Defining Retirement Success for Defined Contribution Plan Sponsors: Begin with the End in Mind

David Blanchett, CFA, CFP®
Head of Retirement Research
Morningstar Investment Management
david.blanchett@morningstar.com

Nathan Voris
Large Market Practice Leader
Morningstar Investment Management
nathan.voris@morningstar.com

February 11, 2014

MORNINGSTAR®

Abstract

How do you define retirement success? For many individuals and households the concept of “retirement success” is somewhat abstract. It can mean different things and be quantified in different ways. For example, retirement success from an accumulation perspective might mean saving enough for retirement. For a retiree, it could mean achieving the desired standard of living over one’s lifetime. For a financial planner, it could mean achieving a goal with some target probability of success. In each case, the perspective of the individual (or entity) helps define what is a successful outcome.

In this paper, we take the perspective of a defined contribution (DC) plan sponsor and outline key things a plan sponsor can do to help maximize the likelihood of its employees achieving a successful retirement outcome (however it is defined). Taking the perspective of a plan sponsor is important, since plan sponsors have considerable ability to impact employee outcomes. Unlike other countries, such as Australia or Great Britain, that are moving toward mandated saving schemes, in the United States, saving for retirement and developing a retirement income strategy is an individual decision.

We outline best practices for plan sponsors focused on maximizing participant retirement success, both during accumulation and retirement (i.e., decumulation). While certain activities, like selecting the optimal plan investments, are an important component of the optimal DC structure, they are only one part of a much larger and more complex puzzle.

Retirement is personal, with each individual's situation slightly different from the next. Two employees of the same age and with the same job who on the surface may appear to have identical investing goals and needs in retirement, may in fact be very different upon closer examination. Factors such as marriage status, housing situation, lifestyle needs, etc. can all contribute to these potential differences.

With the rise of the DC plan, each participant is largely left to himself or herself to figure out how to adequately prepare for retirement. When DC plans first started gaining traction, the assumption was that employees were capable of making these decisions. However, numerous studies now suggest otherwise, and the overall public perception of DC plans is mixed.

Employers, particularly larger employers, are well positioned to offer better solutions than their employees might be able to find on their own as economies of scale drive down fees on investments and financial advice. Further, where a person works and what he or she does for a living affects the retirement need. Employers know their people, and with the help of consultants and DC experts they can create customized solutions that meet employee needs.

We highlight several key considerations that can help move a plan forward and position employees for retirement success for employers who embrace their role in preparing their employees for retirement, and strive to go beyond their fiduciary obligations. We break these key considerations into two categories: accumulation and distribution. While many of the same considerations apply to both stages, employers often perceive these two periods as fundamentally distinct. In this paper, we will try to highlight the key differences in each, covering the bulk in the accumulation section.

Accumulation

In this section, we discuss some of the key considerations for a DC plan sponsor interested in helping employees prepare for retirement.

1. Build for Behavior
The key is to design a program that helps make it easy for employees to make the right decisions. A few concepts include:

- **Make it Automatic**
  The potential benefits of automatically enrolling participants and automatically escalating participant deferrals are well documented. Participants tend to take the path of least resistance and view plan defaults as being at least implicitly endorsed by the plan sponsor.

  Defaults are an important consideration in any type of "auto" arrangement. Many plans that were early adopters of automatic enrollment selected deferral defaults that were too small, with 3% being very common. We believe moving beyond the standard 3% default deferral rate to a more impactful savings rate is paramount in making auto programs truly successful and allowing participants to reach their retirement goals. Research by Choi, Laibson, Madrian, and Metrick (2004)[1] has demonstrated there is very little effect on participant adoption when moving the default from 3% to 6%. The key is setting a default savings rate that is both meaningful and likely to be adopted by participants, and for the vast majority of DC plans, this number is probably 6% or higher.

- **Move the Carrot**
  People tend to like free stuff, especially free money. That's why many participants will save up to the employer match and no more. For companies that are unable to increase the amount of dollars allocated to making matching contributions, it may make sense to change the match schedule. For example, instead of matching 100% on the first 3% of employee deferrals, match 50% on the first 6%, or even 25% on the first 12%. These lower match schedules do a better job getting employees to "share the load" when it comes to funding retirement.

  The optimal match schedule is likely different for each company and therefore will vary by plan sponsor. These relatively small changes, though, can have a big impact on participant outcomes. A participant who was only saving 3% to get the full employer match who moves to saving 6% to get the same matching benefits, will have a 50% larger account balance at retirement because of this change. In this example, the plan sponsor achieved better participant behavior (i.e., higher savings rates) through plan design modifications at no additional cost.

- **One Part of the Benefits Package**
  Health insurance coverage is not a "one and done" decision like DC plans. Instead, each employee must go in once a year, usually in the fall, and either re-confirm existing coverage or select new health coverage.

[1] Choi, James J., David Laibson, Brigitte C. Madrian, and Andrew Metrick. "Saving for Retirement on the Path of Least Resistance," July 19, 2004

Plan sponsors should leverage the well-worn path of annual enrollment, by making retirement decisions an additional consideration during the process. Something as simple as telling each employee, that those who are not enrolled in the plan will be re-enrolled at the default savings rate each year, will help scoop up employees who either decided not join the plan initially or have since opted out. A plan sponsor could even go as far as "re-enrolling" the plan each year into the age-appropriate QDIA option (presumably a target-date fund) unless the employee elects otherwise

These small changes to the fourth quarter of the year could potentially yield very powerful results for plan participants.

2. Thoughtful Investment Menus

Investment menu design is an important component of managing a DC program. Because of the nature of self-directed programs, and the plan sponsor's fiduciary liability attached to investment decisions, investments often get the majority of plan sponsor attention. It's no surprise many of the committees created to monitor the plan have very specific titles like "Investment Committee" versus more broad names like "Plan Oversight Committee."

Many plan sponsors spend significant time reviewing detailed performance statistics on plan investments, such as alpha, information ratio, Sharpe ratio, tracking error, etc., each quarter, while devoting little time to participant success. Here are a few guideposts to consider when developing a plan menu to optimize participant outcomes as well investment performance:

- **Cover the Basics**
  Offering the core building blocks that should be in each plan. We define these as five asset classes: cash (e.g., stable value or money market), bonds, domestic large cap equity, domestic small-cap equity, and international. Having single options that represent each asset class is an important step to avoiding unnecessary complexity and overlap. Larger plans could potentially consider white labels or multimanager structures that make it simpler for the participant.

- **Go Beyond the Basics**
  Offering broad, diversified exposure to non-core asset classes like TIPS, commodities, real estate, and emerging markets, in a bundled and simple fashion can also benefit participants.

- **Balance Design**
  Many menus today have equity-focused investment menus with more than 10 equity options, but few income options. This overweight to equities may send signals to the participant that equities are more important than fixed income.

- **Rethink the Style Box**
  The style box provides a reasonable starting point when contrasting the different market exposures for investments, but most participants can't intelligently articulate the differences between growth and value. Therefore, it isn't a requirement to fill each "box" of the style box. Rather, assemble a lineup of investments that enables participants to create a diversified portfolio.

- **Minimize or Eliminate Employer Stock**
  There are many reasons this makes sense. You can find our research and perspective here: http://corporate.morningstar.com/ib/documents/MethodologyDocuments/ResearchPapers/Employer-Stock-Ownership-in-401k-Plans.pdf

- **Look at Target-Date Funds**
  Target-date funds have exploded in popularity following passage of the Pension Protection Act of 2006. Not surprisingly, target-date funds now receive the majority of flows for DC plans using them as the default option, and will likely continue to receive significant attention in the process. Management consulting firm Casey, Quirk & Associates estimates that target-date funds will represent nearly half of the projected $7.7 trillion in U.S. DC assets by 2020—many plans that were early adopters may already have over half of plan assets in target-date funds. Therefore, it's critical for plan sponsors to have a due diligence process for selecting and monitoring target-date funds.

- **Consider Advice and Managed Accounts**
  Offering an advice and managed account service can not only help participants determine an appropriate allocation among the plan's investments, but also help them set an optimal savings rate and a goal for retirement income.

3. Educate

This means going beyond the standard investment menu, and highlighting the resources, tools, and solutions that can help craft investment and savings recommendations that will resonate with participants

- **Communications – Move From What to How**
  Participant communications are often overly complex, attempting to explain the nuts and bolts of how each aspect of the plan works in great detail, or designed to check the legal box.

  Participants often don't read these materials or simply don't care (how many even review their quarterly statements?). Therefore, what few communications go out should be simple and focused on what really creates better outcomes. For example, a participant is much better served receiving a one-page mailer about how to save for retirement or what their optimal savings rate should be, rather than a five-page document outlining the formula for determining the monthly crediting rate for their stable value fund.

- **Financial Wellness Today**
  Getting a handle on paying off high interest credit cards and student loans may be a more important goal than socking away money for retirement for some participants. The interest rates on credit cards can exceed 20%, which is a much higher "return" than one can be reasonably expected to earn through investing in stocks or bonds. Our research on the topic of credit card debt and saving for retirement can be found here: http://corporate.morningstar.com/ib/documents/MethodologyDocuments/IBBAssociates/SavingforRetirementCreditCards.pdf.[2] Furthermore, integrating financial wellness programs like HelloWallet into the retirement equation provides a more holistic solution than is the norm today.

[2] http://corporate.morningstar.com/ib/documents/MethodologyDocuments/IBBAssociates/SavingforRetirementCreditCards.pdf

4. Customize

Every plan is different, yet most plan sponsors select one from among only a handful of target-date providers.

- **One Size Does Not Fit All**

  While custom target-date funds may not make sense economically for some plan sponsors, they should be considered for larger plan sponsors with $100 million or more in plan assets. The benefits of using company-specific, plan-specific, and participant-specific data in place of national averages and general assumptions are clear. Because custom target-date funds are constructed from the existing lineup, they also leverage the due diligence previously done on the core menu. This topic is covered in greater detail in Morningstar Investment Management's *Insights* newsletter[3] as well as in a forthcoming paper by Morningstar.

5. Keep it Together

Plan leakage is an important problem for plan sponsors. While things like hardship distributions and loans can provide a valuable source of liquidity for some employees, they pose definite risks to retirement readiness. For example, research by Aon Hewitt (2011)[4] suggests that removing money from a retirement plan can decrease a participant's expected wealth at retirement by as much as 67%, in some cases. There has been new research on this topic over the past few years, with the primary focus on stopping participant leakage through intelligent plan design by limiting provisions such as loans and hardships. DCIAA has a great research paper that addresses the impact of leakage and possible solutions that is available here: http://www.dciia.org/info/publications/Documents/DCIIA%20Plug%20the%20Drain.pdf [5].

6. Get What You Paid For

Running a retirement plan costs money, from administration fees, fund expenses, consultant fees, managed account fees, and the list goes on. For each item on that list, a plan sponsor can get sued for not properly monitoring the costs to ensure they are reasonable. Furthermore, sponsors want to make sure they are actually getting value/service for the costs incurred. A few things to consider that should be done at appropriate intervals:

- **Investment Expense Comparisons**

  A peer group comparison of the investment-only expenses is only one part of the total costs of a DC plan. And watch the peer group. The peer group for a $5 billion DC plan is vastly different than a $50 million DC plan. This is easy information for a consultant or provider to gather, and should be delivered on a quarterly basis.

- **Administration Expenses**

  RFPs are time consuming; but they nearly always result in a better price, more service, and often both. Don't let your provider run the plan; they are not the fiduciary. It is important to ask your provider for a detailed fee analysis of all plan fees on an annual basis.

[3] https://corporate.morningstar.com/us/documents/MethodologyDocuments/ResearchPapers/Retirement-Insights.pdf
[4] http://www.aon.com/attachments/thought-leadership/survey_asset_leakage.pdf
[5] http://www.dciia.org/info/publications/Documents/DCIIA%20Plug%20the%20Drain.pdf

- **How Are Fees Paid?**
  Uneven expense arrangements, with fees through revenue sharing, brokerage fees, etc., rather than a more pure administrative fee, are under scrutiny more and more. The big question: should a participant who uses a product/service that happens to carry revenue sharing, or generate some fee, pay more for the administration of the plan? We believe the answer is no, and that a level, balanced administrative fee approach is the most prudent. Within this context it's important to ensure some participants aren't subsidizing the plan cost for others by investing in funds with higher revenue sharing.

- **Are You Getting Good Investment Advice?**
  Consultants give investment recommendations, do quarterly reviews, and monitor their recommendations. Once upon a time, independent information and data about investments was hard to come by; however, with vast amounts of data and analytics tools available on the web, those days are gone .

  How do you know if your consultant is giving you high-quality advice that is worth the fee? It's a tough question, with no easy answer; but a few ideas that could be useful:

  - *Captain's Log*
    If a fund is being replaced for performance reasons, continue to keep track of that fund and compare the future performance of the two funds. You can even request that an appendix be added to the quarterly performance book with all the replaced funds and their relevant statistics.

  - *Mirror Process*
    When you receive a recommendation, focus on how the recommendation was derived, i.e., what the process was that lead to a particular fund recommendation. Many consultants will provide a "map" of each round of analysis, showing the total number of funds that were eliminated based upon each of their criteria. Ask yourself if there is anything innovative, proprietary, or unique that makes this process valuable. Is it a simple screening process, or are qualitative factors at play that add value beyond the data?

  - *The Big Picture*
    It's easy for investment consultants to dazzle plan sponsors with fancy statistics about investment performance, but how does all of it fit into the big picture? Sure, creating alpha of 100 bps in a fund is great, but how much of the assets are actually in the fund? Is the fund suitable for the plan participants? Is it being used appropriately? These are all questions that should be addressed within the greater context of participant outcomes when thinking about plan investments.

Distribution

In this section, we discuss some of the key considerations for a DC plan sponsor interested in helping participants through retirement. While many of the same topics discussed in the Accumulation section apply for this section, we try to focus on those unique to distribution in this section.

1. Keep the Party Going

You've been a great partner to your employees, providing a low-cost, efficient means to help your employees save for retirement. Keep it going by allowing them to continue to use the DC plan as a vehicle for their needs in retirement:

- **Low Cost**
  Your employees may not be able to do better, from a fee perspective, than what you have been able to provide by leveraging the scale and buying power of the plan as a whole.

- **Sound Advice**
  Managed account services can offer comprehensive, customized distribution recommendations to participants that can include appropriate recommendations to an annuity, if available in the plan.

- **Retirees Help Current Employees**
  Administrative costs are typically priced as a per-participant fee, and investment expenses are typically asset-based fees. In both instances, having retirees in the plan should lower both the administrative and investment expenses, because more people in the plan lowers average administrative expenses and retiree balances tend to be larger than active employees. So keeping retirees in the plan actually benefits active employees as well as the retirees themselves.

2. Keep it Real

The goal of many retirees is to generate some amount of income during retirement, increased annually by inflation. Therefore, inflation is a very important consideration when working toward this goal. Real assets, or asset classes that generally rise with inflation, can be valuable investment options for retirees. Some examples of common real assets include TIPS, real estate, commodities, etc. For some plans, it may make sense to consider a single multi-managed "real asset" option to provide participants with a one-off way to gain exposure to real assets.

3. Guaranteed Income for Life

Retirement may end up being 30 years or more. Generating income for such an extended period is no easy feat, especially given today's low bond yields[6]. Therefore, including some type of guaranteed income option in a DC plan is an important consideration, but one with interesting fiduciary considerations. Fortunately, there are ERISA standards for selecting annuity providers; we address some of those guidelines and additional concerns below.

[6] http://corporate.morningstar.com/ib/documents/MethodologyDocuments/ResearchPapers/LowBondYieldsWithdrawalRates.pdf

- **Keep Good Records**
  Plan sponsor DC committee members come and go, but an annuity can last forever (or at least 30 years). Therefore, it's essential to keep detailed records of the due diligence procedures for selecting and monitoring any type of plan annuity option. Unlike a traditional investment, like a mutual fund, that can be easily removed from a plan lineup, there are far more complex concerns associated with removing guaranteed options. Also, the annuity company is promising benefits for the next 30+ years, therefore it's important the company is, and remains, on solid financial footing.

- **Portability**
  How are participants who want to roll out of the plan affected? Portability is important, given participant behaviors, especially if the participant has paid for some type of guaranteed benefit and loses this insurance if he/she rolls out of the plan. The SPARK Institute has data format standards for operations portability that should be considered when assessing guaranteed options.

- **Peel Back the Onion**
  Annuities can be incredibly complex vehicles and come in many shapes and sizes. Therefore, it's important for plan sponsors to really understand what they're buying and how it can fit the needs of their participants.

- **Bring in the Expert**
  Given the complexity of the annuity decision, it makes sense to seek counsel from experts. While many plan sponsors may be comfortable using various quantitative tools for screening traditional investment options, such tools don't really exist in the guaranteed income space, especially from the perspective of a DC plan sponsor.

- **Gauge the True Cost**
  Annuities, as a form of insurance, should not be expected to result in a positive value for the average participant. While some participants will be better off purchasing an annuity than investing the money themselves in a portfolio and taking withdrawals, insurance companies are in business to make a profit and are generally quite good at pricing risk. The difference in the expected benefits and expenses paid to the insurance company represent the true "cost" of the annuity from the perspective of the participant. The fact that insurance companies do not lose money on each annuity sold is probably a good thing, though, since this implies the insurance company is correctly pricing the risk and that the company should have the ability to pay future claims, which can be 30+ years into the future. Understanding this cost, and how it affects different participants, is an important component in selection and monitoring process.

- **Participant Experience**
  The final consideration is participant communications and the participant experience when owning and using the guaranteed income option to fund retirement. One size does not fit all, and therefore different guaranteed income options are likely to work best for different types of DC plans.

[6] http://corporate.morningstar.com/ib/documents/MethodologyDocuments/ResearchPapers/LowBondYieldsWithdrawalRates.pdf

4. Retirement Solutions

Target-date funds were created as an easy investment solution for accumulators. Similar investments exist for retirement; in fact, Morningstar, Inc. has an entire category dedicated to these retirement income funds. Plan sponsors looking to help participants make better investment decisions should consider an advice or managed account solution to help participants with these choices as well as potentially a packaged solution.

5. Unique Choices

Retirement is full of unique and important choices. One example is when to claim Social Security retirement benefits; another could be helping participants with appreciated employer stock use net unrealized appreciation. These are often decisions with significant implications; for example Blanchett (2013)[7] notes that optimal Social Security retirement benefit claiming can increase the total retirement income by more than 9% for a hypothetical married couple. Working with a consultant that understands these issues, and can help identify them, is important for DC plan sponsors.

6. Plan Distribution Options

In order to discourage lump sum distributions, plan sponsors should be sure the plan offers an installment option for retirees and the flexibility to withdraw money as it is needed in retirement.

[7] Blanchett, David M. 2012. "Optimal Social Security Claiming Strategies." *Journal of Personal Finance.* vol. 11, no. 2: 36-87.

Conclusions

Creating an optimal defined contribution plan that helps maximize retirement success for employees is obviously a complicated process. In this paper, we broke down a variety of choices and decisions a plan sponsor can make, to better ensure retirement success for its employees and participants. While many plan sponsors may be uncomfortable implementing some of these decisions on their own, they can form the basis of discussion topics with consultants. Better choices made by plan sponsors help all employees—current and retired—to achieve what should be the fundamental goal of each DC plan: retirement success.