "*Defined Contribution plan enrollment: A fiduciary imperative?"* Russell Investments

[13] According to the most recently updated prospectuses released in Q1 2017 from the top 20 target date fund providers in terms of AUM

[14] Source: Russell Investments

[15] Source: U.S. GAO "401(K) Plans: Improvements Can Be Made to Better Protect Participants in Managed Accounts" June 2014

[16] Source: Employee Benefit Research Institute 2016 Survey of Consumer Finances

RELATED READING

Verdeyen, H. (2016, March). "Defined Contribution plan re-enrollment: A fiduciary imperative?" *Russell Investments.*

Knowles, K. (2015, February) "Russell Investments' beliefs in building institutional-quality target date solutions" *Russell Investments.*

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ABOUT RUSSELL INVESTMENTS

Russell Investments is a global asset manager and one of only a few firms that offers actively managed multi-asset portfolios and services, which include advice, investments and implementation. Russell Investments stands with institutional investors, financial advisors and individuals working with their advisors—using our core capabilities that extend across capital market insights, manager research, asset allocation, portfolio implementation and factor exposures to help investors achieve their desired investment outcomes.

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