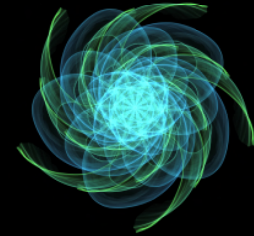
DC top ten for 2022

Ten steps for Defined Contribution plan sponsors to consider this year



Defined contribution (DC) plans in the United States are facing unprecedented challenges. According to an article from Groom Law Group,[1] 2020 was a record-setting year for litigation under Employee Retirement Income Security Act of 1974 (ERISA) with more than 200 new class action suits filed, which is an 80% increase over 2019 and more than double the number filed in 2018. Further, the U.S. Supreme Court issued four decisions involving DC plans, which is more than any other single year in the 47 years since the passage of ERISA. Although the activity in 2021 is off slightly from the pace set in 2020, there continues to be many suits filed for issues such as excessive fees, cybersecurity and imprudent investments.

DC investment committees are now faced with interpreting and adapting to new regulatory guidance and evaluating proposed rules. On April 14, 2021, the Department of Labor (DOL) released cybersecurity guidance, which emphasized that a fiduciary's responsibility for monitoring service providers (i.e., the plan's recordkeeper and trustee) extends to evaluating the security of participant data. The back and forth on Environmental, Social and Governance (ESG) that has occurred during changes in administrations over the past 20 years continues with a new proposal issued on October 13, 2021. And, while it is not a new regulation, some are still considering the impact of the June 3, 2020 letter from the DOL, which indicated that plan fiduciaries would not violate ERISA solely because they chose to include private equity in a DC portfolio.

All of this comes at a time in which plan sponsors are realizing that they must adapt their governance practices to meet the challenge of preparing their participants for retirement. The consequence of inaction for many is delayed retirement, which has a measurable financial impact as a direct result of workforce management complications. Unlike a Defined Benefit (DB) plan with a specified benefit, DC plans require the individual to determine the appropriate contribution rate, so when combined with investment earnings, their retirement will be adequately funded. The question that many committees are asking is, what are the steps to take in this difficult environment to put our participants on a path to creating a fully funded retirement income stream?

This paper first reviews strategies to navigate the onerous legal and regulatory issues faced by plan fiduciaries today, which will understandably take precedent over any other plan consideration. We then shift to examining tactics to better fund future "liabilities," including increasing savings and creating more efficient investment strategies for both active participants and retirees, with an overall objective of increasing the likelihood that employees will have successful retirement outcomes.

For DC plans to succeed as a vehicle that can help participants reach their personal funded status goals, it is important that committees consider the savings and investment strategies discussed in this paper and prioritize those that will be most impactful.

[1] Source: https://www.groom.com/resources/2020-erisa-litigation-trends-hint-at-whats-ahead-this-year/

Navigating legal and regulatory issues

1. Review and update plan governance to meet the new challenges

Eliminating all litigation risk and fiduciary responsibility is not possible for a plan sponsor once it has signed the plan's original document. There are steps that can be taken to mitigate risk, such as regular fee benchmarking, operating in compliance with the plan document and investment policy statement and ongoing monitoring of plan investment options. However, such processes will only be successful with a sound foundation. In the oversight of any institutional investment portfolio, like a DC plan, such a foundation is a strong governance process. Although, DC has replaced DB as the primary source of retirement income for millions of Americans, committees have been slow to adapt their governance to meet the new challenges.

Many investment committees focus on reviewing benchmark-relative performance of the DC menu, with little time devoted to an overall strategy for managing the plan. This occurs despite research indicating that improving governance, which enhances discipline and consistency, can increase the performance of a portfolio. Beyond that, this key foundation provides the structure to establish processes to better manage the risk of litigation that has become commonplace for large DC plans.

An important initial step in the process of improving governance is to establish formal investment beliefs and objectives for the plan. They are considered a core factor in global best-practice models, fundamental to improved governance, and are now utilized by many of the largest plans in the world. Establishing beliefs saves time and allows committees to focus more on managing fiduciary risks, along with strategies to improve retirement outcomes for participants. Russell Investments strongly believes that codifying beliefs and objectives should be standard practice for all DC plans.

2. Improve governance through delegation of investment decision making

The passage of the SECURE Act (Setting Every Community UP for Retirement Enhancement Act) in 2019 included reforms intended to broaden plan coverage for employees of smaller companies by allowing them to band together to participate in a single plan, known as either a Pooled Employer Plan (PEP) or Multiple Employer Plan (MEP). The SECURE Act made both options easier by eliminating the "one bad apple rule," which could have disqualified the entire plan due to the actions of one employer. We believe that MEPs and PEPs are excellent options for small employers that can benefit from the collective purchasing power to obtain lower fees and more comprehensive services.

However, MEPs and PEPs are not the panacea that some might suggest for avoiding fiduciary and litigation risks. In these arrangements, employers still maintain fiduciary responsibility for the careful selection and ongoing oversight of the MEP and PEP providers. Further, there is limited flexibility in plan design and in choosing investment options that together may inhibit the sponsor's ability to make the changes necessary to help their participants. Russell Investments is supportive of committees delegating their investment decisions, but we believe that an internal subcommittee for those with sufficient resources, or an outsourced chief investment officer (OCIO) arrangement, is more appropriate for mid- and large-sized plans.

Committees are often comprised of senior level executives with competing priorities, who have limited capacity to focus on the organization's retirement plans. To mitigate the workforce management risk and maximize the probability that participants will not need to delay retirement, committees should re-evaluate how they spend their time. DC committees would benefit by deciding to focus more time on strategy and outsource investment decisions to an OCIO provider. Similar to a MEP or PEP, the sponsor has responsibility for the selection and monitoring of the provider, but it maintains the flexibility of managing the plan as its own.

3. Mitigate cybersecurity risk

The Department of Labor's (DOL) new cybersecurity guidance, issued on April 14, 2021, begins with the statement "ERISA-covered plans often hold millions of dollars or more in assets and maintain personal data on participants, which can make them tempting targets for cyber-criminals. Responsible plan fiduciaries have an obligation to ensure proper mitigation of cybersecurity risks." Globally, 30,000 websites are hacked daily and every 39 seconds there is a new attack somewhere on the web. Nearly 64% of companies worldwide experienced at least one form of cyber attack, which included 20 million breached records in March 2021 alone.[2]

For fiduciary committees, the responsibility to mitigate cybersecurity risks is critical in their efforts to reduce potential litigation. If recent history has shown us anything, it is that when there is an issue with a provider, the plan sponsor will most often be the lead defendant in a class action. To help plan sponsors manage this risk, the DOL included "tips' for hiring service providers with cybersecurity responsibilities, which include[3]:

- Ask about the provider's security standard practices (including how practices are validated), and policies, the security levels/standards it has met, and its audit results, and compare them with those of other firms.
- Review the provider's "track record," including information security incidents and litigation/legal proceedings and ask about past security breaches.
- Find out if the provider has any relevant insurance policies.
- Contract for ongoing compliance with cybersecurity/information security standards and beware of contract limitations on this responsibility and for security breaches.

However, it isn't sufficient to simply ask the right questions or gather information from the plan's service providers. Russell Investments recommends that fiduciary committees review the responses with their internal IT team, or with a trusted external vendor to ensure that the provider's processes are reasonable and considered best-in-class.

4. Environmental, Social and Governance (ESG)

Whether and how plan fiduciaries can incorporate ESG into DC plans has been like an endless game of ping-pong for the past two decades. This is primarily due to regulations being delivered through DOL guidance and rules, which are relatively easy to change by future administrations. The most recent proposal, issued on October 13, 2021, is intended to make it easier for plan fiduciaries to incorporate ESG into their DC plans, including the Qualified Default Investment Alternative (QDIA), and will likely amend ERISA's prudence and loyalty standards to make it more difficult to change. However, committees are still prohibited from assuming more risk or sacrificing return simply to support collateral objectives.

Russell Investments believes the most appropriate way for plan fiduciaries to incorporate ESG, while minimizing their legal and regulatory risk through potential future back-and-forth, is by leveraging ESG integration, which considers factors that have a clear financial benefit. In other words, any ESG consideration should improve the expected risk and return profile of the portfolio. This can be achieved by focusing on investment managers that include ESG integration as part of their process in the same way they may consider valuation, potential growth, credit quality etc. In addition, as with everything else, plan fiduciaries should ensure they make decisions on this topic utilizing a well-considered process while documenting everything carefully. By doing this, we believe risks are reduced meaningfully no matter how much ping-ponging occurs in the future.

[2] Source: https://techjury.net/blog/how-many-cyber-attacks-per-day/

[3] Source: O3 Plan Advisory Services

Improving participant outcomes

5. Understand funding policies for the DC plans

“Personal Funded Ratio” is a Russell Investments-coined phrase and patented process[4] for determining an individual DC participant’s personal retirement readiness based on the asset-liability funded ratio approach used by institutional investors.

Most investment committees spend much of their time in quarterly meetings discussing the funded status of their pension plans. Their focus is typically on whether they will be required to make additional contributions or increase their allocation to return-seeking assets. Compared to their well-resourced employers, the risk to DC participants is far more onerous and they are generally ill-equipped to determine how much additional they should save or how to adjust their asset allocation to increase expected return.

Because participants look to their employers to tell them what to do through plan design, sponsors should be using participant inertia to their advantage. Optimizing the use of automatic features is among the strategies that likely have the biggest impact in improving personal funded ratios. Much like how organizations periodically review the funding policies for their pension plans, it is critical that employers understand the impact that their decisions (e.g., initial auto enrollment levels and what cap to use for auto escalation) have on funding DC liabilities. Periodic re-enrollment should also be discussed to get non-contributing employees to begin saving and defaulting current participants into a more appropriate asset allocation.

Russell Investments recommends triennial retirement readiness studies to evaluate progress and determine which levers will have the biggest impact. It is difficult to accurately determine what changes are necessary, or to measure the impact of prior decisions, without establishing the baseline and making periodic assessments.

6. Consider the use of private securities in white label and custom target date fund (TDF) portfolios

The Russell 1000® Index experienced significant drawdowns during both the Global Financial Crisis of 2008-2009 and the COVID-19 pandemic, with peak to trough declines of 53% and 20% respectively. These were painful periods for well-resourced DB sponsors that may have been forced to make additional contributions to improve their plan’s funded status. However, the impact was more significant for DC participants, particularly those at the end of their glidepath, many of whom were forced to delay retirement.

DB plan fiduciaries have long understood that creating portfolios with the appropriate balance between return seeking and hedging strategies most often leads to success. Since both DB and DC plans are solving for the same solution – fully funding a liability – it seems logical to create portfolios that have the same or a similar asset allocation. DC plans that offer white label portfolios or custom TDFs should consider incorporating similar strategies to help improve the efficiency of their plan’s investment options. Although not suitable as a standalone option, Russell Investments believes a competently managed exposure in a custom TDF or white label fund to illiquid assets has the potential to improve the risk-and-return profile versus comparable liquid assets in many market environments.

On June 3, 2020, the DOL issued an information letter in response to requests from two managers, with respect to the inclusion of private equity investments in a designated investment alternative. In summary, the DOL concluded that, as a general matter, “…a plan fiduciary would not…violate [ERISA fiduciary rules] solely because the fiduciary offers a professionally managed asset allocation fund with a private equity component as a designated investment alternative for an ERISA covered individual account plan in the manner described in [the] letter.”

Particularly in light of the DOL’s December 21, 2021 supplement to the 2020 information letter, sponsors considering such an option will want to review these issues with counsel.

[4] U.S. Patent No. 10,223,749 entitled "Retirement Planning Method."

7. Rethink core menu design and portfolio structure

Investment committees that still view DC plans as supplemental often emphasize choice over the quality or clarity of investments. However, as fewer employees are covered by a pension benefit, it becomes even more important to have a clear and well-designed core menu to improve the likelihood of successful retirement outcomes. Including both an active and a passive investing tier in a DC plan. in an effort to accommodate the needs of a majority of employees, is a reasonable approach. However, the distinction between the tiers must be communicated to avoid overwhelming participants with too many highly correlated investment choices.

Russell Investments has established a baseline investment structure that includes an active and passive mirror for the core menu. The objective is to simplify participant investment decisions, maintain economies of scale with plan assets invested in fewer options and accommodate the investment needs of most participants. Our model core asset class line-up looks something like Exhibit 1.

Exhibit 1: Example of a core menu

PASSIVE	ACTIVE
International Equity	International Equity
U.S. Small Cap Equity	U.S. Small Cap Equity
U.S. Large Cap Equity	U.S. Large Cap Equity
Core Fixed Income	Core/Plus Fixed Income
	Capital Preservation

For committees seeking to engage participants and help them achieve better retirement outcomes, using a multi-manager, white-label structure to consolidate and simplify the plan menu is an appropriate step. Multi-manager, multi-style investing is not a new idea. It's the way institutional investors, such as DB plans, have been investing for decades. DB plans would never invest all their assets with one underlying investment manager – especially across asset classes, but not even within asset classes. Thus, multi-manager, multi-style investing helps to institutionalize a DC plan.

8. Revisit the Qualified Default Investment Alternative (QDIA)

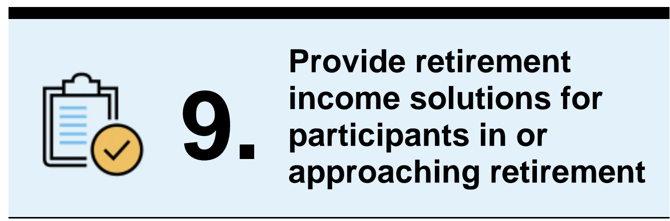
Most U.S. DC plans have chosen to use off-the-shelf TDFs as their plan's QDIA. Target date funds provide a one-stop-shop experience by creating diversified portfolios with varying combinations of return-seeking and fixed income investments. Their intuitive nature is one of the reasons that the series is often the largest investment in terms of assets under management (AUM) and receives the most ongoing contributions. While they allow participants to avoid making investment decisions from initial enrollment through retirement, it's important that committees don't avoid their obligation to periodically evaluate their manager beyond a quarterly review of benchmark relative performance.

To assist committees in the selection and ongoing evaluation of their TDF manager, the DOL issued "tips" in 2013. The elements of an annual review should include an evaluation of the glidepath, portfolio construction and fees for a reasonableness check relative to peers. Every three years, or whenever there are significant changes in the workforce (e.g., acquisition, spinoff, reduction in headcount, etc.), committees should also conduct a demographics-based glidepath analysis to ensure they are using the manager that is the best fit for their population. However, beyond those reviews, we believe that committees should periodically revisit the type of QDIA utilized to ensure it still aligns with their beliefs and objectives, including an evaluation of more personalized solutions.

Off-the-shelf TDFs are based on an average U.S. citizen, rather than specific investor characteristics. While they have clear advantages over earlier best-in-class solutions, such as risk-based funds, they are only attempting to simplify investment decisions, rather than providing advice on both funding and investing strategies. On the other hand, managed accounts, which are frequently offered in a DC plan, recommend the savings level and investment allocation designed to put the participant on the path to fully fund their retirement. These solutions have also been specifically structured to function as the plan's QDIA. Just like funding and investing policies for pension plans are unique to each sponsor, DC participants would likely benefit from more comprehensive and personalized advice for more successful outcomes.

However, since most recordkeepers only provide access to one or two managed account providers, one of which is often proprietary, plans have limited ability to negotiate their fees. With off-the-shelf pricing that may begin at .50%, in addition to fees paid to the core managers, it may be difficult to justify using this as the QDIA when TDFs are available at significant discounts. Russell Investments believes that committees should formally review the services of their managed account provider, including fee benchmarking, triennially. This is particularly important if the managed account serves as the plan's QDIA. Given the fee compression experienced by the rest of the industry, there should be an expectation of a reduction in their managed account fee schedule.

An alternative that is starting to garner interest, along with some limited implementation, is a hybrid approach where participants are initially defaulted into a TDF but are then automatically moved, through a secondary default, to the managed account as retirement nears. The rationale of this approach is that participants don't need as much customization early in their careers when they are less engaged but will benefit when they begin to pay more attention as they get closer to retirement. This approach could be a solution for those committees concerned about the managed account fees for a full-career employee.



9. Provide retirement income solutions for participants in or approaching retirement

The primary focus for DC plan sponsors and committees has historically been on helping participants accumulate assets during their working years, with little support provided in retirement. A common analogy is taking an airplane flight only to have the pilot parachute out of the plane just before reaching the destination, leaving passengers to maneuver the landing on their own. The "landing gear" of our DC system is the strategies designed to help participants convert their accumulated retirement balances into a reliable stream of income. Without this support, most of today's retirees rely on Social Security as their primary retirement benefit, and their only source of guaranteed income.

However, a flashpoint may be on the horizon. The SECURE Act provides a new fiduciary safe harbor for selecting an insurance provider as a distribution option. Combined with greater product availability, the SECURE Act appears to be a catalyst and more committees are now expressing interest in evaluating retirement income solutions for their DC plans, including several large plans that are in various stages of implementing strategies.

In our view, initial efforts should be focused on participants that appear to be asking for assistance during accumulation. To us, that means committees should first focus on strategies that incorporate automatic or default distribution options in the plan's QDIA and the managed account option, if available. Russell Investments has modeled the retirement outcomes from different product types, based on company specific demographics, to facilitate a comprehensive evaluation of retirement income options. After many years of discussing retirement income, we believe that we will finally begin to see more widespread implementation over the next few years.

10. Managed Efficient implementation

Implementation is broadly defined as trading strategies executed by a third-party to mitigate the costs and unintended risk exposures when a committee elects to make a manager change and move among investment mandates. Any asset movement in a DC plan can have serious implications if risk and costs are not carefully managed with thoughtful implementation. In DC plans, implementation comes in many forms, including transitioning assets from one investment manager to another, centralized investment implementation of multi-manager portfolios (i.e., portfolio emulation) or an implementation account within a custom TDF to improve the trading efficiency of rebalance and roll-down.

Russell Investments believes that plans should engage with implementation specialists because it is a natural extension of the current focus on fees. The pitfalls of relying on managers to transition assets among mandates are becoming more apparent as DC plans move away from mutual funds to more institutional structures. Efficient investment implementation reduces turnover and trading costs, keeps participants fully invested in the capital markets and avoids blackout dates and performance holidays commonly associated with transitions in DC plans today.

Conclusion

Today's DC committees face significant challenges in preparing their participants for retirement, which is further complicated by a myriad of legal and regulatory concerns. However, committees must avoid being paralyzed by fear of litigation if they hope to improve participant outcomes. For DC plans to succeed as a vehicle that can help participants reach their personal funded status goals, it is important that committees consider the savings and investment strategies discussed in this paper and prioritize those that will be most impactful.

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