2016 Research

DC PLANS AT A CROSSROADS

Building a holistic retirement model in a time of sweeping change

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INTRODUCTION

Americans face a host of retirement challenges. The transition to defined contribution (DC) plans hands more responsibility to workers to provide for themselves in retirement. Fiscal pressures on Social Security and Medicare place the future of those systems in doubt. Rising health care costs add further uncertainty. And slow growth in real household income and rising costs of day-to-day living make saving more difficult for many households.

These concerns emerge starkly in a 2015 survey by the National Institute on Retirement Security. This biennial poll found some 86 percent agreeing that the nation faces a retirement crisis. Respondents rank retirement benefits as almost as important a feature of their jobs as salary (72 percent versus 75 percent). Concerned they will not have enough assets to retire, 72 percent said they plan to stay at their current job as long as possible.[1]

CHALLENGES TO PLAN WELLNESS

Given this backdrop, how do plan sponsors and their consultants and advisers view the challenges facing DC plans? What actions are employers taking to address this strong sense of unease and insecurity? Are they achieving plan wellness — putting a plan design, investment options and participant education in place that help participants to achieve individual financial wellness while enabling the employer to make the best use of its dollars? And what about industry wellness — is the retirement industry providing the services plan sponsors need, in a regulatory environment that encourages employer-sponsored retirement saving? To find out, Institutional Investor, in partnership with Prudential, recently conducted a survey of over 500 sponsors of DC plans with assets over $50 million; to obtain a wider, outside view, we also surveyed nearly 300 consultants and advisers to DC plans. Supplementing the study were interviews with more than a dozen plan sponsors, consultants and advisers. The study asked them what their greatest challenges are — particularly in getting employees to save, and save more — what they are doing to address these challenges and their views of the overall U.S. retirement system.

Plan sponsors are concerned about the stability of the retirement system. Although nearly half say it is evolving and will likely adjust to the changing needs of employers and employees, one-third believe it is in crisis. Consultants and advisers who work with DC plan sponsors are more pessimistic, 38 percent agreeing the system is in crisis.

Employees' retirement readiness is as important to employers now as it was before the DC transition began — and the results of the Institutional Investor

[1] Diane Oakley and Kelly Kenneally, "Retirement Security 2015: Roadmap for Policy Makers," National Institute on Retirement Security, March 2015.

study highlight strong concerns about the impact of low saving. More than half of plan sponsors are very concerned about the impact of low saving for retirement, employees underestimating the impact of health care costs in retirement and employees not starting to save early enough. Almost half of plan sponsors reported that participants fail to make the maximum contribution and more than one-third said most of their employees are not participating in the plan at all.

There are clear signs that DC plans are not as healthy as they could be and that many plans sponsors may not be making the most of the tools available to address these problems. While 61 percent regard their plan's overall health as excellent or near-excellent, consultants and advisers are far less optimistic: 55 percent answered unfavorably as to their clients' overall plan health. This extends to the way plan sponsors manage investment selection. While more than half rate their investment options excellent or near-excellent, almost half of consultants and advisers say their clients are challenged in this respect.

500+ plan sponsors

300 consultants and advisers

ELEMENTS OF A HOLISTIC DC PLAN

Crafting a retirement benefits structure that reduces risk, satisfies regulators and lawmakers and helps employees provide for a secure retirement means adopting a more holistic approach to building and maintaining DC plans: one that commands greater attention at the management level, emphasizes due diligence, includes a greater financial commitment by the employer and focuses more intently on motivating employees to save. The study identified ten key elements of an effective DC plan, starting with financial and organizational commitment and the quality and cost-effectiveness of investment options, effectiveness of the advice and education they extend to plan participants and ability to benchmark the quality of the plan as a whole. While relatively few employers have put all of them in place, the study and one-on-one interviews revealed strong agreement that these features are necessary for plans to perform well and best serve participants:

A SERIOUS FINANCIAL COMMITMENT. Plans that offer a relatively generous, well-tailored company match tend to be better designed and run than those with less commitment to funding.

CROSS-DEPARTMENTAL COOPERATION. As plans accumulate more assets, running the plan entirely through the benefits or total rewards function becomes more difficult. At many companies, these departments work closely with finance or treasury to select and regularly monitor investments.

LEVERAGING DATA ANALYTICS. Understanding employees makes it easier for plan sponsors to target communications at specific individuals or groups who may be at risk.

CUSTOMIZING INVESTMENT OPTIONS. In interviews, plan sponsors emphasized the advantages of creating a layered set of investment options that addresses the needs of employees at different levels of financial sophistication.

COST CONTAINMENT. More than three out of five plan sponsors emphasized the importance of keeping fees and other costs low.

AUTOMATIC ENROLLMENT AND OTHER INCENTIVES. More than nine out of ten plan sponsors either have automatic enrollment today or expect to in the next three years. Auto-escalation, too, is on the way to becoming a standard plan feature.

TARGET DATE FUNDS (TDFS). Eighty-six percent of plan sponsors surveyed said they either currently have TDFs in place or expect to offer them in the next year. TDFs meet a clear need: 44 percent of plan sponsors said their participants almost always fail to adjust their investment allocation to reflect their age or years to retirement.

ONLINE RETIREMENT PLANNING TOOLS. Online calculators allow employees to pick a retirement date and figure the level of assets they will need to replace a certain percentage of income. Over half of plan sponsors said these tools are very effective at helping mitigate risks to employees' retirement security.

ONE-ON-ONE ADVICE. While getting employees to take advantage of personal advice on asset allocation and financial planning is often difficult, 62 percent of plan sponsors and 81 percent of consultants and advisers believe it is one of the most effective tools for boosting savings and improving investment outcomes.

REGULAR BENCHMARKING OF PLAN FEATURES. Increasingly, plan sponsors regard the quality of their DC plan as a factor in their ability to compete for top talent. Consultants are helping them to better compare their plan to other employers' by industry, size or other characteristics.

PUTTING THE ELEMENTS IN PLACE

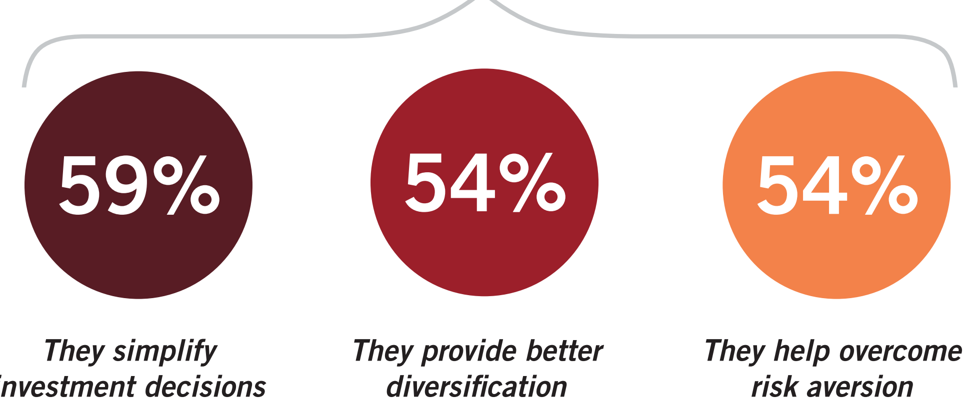
A well-designed DC plan combining these ten elements is not simple or inexpensive to create and maintain, and employers must balance the resources they commit to the plan against those allocated to other employee benefits. This is a challenge, particularly for smaller plans. The danger is that a two-tier system may develop in which larger companies succeed in creating robust, holistic DC plans while those at smaller, more capital-constrained companies lag.

Nevertheless, the study found that a wide range of companies are putting the elements of a more holistic plan design in place, suggesting the DC model is flexible enough to give a diverse population of employees the support they need to retire successfully. Consultants, recordkeepers and third-party providers are making the elements of a holistic plan easier and less expensive to adopt. Additionally, some consultants are urging plan sponsors to shift more DC plan decision-making to them — choosing, structuring and monitoring the plan's investment selection, in particular. That frees the plan sponsor to focus more on boosting plan participation and contribution levels.

There is no panacea for poor investment habits, however. At many companies automatic features may have already nudged the most likely candidates to join; what's left are the employees who plan sponsors, in interviews, say are the least easily persuaded — generally lower-wage workers with less financial literacy. Motivating them to participate, and then to improve their investment habits, may be one of the toughest hurdles plan sponsors face.

The TDF Effect

To what extent do you agree with the following statement about target date funds?



TDFs will play an important role in overcoming this challenge. Most plan sponsors strongly agree that TDFs simplify investment decisions for less sophisticated employees, provide better diversification than employees would develop on their own and help employees overcome risk aversion. Another indication of the importance attached to TDFs is the frequency with which plan sponsors reevaluate their offerings: nine out of ten that offer TDFs told us they are likely or very likely to reevaluate them in the next few years.

Plan sponsors' efforts to reach DC plan holdouts and improve asset allocation also encompass education and communication. Using the data they have assembled on employees and the greater data analytic capability of their recordkeepers, plan sponsors are learning to tailor their approach to specific workforce audiences and subgroups, hoping a targeted approach will be more effective than blanket e-mails and home mailings. But communicating effectively on an individual level — to build financial literacy, familiarity and willingness to plan for the decades after retirement—requires knowing the employee better. This in turn means working more closely with consultants, recordkeepers and perhaps the functional areas of the business itself.

AUTOMATIC FEATURES AND BEYOND

Features like auto-enrollment, auto-escalation, TDFs and more generous matching contributions have helped greatly to improve plan wellness. More than two-thirds of plan sponsors that offer auto-enrollment rate the overall health of their plan as high, compared with only slightly more than one-third of plans that do not include it. Yet even employers that have improved participation and are watching employees escalate their contributions year after year may not see them accumulate enough to retire comfortably, either because escalation is still not as steep as needed, the employer match is too small, certain demographics are harder to reach or some combination of these.
Overcoming these hurdles will require more sophisticated approaches to education and communication than most plan sponsors have used thus far — some of which may not yet exist. This study indicates that plan sponsors and consultants are applying more creativity to the challenge; the next few years will show whether it bears fruit.

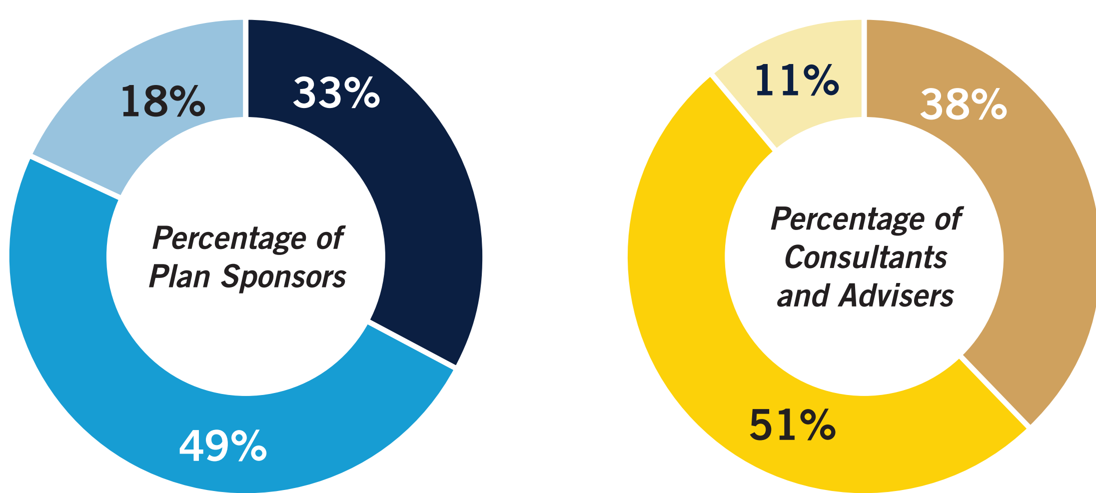
Nine out of ten plan sponsors that offer TDFs are likely or very likely to reevaluate them in the next few years.

1. PENSIONS IN TRANSITION

The anxieties that Americans express about the future of retirement are echoed, at least partially, in our survey findings. Plan sponsors are concerned about the stability of the U.S. retirement system. Although nearly half said the system is evolving and will likely adjust to the changing needs of employers and employees, one-third believe the system is in crisis and in grave danger of failing (*see Figure 1*). Consultants and advisers who work with DC plan sponsors are more pessimistic, 38 percent agreeing the system is in crisis.

One in three plan sponsors believes the U.S. retirement system is in crisis and in grave danger of failing.

Figure 1: TRANSITION OR CRISIS?



The U.S. retirement system is...

- *...in a crisis and in grave danger of failing.*
- *...evolving and will likely adjust to changing needs.*
- *...healthy and continues to provide a good platform for employees to retire successfully.*

What lies behind these concerns? The transition to a retirement model centered on DC plans was supposed to simplify the benefits structure, reduce expenses and shift the responsibility for employees' retirement readiness away from employers — and in the strictest sense, this is what it has done. Yet, a substantial body of workers are nearing retirement age without adequate retirement provision.

Regulatory change and demographic shifts will have the greatest impact on DC plans in the next three years.

The DC plan landscape is vastly different today as well. DC plans were once simple structures: a set of investment options into which employees could allocate some of their pay, tax-deferred, if they chose to do so. Now, more workers than ever depend on them as their main source of retirement income. The sheer volume of assets in DC plans is so great — 401(k)s, 403(b)s and other variations hold nearly $25 trillion in assets, according to 2015 data from the Investment Company Institute — that many have multiple billions invested on employees' behalf. The result is greater scrutiny from government, which means more rules for plan sponsors to follow as fiduciaries if they do not want to risk regulatory or legal action.

Failure to save and save enough is not just the employee's problem; it typically means higher costs for employers. New research estimates that a one-year delay in retirement may result in incremental workforce costs of 1 percent to 1.5 percent annually.[2] This complicates succession planning, disrupting the employer's efforts to shift younger workers with, perhaps, different skillsets into existing positions. Further complicating the task, DC plans serve a much more diverse population than they did when they were first launched: Boomers, Gen Xers and Millennials have different profiles, needs and behaviors; educating and communicating with them is no longer a one-size-fits-all affair. Together, these shifts have made running DC plans a more difficult, and weightier, responsibility for employers.

"The U.S. retirement model is on a challenging new road that we'll all have to adapt to," says Ryan Gardner, principal and senior consultant at Fiduciary Investment Advisors. Plan sponsors feel buffeted by forces they often have no control over. One in three place changing demographics and a changing regulatory environment among the top three trends they expect to impact their plans in the next three years (***see Figure 2***). Consultants and advisers, with a wider-angle view of the aging workforce, were even more concerned about changing demographics, 53 percent placing it among the highest-impact factors. Not surprisingly, the largest plans feel the most weight of scrutiny from regulators: over half of plans with more than $1 billion in assets name changing regulations as a trend affecting them strongly; others, much less so.

[2] Prudential, with supporting research and analysis conducted by the University of Connecticut's Janet and Mark L. Goldenson Center for Actuarial Research, 2015-16.

Many plan sponsors may not be using all the tools at their disposal to address these challenges, however. “The system today can do an extraordinarily good job for many Americans — if they understand it well. But it’s not being utilized well enough by participants, and plan sponsors are not taking advantage of the tools the Pension Protection Act gave them: not enrolling robustly enough, not escalating to higher levels,” says Lori Lucas, defined contribution practice leader at Callan Associates.

Figure 2: TROUBLES AHEAD

	What trends do you expect will have the greatest impact on your DC plan in the next three years?	*What trends do you expect will have the greatest impact on your DC plan sponsor clients in the next three years?*
Changing regulatory environment	33%	53%
Changing demographics	33%	31%
Employees’ lack of financial knowledge and understanding	28%	29%
Shift from defined benefit to defined contribution plans	26%	29%
Low-interest-rate environment	25%	22%
Volatility of financial markets	20%	15%
Low contribution rates	16%	11%

Plan sponsors (blue)
Consultants and advisers (yellow)

2. PARTICIPANTS: FAILURE TO ACT

Plan sponsors' concerns begin with employees' all too frequent failure to save and save enough. "The biggest problem with the system is still getting people to save — not spend," says Robyn Credico, defined contribution consulting leader at Willis Towers Watson North America. Many if not most private-sector employees

Failure to save, and save enough, is undermining employees' retirement security.

Figure 3: THREATS TO RETIREMENT SECURITY

	What factors will have the greatest impact on your employees' financial health and security?	*What factors will have the greatest impact on employees of your DC plan sponsor clients?*
Employees not starting to save early enough	59%	59%
Employees not saving enough	57%	80%
Employees underestimating the impact of health care costs	56%	60%
Lengthier retirement due to longer life spans	54%	56%
Regulatory changes that could alter Social Security, Medicare and other programs	53%	62%
Employees underestimating the impact of inflation	50%	62%
Employees investing too conservatively or too aggressively for life stage	46%	65%

Percentage of plan sponsors choosing very high or high impact (blue)

Percentage of consultants and advisers choosing very high or high impact (yellow)

are not highly literate financially and are unaccustomed to making the saving and asset allocation decisions critical to a secure retirement. Many still are reluctant to sacrifice current needs to generate income decades in the future.

More than half of plan sponsors are very concerned (*see Figure 3*) about employees not starting to save early enough (59 percent), the impact of low retirement saving rates (57 percent) and employees underestimating the impact of health care costs in retirement (56 percent). “I wish I could convince our relatively young workforce

Almost half of employers say their employees are not consistently making the maximum contribution and are failing to take opportunities to raise their financial literacy.

Figure 4: LACK OF COMMITMENT TO THE PLAN

	How prevalent are the following behaviors among your employees?	*Are the following behaviors a problem among your DC plan sponsor clients' employees?*
Failure to take opportunities the plan offers to educate themselves or obtain personal financial advice	47%	65%
Failure to consistently make the maximum plan contribution	47%	65%
Failure to adjust investment allocation/ style to reflect age/years to retirement	44%	63%
Younger employees investing too conservatively	41%	55%
Not contributing enough to get full company match	40%	70%
Early withdrawal or borrowing against defined contribution plan assets	40%	68%
Overexposure to risky assets at or near retirement	39%	51%
Not participating in the company’s defined contribution plan	38%	57%

Percentage of plan sponsors choosing "always" or "almost always" (blue)

Percentage of consultants and advisers choosing "acute problem" or "problem" (yellow)

of the importance of saving and planning for the future," the CEO of a media/ technology company told us. Plan sponsors ranked these problems as more likely to have a high impact on their employees' retirement security than lengthening years in retirement (54 percent) or changes to Social Security and Medicare (53 percent). Almost half (46 percent) said their employees are saving either too conservatively or too aggressively for their stage in life.

Employee lack of commitment to the plan is widespread (***see Figure 4, page 13***). More than one-third of plan sponsors said most of their employees are not participating in the plan at all. Nor are employees acquiring the knowledge and help they need to invest successfully for retirement. Almost half (47 percent) said their employees nearly always fail to take opportunities the plan offers to educate themselves or obtain personal financial advice. And (47 percent) of plan sponsors reported that employees fail to make the maximum contribution while 40 percent said employees "always" or "almost always" do not contribute enough to get the full company match. This is especially troubling because, in one-on-one interviews, both plan sponsors and consultants repeatedly emphasized the importance of a healthy match. Yet if they cannot persuade participants through communication and education to max out the match, much of this effort goes for naught.

61 percent of plan sponsors say their DC plan's overall health is excellent. But 55 percent of consultants and advisers say their clients are frequently encountering problems.

Many consultants see a crisis looming as participants reach retirement without sufficient assets to live comfortably — perhaps forcing them to delay exiting the workforce. Almost two thirds said that plan participants' failure to adjust their investment allocation and style to reflect their proximity to retirement age was a serious problem. And more than two thirds said it is a serious problem that participants are taking early withdrawals or borrowing against plan assets — potentially forcing them to remain on the job longer.

Are employers crafting DC plans that address these challenges? Are they doing all they can to help employees save and get the most out of their benefit? On these points, our study revealed a dramatic difference of opinion between plan sponsors and consultants and advisers (***see Figure 5***).

Figure 5: ROOM FOR IMPROVEMENT

	How do you rate your DC plan in each of the following areas?	*How frequently do your clients encounter problems in each of the following areas?*
Overall plan health	61%	55%
Quality of investments offered	58%	49%
Company match	58%	52%
Competitiveness of fee structure	56%	50%
Range of asset classes/ categories offered	55%	59%
Financial education programs	55%	57%
Expense ratio of available fund choices	54%	55%

Percentage of plan sponsors choosing "excellent" or "near-excellent" (blue)
Percentage of consultants and advisers choosing "very frequently" or "frequently" (yellow)

Most plan sponsors (61 percent) regard their DC plan's overall health as excellent or near-excellent. Many see room for improvement in categories including quality of investments offered, expense ratio of investment choices and financial education, but the overall picture is nevertheless positive. Consultants and advisers are far less optimistic. More than half (55 percent) answered unfavorably as to their clients' overall plan health and most said their clients frequently encounter problems in almost every area of the plan.

Plan sponsors may not be doing as good a job as they think helping employees retire successfully, either (*see Figure 6*). More than half (55 percent) said they are effective or very effective, but 71 percent of consultants and advisers said their clients have a great or very great need of assistance. At least half of plan sponsors give

55 percent of plan sponsors say they are very effective at helping employees achieve a successful retirement. But 71 percent of consultants and advisers say their clients often need advice and assistance.

Figure 6: HELP NEEDED

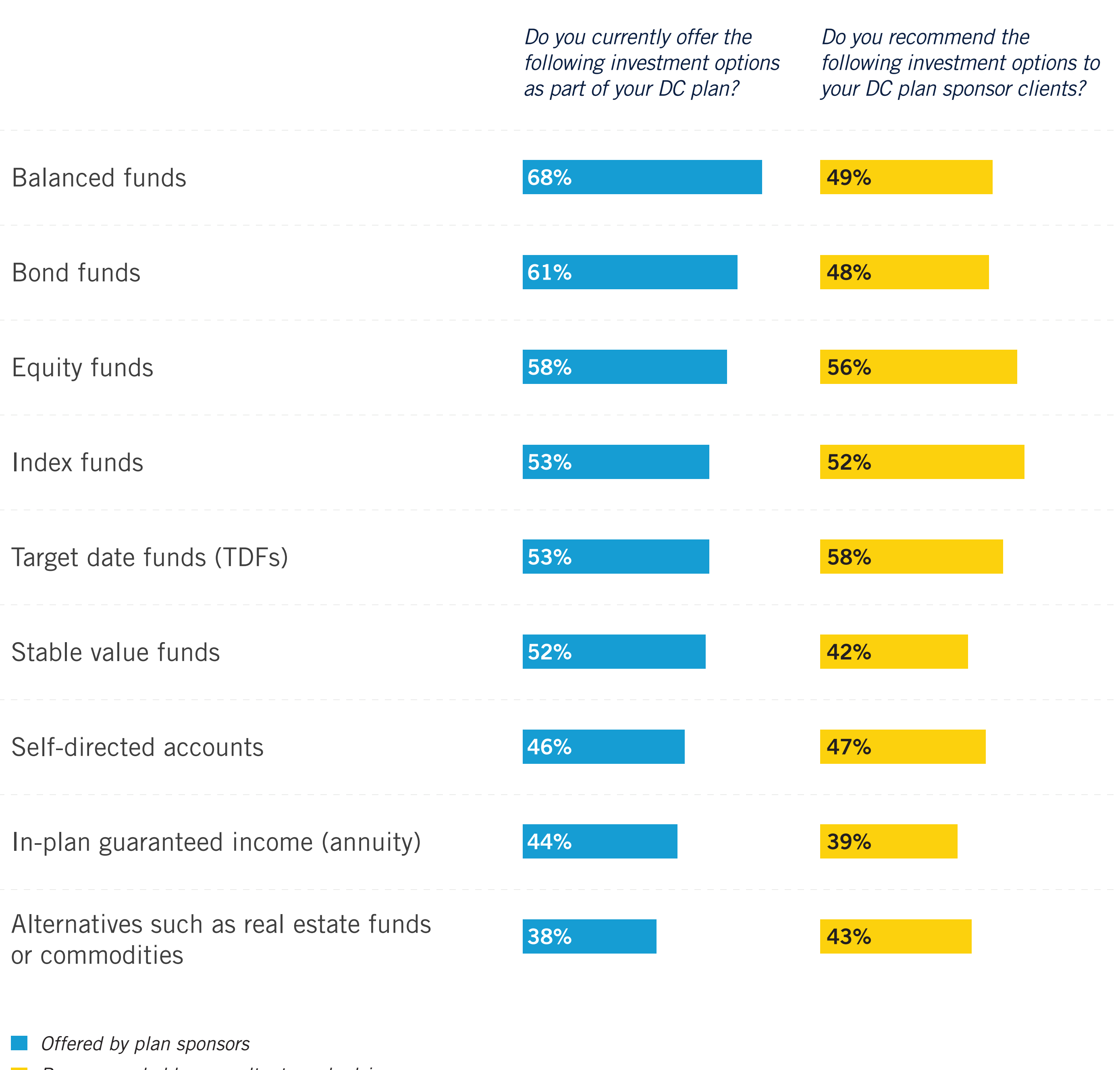
	How effective is your DC plan at helping employees do the following?	*How much assistance do your DC plan sponsor clients generally need in aiding their employees to do the following?*
Understand how much they need to save to have a financially secure retirement	59%	68%
Start the process of saving/ investing for their retirement	57%	62%
Monitor and understand their progress toward their retirement savings goals	56%	60%
Sustain an adequate income source once they retire	56%	60%
Achieve a successful retirement	55%	71%
Choose the right investments to achieve their retirement savings goals	53%	68%
Protect themselves from financial markets volatility	50%	66%

Percentage of plan sponsors choosing "very effective" or "effective"

Percentage of consultants and advisers choosing "very great" or "great need of assistance"

themselves high marks in such areas as helping employees start the process of saving, understand how much they need to save to retire securely and choose the right investments to meet their retirement goals. By contrast, well over half of consultants and advisers said their clients frequently encounter problems in each of these areas.

Figure 7: EVOLVING THE ASSET MIX



These strikingly different views may reflect, in part, employers' tight focus on their own plans and consultants' exposure to client companies with DC plans of varying quality and size — many of them below the $50 million-in-assets cutoff for inclusion in the study. Nevertheless, it casts doubt on the effectiveness of many DC plans.

Consultants want to see plan sponsors offering more target date funds, but are less enthusiastic about balanced funds.

This extends to the way they manage investment selection. While 58 percent rate their investment options excellent or near-excellent, 49 percent of consultants and advisers said their clients are challenged in this respect. While 55 percent of plan sponsors give themselves high marks for the range of asset classes they offer, 50 percent of consultants say their clients often encounter problems in this area. And plan sponsors reported they are much more likely to offer some DC investment categories that consultants are less enthusiastic about (***see Figure 7, page 17***): 61 percent offer bond funds to participants, while only 48 percent of consultants currently recommend them; 44 percent offer in-plan guaranteed income funds (annuities), while only 39 percent of consultants recommend them; and 68 percent offer balanced funds, compared with 49 percent of consultants recommending them. By contrast, 58 percent of consultants and advisers recommend target-date funds, compared with only 53 percent of plan sponsors that offer them.

"Plan sponsors are at a crossroads now," says Lucas. "It's hard to find the resources within the organization sometimes, and even those with resources are looking at increasing fiduciary requirements and the threat of litigation. That's an environment which makes them very cautious in their approach." Nevertheless, many experts say the burden of getting employees to save more will continue to fall on the employer. Many plan sponsors, accordingly, are turning to automatic features, better targeted communications and other plan tools to encourage greater participation and more effective asset allocation by participants. We explore these elements, and how plan sponsors are using them to create a better structured DC plan, in the following section.

3. PLAN DESIGN: TOWARD A MORE HOLISTIC DC PLAN

Crafting a retirement benefits offering that reduces risk, satisfies regulators and lawmakers and helps employees provide for a secure retirement means adopting a holistic plan design: one that commands greater attention at the management level, that emphasizes due diligence, that includes a greater financial commitment from the employer and that focuses more intently on motivating employees to save. The objective of a holistic DC plan is to do what's right for the employee while balancing cost and value. To achieve this requires, perhaps ironically, an infrastructure not unlike the one that traditionally directed defined benefit plans — and still does at some of the largest companies.

That includes having a well-defined institutional structure and processes that include regular review of plan features and investment options and a budget to support it. In our survey and one-on-one interviews, we identified ten key elements of a more holistic DC plan model, starting with financial and organizational commitment and the quality and cost-effectiveness of investment options and extending to the effectiveness of the advice and education the plan sponsor offers to participants and its ability to benchmark the quality of the plan as a whole. While relatively few employers have put all of them in place, the study revealed strong agreement that plans need these features to perform well and best serve participants.

A SERIOUS FINANCIAL COMMITMENT. The most important characteristic of a well-designed plan "is the commitment of the employer to fund the plan," says Paul Denu, defined contribution practice leader at USI Consulting Group. Those with a "significant" match "are much better designed and run in all aspects than those that are not committed to funding."

CROSS-DEPARTMENTAL COOPERATION. Like traditional pensions, DC plans have two facets: benefits and investments. As they accumulate more assets, running the plan entirely through the benefits or total rewards functions becomes more difficult. At many companies, these departments work together with finance or treasury to select and regularly monitor investments and make sure the investment selection is relevant and meets plan expectations. "At the institutional end of the spectrum, which is where I hope to see more and more plans, they're using collective trusts and making the plan more flexible, with access to a broader array of managers," says Lucas.

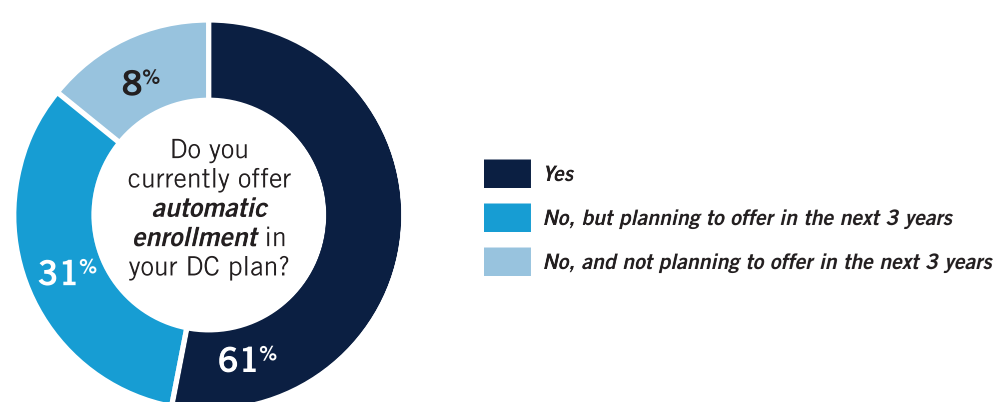
LEVERAGING DATA ANALYTICS. "One thing vendors and recordkeepers have become much better at is, through data mining, quantifying the extent to which participants are on pace to replace a certain percentage of income," says Gardner. This makes it easier for plan sponsors to more precisely target communications at

specific individuals and groups that may be at risk of retiring with insufficient savings. As a result, it "helps the employer to design a plan that's successful in attracting as many participants as it can possibly reach."

CUSTOMIZING INVESTMENT OPTIONS. Almost half of plan sponsors (47 percent) and more than half of consultants and advisers (55 percent) said that limiting investment options to avoid confusion and overlap is a very effective means of mitigating risk to plan participants. In interviews, plan sponsors also emphasized the advantages of creating a layered set of investment options that addresses the needs of employees at different levels of financial sophistication. "Our population is very diverse," says Greg Tahvonen, vice president of total rewards and global human resources at Delta Air Lines, which has $15 billion in 401(k) assets, "so we needed to create a plan that would meet the needs of the more passive person who doesn't want to make decisions, all the way up to people in investment clubs."

COST CONTAINMENT. "There's no one benchmark for plan performance, but reasonableness of fees is one important measure," says Credico. More than three out of five plan sponsors (61 percent) we surveyed emphasize the importance of keeping fees and other costs low. Ford Motor Co., which has $14 billion in its 401(k) plans covering 85,000 active participants, includes only one retail mutual fund in its lineup, and many of the others are constructed specifically for the automaker's 401(k). Pacific Life Insurance Co. switched all of its 401(k) investment options, including its suite of target date funds, into a trust share class to take advantage of lower fees. "The driving force is not to pick all the cheapest funds, but we look at the investment mix, and if a lower-cost share class is available, we'll switch to it," says Patrick Paynter, group retirement analyst.

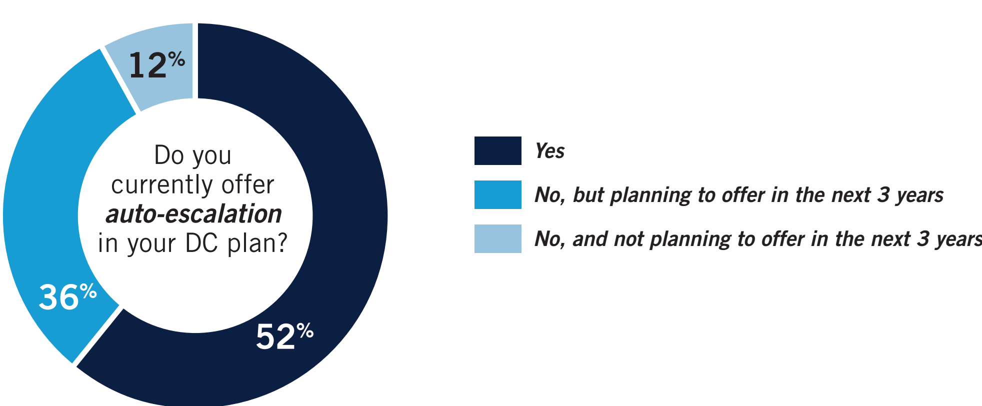
Figure 8.a MOVING TO AUTOMATIC ENROLLMENT



92 percent of plan sponsors expect to offer automatic enrollment in three years.

AUTOMATIC ENROLLMENT AND OTHER INCENTIVES. Automatic enrollment is one of the principal tools that plan sponsors look to for help in mitigating risks to employees' retirement security. More than nine of ten either currently offer auto-enrollment or expect to in the next three years. (*see Figure 8.a*).

Figure 8.b MOVING TO AUTO-ESCALATION



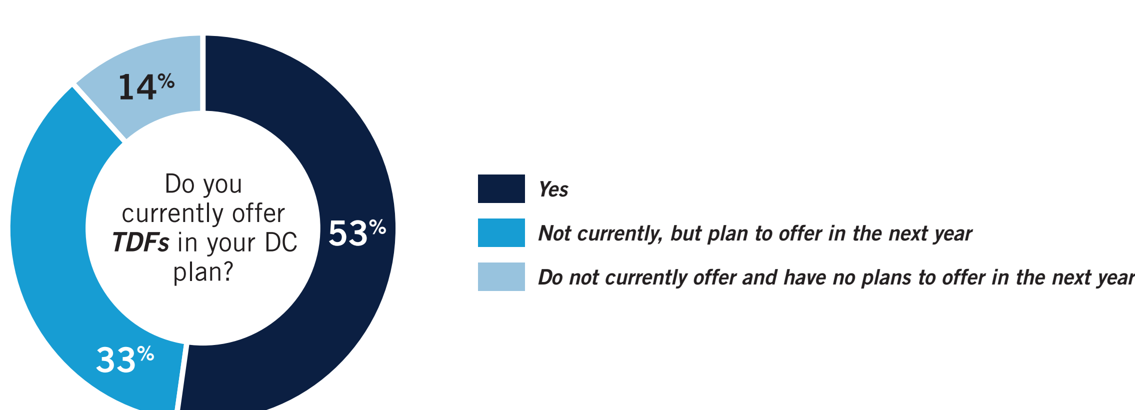
More than half (55 percent) of plan sponsors and 61 percent of consultants and advisers said it is very effective; indeed, 55 percent of participants, on average, accept the default investment option when their plan features auto-enrollment. Auto-escalation, too, is on the way to becoming a standard plan feature, as 88 percent of plan sponsors expect to offer it in the next three years (*see Figure 8.b*).

"A healthy plan has as many automatic features as you can," says Tom Foley, director of employee benefits at building materials manufacturer USG Corp., which has $900 million in 401(k) plan assets alongside a defined benefit plan that it converted into a cash-balance structure for new hires in 2011.

Rapid adoption of automatic features is taking place across plans of all sizes; even among those with less than $100 million in assets, only 10 percent do not expect to offer auto-enrollment in the next three years and only 11 percent do not expect to offer auto-escalation. Urging by consultants and advisers may have something to do with the rapid spread of these features: 43 percent said they recommend auto-escalation to clients more than 75 percent of the time, while another 47 percent said they do so 50 to 75 percent of the time.

TARGET DATE FUNDS (TDFS). TDFs are in place at more than half (53 percent) of plan sponsors we surveyed and another 33 percent said they expect to offer them in the next year, leaving only 14 percent with no intention to do so (*see Figure 8.c*). Plans of all sizes are adopting them: only 19 percent of those with assets less than $100 million do not expect to include TDFs, although this is considerably higher than for other groups. Well over half of consultants and advisers (58 percent) said they have recommended TDFs in the last year while 30 percent said they are likely to do so in the next year. "Almost all of our clients offer TDFs and are minimizing the number of investment options in the plan," says Credico.

Figure 8.c MOVING TO TARGET DATE FUNDS



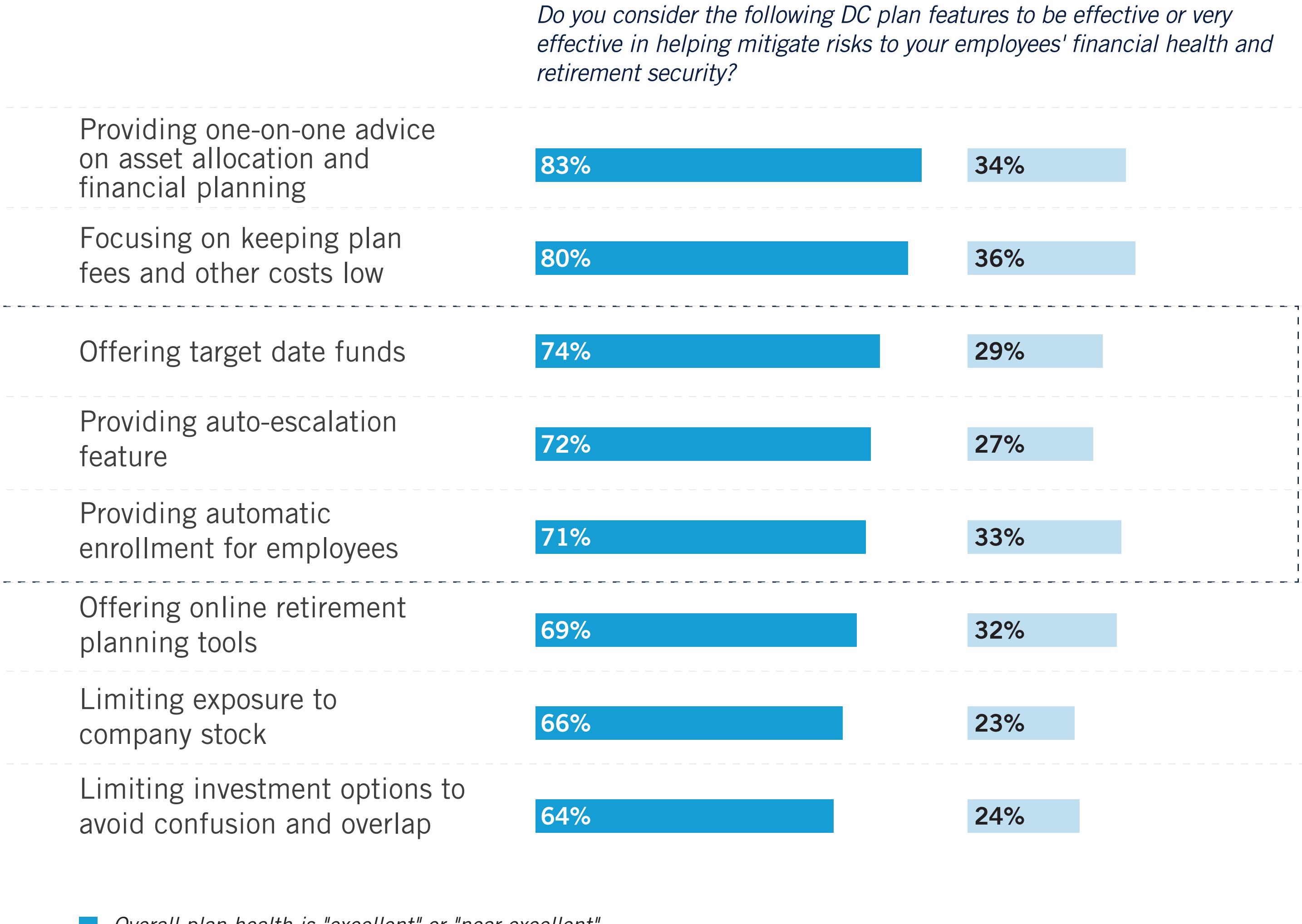
ONLINE RETIREMENT PLANNING TOOLS. Through their recordkeepers and third-party providers, plan sponsors are making online calculators available that allow employees to pick a retirement date and figure the level of assets they will need to replace, say, 80 percent of income. "Third-party tools are very new and utilization has not been high, but they do help people get a handle on how today's decisions affect tomorrow when you don't save enough," says Gardner. They can then determine how much money they need to save each month, through their DC plan or other sources, to reach that target. Over half (53 percent) of plan sponsors said retirement planning tools are very effective at helping mitigate risks to employees' retirement security.

ONE-ON-ONE ADVICE. While getting employees to take advantage of personal advice on asset allocation and financial planning is often difficult, 62 percent of plan sponsors and 81 percent of consultants believe it is one of the most effective tools for boosting savings and improving investment outcomes. Some are going further, making direct financial management available to participants through third-party providers.

REGULAR BENCHMARKING OF PLAN FEATURES. Increasingly, plan sponsors regard the quality of their DC plan as a factor in their ability to compete for top talent. Consultants are helping them to compare their plan to companies in their industry or others of comparable size. For example, every quarter, BMC Software, a tech firm with $700 million in 401(k) assets, compares average and median account balances for its plan participants against plans of the same size and plans in the same industry.

Plan sponsors that give their DC plan high marks also give the highest endorsement to features like auto-enrollment, TDFs and one-on-one advice.

Figure 9: THE ELEMENTS OF A HOLISTIC DC PLAN



An employer that wants to design a DC plan that combines all ten of these elements still must balance the resources it commits against those allocated to other employee benefits. Nor do all plan sponsors see these features as equally effective. In fact, the study found that they define a gap between plan sponsors who rate their DC plan above average for overall health and those who rate it below average. Overwhelmingly, the former regard features like one-on-one advice, online retirement planning tools, auto-enrollment and escalation, low fees and TDFs as being highly effective — while the latter see them as only moderately effective (***see Figure 9, page 23***).

Larger plan sponsors give themselves higher marks than smaller plan sponsors for plan health — and for helping participants achieve a secure retirement.

One reason may be that structuring a holistic plan is not easy or inexpensive. Over half of consultants and advisers say their clients encounter problems offering a robust company match, for example. While plan sponsors generally agree that one-on-one advice is very effective at helping employees save for retirement, often the expense holds them back. "Ninety-five percent of my clients would love to have a financial wellness solution that includes one-on-one advice," says Flodin. "But it's costly."

Elements of corporate culture can hinder the employer from offering features like auto-enrollment (***see* Barriers to Implementing Best Practices, page 27**). And while DC plans are widely extolled as recruiting and retention tools, they are often managed day-to-day by as few as one or two persons, except at the largest companies.

"Plan sponsors increasingly are resource-constrained. They have less time to do more work," says Mark Teborek, senior consulting analyst at Russell Investments. Larger companies that still sponsor defined benefit plans in some cases enjoy an advantage because they have expertise in-house to monitor and evaluate investments and can negotiate lower fees by building some of their DC offerings off the underlying funds in their pension portfolio.

The danger is that a two-tier system may develop in which larger companies succeed in creating robust DC plans that serve their participants well while smaller plans at smaller, more capital-constrained companies lag. This comes through clearly in plan sponsors' self-assessments (***see Figure 10***): Less than half (49 percent) of those with $50 million to $100 million in assets rate their overall plan health excellent or near-excellent, compared with 65 percent of those with more than $100 million. The gap was even larger when they were asked how effective they are at helping employees choose the right investments to achieve

Figure 10: ARE LARGER DC PLANS BETTER AT ACHIEVING THEIR GOALS THAN SMALLER ONES?

How effective is your DC plan at helping employees achieve the following goals?

Goal	More than $100M in AUM	Less than $100M in AUM
Achieve overall plan health	65%	49%
Understand how much they need to save to have a financially secure retirement	62%	50%
Start the process of saving/investing for their retirement	59%	49%
Sustain an adequate income source once they retire	58%	50%
Monitor and understand their progress toward their retirement savings goals	58%	48%
Achieve a successful retirement	57%	47%
Choose the right investments to achieve their retirement savings goals	57%	40%
Protect themselves from financial markets volatility	51%	44%

More than $100M in AUM
Less than $100M in AUM

a successful retirement (57 percent versus 40 percent). This reflects factors that may be endemic to companies of differing size and scale of resources. A majority (59 percent) of larger plans said they were able to obtain a highly competitive fee structure, compared with 45 percent of the smallest, for example.

Happily, consultants, recordkeepers and third-party providers are making some of the elements of a robust plan easier and less expensive to adopt. "The mindset in the investment industry is changing to focus on retirement readiness as a goal," says Teborek. Automatic features, TDFs and online calculators are becoming standard recordkeeper offerings, with the result that assembling the elements of a holistic framework is becoming less difficult and costly even for smaller employers. Our survey found that 53 percent of plans with $50 million to $100 million in assets now offer auto-enrollment, although adoption by plans with more than $100 million is considerably higher at 64 percent.

A well-designed, holistic DC plan is not simple or inexpensive to create and maintain.

And while larger plans are more likely than smaller ones to offer auto-escalation today (54 percent versus 49 percent), within three years smaller plans expect to draw almost even (88 percent versus 89 percent of larger plans).

Additionally, some consultants are urging plan sponsors to shift more DC plan decision-making to them — choosing, structuring and monitoring the plan's investment selection, in particular. "Our role should be to help you design the plan, make sure expenses are not out of control and make sure the asset quality is the best possible," says Denu. Especially at smaller companies, that frees the plan sponsor to focus more on boosting plan participation and contribution levels: the crucial factors in providing for a secure retirement and those the employer is best placed to influence.

BARRIERS TO IMPLEMENTING BEST PRACTICES

No two plan participants are alike, plan sponsors and consultants stress repeatedly. The same goes for plan sponsors themselves, who often combine best practices with others that need improvement under the same roof.

Long-standing structural factors, like labor agreements and the presence of a legacy defined benefit plan, can act as a constraint. At Ford Motor Co., there are 401(k) plans for salaried and hourly employees; while the participation rate is high for the salaried workers, it is only about 50 percent for hourly, says Mark Kopp, associate director of U.S. defined contribution plans, in part because many of these employees participate in a residual defined benefit plan and continue to see the 401(k) as a supplement. Only last year did contract negotiations with the United Auto Workers include adding automatic enrollment to the 401(k) for new hourly employees.

History can be a factor: many DC plans have a checkered past marked by repeated corporate mergers and breakups, leaving them with investment options and other features that no longer cohere. Corporate culture sometimes stands in the way as well. Jennifer Flodin, defined contribution practice leader at Pavilion Advisory Group notes that the investment committees at some companies still resist automatic enrollment or making a target date fund the default option, because it seems "too Big Brotherish."

Delta Air Lines, whose $15 billion in 401(k) plan assets are in part the product of a 2008 merger with Northwest Airlines, recently instituted automatic enrollment for new salaried hires, but not for long-term employees. The latter already have a good savings rate and also participate in the company's frozen defined benefit plan, says Greg Tahvonen, vice president of total rewards.

At Ford, the hourly 401(k) plan also allows workers to take out four loans at a time, and it is "used heavily," Kopp says — a feature the union has been reluctant to change. By contrast, at Pacific Life Insurance Co., only one loan is allowed at a time and participants receive occasional communications showing them how overuse of loans could affect their retirement. Flodin recommends not only limiting loans to one at a time, but also barring participants from taking a loan against any employer's matching contribution.

Eliminating company stock from the plan is not so simple, either. Objections often come from older participants, who are faced with the end of a tax benefit they have enjoyed for years. And while some fear that brokerage windows can encourage overly aggressive trading and erode diversification, eliminating them may alienate participants who want a broader assortment of options. "We support brokerage windows because, one, there's fairly low utilization, and two, it gives the squeaky wheels, who want a range of investment options, somewhere to go," says Robyn Credico, defined contribution consulting leader at Willis Towers Watson North America.

While some less-than-optimal features may be difficult to eliminate, others may fade with time — once remaining defined benefit plan participants retire, for example. In other cases, jawboning eventually does the trick. To counter internal resistance to auto-enrollment, Flodin says, FIA consultants work hard to point to research studies that indicate auto features are effective in getting participants to a more secure retirement.

4. TARGET DATE FUNDS: THE DEFAULT OPTION

Like auto-enrollment, TDFs are quickly becoming a central element of DC plan structure. “TDFs are a must,” says Flodin. “Most of America doesn't understand investing and are overwhelmed with constructing their own portfolios. With the TDF, the money goes in and it’s done for them.”

They meet a clear need: 44 percent of plan sponsors said their participants almost always fail to adjust their investment allocation to reflect their age or years to retirement. But consultants and advisers reported that 35 percent of clients’ plan assets are invested in TDFs, and our plan sponsor respondents who offer them reported an even higher figure: 49 percent on average. These figures don’t vary much by size of plan: 51 percent of employees in the largest plans, on average, have assets in their plan’s TDF, compared with 47 percent at plans with less than $100 million in assets. The smallest plans actually reported a somewhat higher percentage of total DC plan assets invested in their TDF: 43 percent, on average, versus 38 percent at those with over $1 billion in assets.

Auto-enrollment has been an important factor in this trend since TDFs were designated a qualified default investment alternative (QDIA) under the Pension Protection Act (PPA) of 2006. In the decade since then, total TDF assets have increased from $116 billion in $763 billion, according to Morningstar. On average, our survey found, 52 percent of participants in plans that have auto-enrollment have assets in the plan’s TDF, compared with 41 percent of those in plans that do not auto-enroll and do not intend to do so. Offering a TDF, usually as the default option in an auto-enrollment feature, is establishing itself as best practice: plan sponsors who offer TDFs and who regard their plan as very effective at helping employees prepare for retirement reported an average 55 percent of employees have assets in their TDF, compared with 42 percent at other plans; likewise, an average 53 percent of assets in these “highly effective” plans are invested in TDFs, compared with 36 percent at others. Just how important a role plan sponsors expect TDFs to play came through when they were asked in what ways TDFs are helpful to employees (***see Figure 11***). Most agreed strongly that they:

- Simplify investment decisions for less sophisticated employees (59 percent).
- Provide better diversification than employees would develop on their own (54 percent).
- Help employees overcome risk aversion (54 percent).
- Help employees to automatically de-risk as they approach retirement (53 percent).
- Limit the temptation to time the market (52 percent).

Only 2 to 3 percent of respondents disagreed strongly with any of these statements. Our findings hint that consultants and advisers have played a role in promoting the use of TDFs as well: they agreed by even larger percentages on every point.

59 percent of plan sponsors agree or strongly agree that target date funds help simplify investment decisions for less sophisticated employees.

Figure 11: THE TDF ADVANTAGE

To what extent do you agree with the following statements about target date funds?

Statement	Percentage of plan sponsors who agree or strongly agree	Percentage of consultants and advisers who agree or strongly agree
They simplify investment decisions for less sophisticated plan participants	59%	79%
They have fees comparable to those charged by other types of funds	55%	69%
They provide better diversification than many employees would develop on their own	54%	71%
They offer financial peace of mind to plan participants	54%	70%
They help employees overcome risk aversion	54%	69%
They help employees to automatically de-risk as they approach retirement	53%	72%
They limit the temptation to time the market	52%	74%

Percentage of plan sponsors who agree or strongly agree

Percentage of consultants and advisers who agree or strongly agree

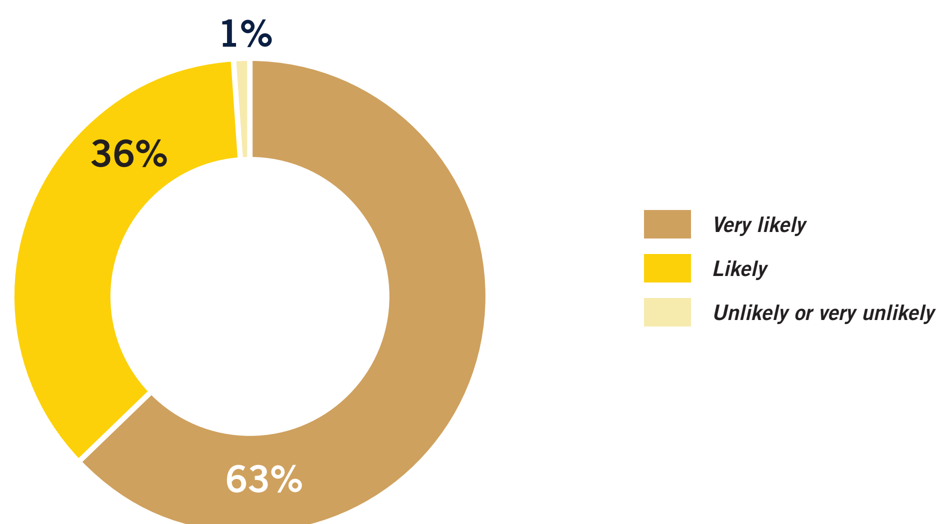
Another indication of the centrality of TDFs is the frequency with which plan sponsors reevaluate their fund offerings (*see Figure 12*): nine out of ten plan sponsors that offer TDFs told us they are likely or very likely to reevaluate theirs in the next few years — roughly in line with the view of their consultants, 99 percent of whom said they are likely or very likely to recommend their clients reevaluate. In part, this is because TDFs themselves are not simple mechanisms. "It's a natural thing to conduct due diligence in any investment group, but with the structure of TDFs, it requires extra attention, because plan sponsors want to make their default option as robust as possible," says Teborek. "TDFs should be frequently reevaluated."

Plan sponsors can be expected to increase not only the frequency but the intensity of their TDF monitoring in coming years, consultants say. More of them are building expertise and understanding of the elements of TDFs: "Glidepath tends to be right at the top of the list," says Gardner. The Department of Labor's "Tips for ERISA Plan Fiduciaries" on TDFs, published in 2013, has also helped, says Lucas: "They're saying the tools are out there so there's no excuse for not knowing what's in your TDF."

Consultants overwhelmingly recommend that plan sponsors reevaluate their target date funds provider in the next few years.

Figure 12: REEVALUATING TDFS

How likely are you to recommend that your client companies reevaluate their TDF offering in the next few years?



5. APPROACHING FINANCIAL WELLNESS

"Plan sponsors have done a good job of taking a complex field and making it simple," says Robert Hunkeler, vice president of investment at International Paper, which sponsors $5 billion in DC plans. Neither TDFs nor tiered investment selection nor any automatic DC plan feature is a panacea for poor investment habits, however, or a guarantee that they will achieve financial wellness. At many companies automatic features may have already nudged the most likely candidates to join; what's left are the employees who plan sponsors, in interviews, say are the least easily persuaded — generally lower-wage workers with less financial literacy.

Likewise, just because an employer adopts automatic features for its DC plan does not mean that employees' retirement investment habits will improve — or, in the case of TDFs, that plan participants will use them as intended. The study found that plan sponsors that offer TDFs are just as likely if not more so than others to report participants failing to make the maximum plan contribution, not contributing enough to get the full company match, taking on too much or to little risk or not participating in the plan at all (***see Figure 13, page 31***). A recent survey[2] found that roughly two thirds of plan participants who use TDFs keep less than 90 percent of their investments in them while another 15 percent have scaled back their allocation — even though 81 percent of these "decreasers" said they understood that TDFs are designed to provide diversification.

Motivating the least persuadable employees to participate, and then to improve their investment habits, may be the toughest challenges plan sponsors face. "Rent, mortgage, children, college, college loans, care-giving — all compete for workers' money," says Denu. "And there's no education in high school or college on personal finance."

Much of plan sponsors' efforts to reach DC plan holdouts and improve asset allocation for those already in the plan focus on education and communication. Using the data they have assembled on employees and the greater data analytic capability of their recordkeepers, plan sponsors are learning to tailor their approach to specific audiences and subgroups within their workforce, hoping a targeted approach will be more effective than blanket e-mails and home mailings.

Concerned that its younger employees are not starting to save early enough, Pacific Life Insurance is designing targeted communications for them. "Millennials are different from Gen X or Y or Boomers," says Paynter. "If you send them something in the mail, they won't read it." There are different schools of thought on these matters, however. At USG, many hourly workers do not have e-mail or seldom use it, Foley says, and so regular mail is the best option. Some companies even have good success sending snail-mail communications to their younger DC plan participants, Gardner says, "because they're not used to it. So they're less likely to treat it as junk mail."

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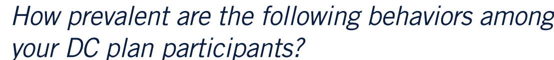
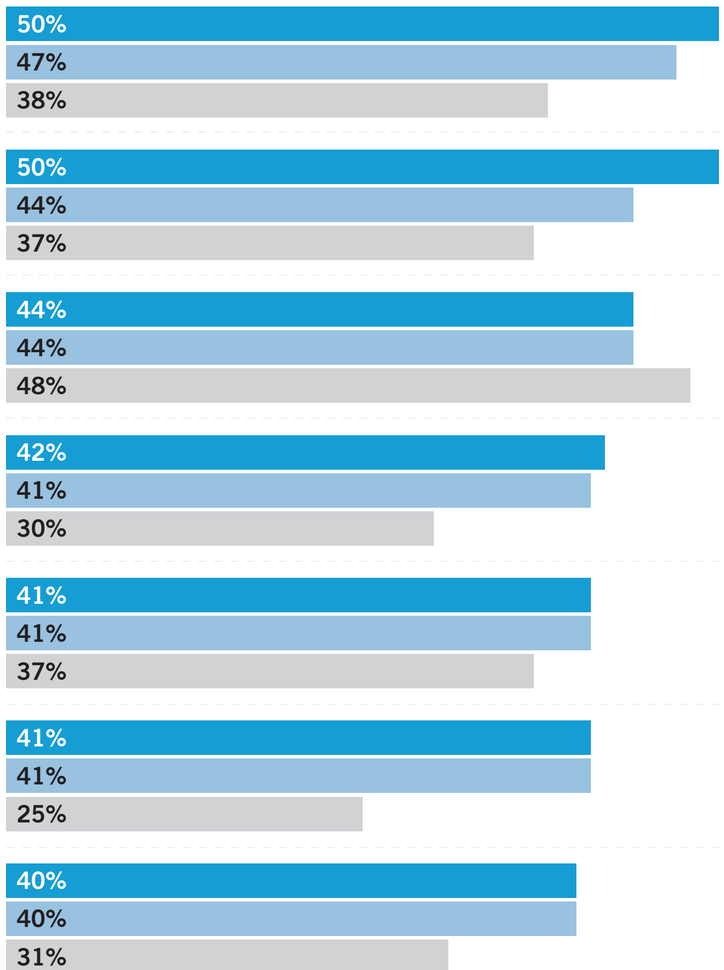
[2] "Not So Simple: Why Target-Date Funds Are Widely Misused by Retirement Investors," Financial Engines, March 2016.

Figure 13: TDFS NO PANACEA FOR BAD BEHAVIOR





Failure to take opportunities the plan offers to educate themselves or obtain personal financial advice

Failure to consistently make the maximum plan contribution

Failure to adjust investment allocation/ style to reflect age/years to retirement

Not contributing enough to get full company match

Younger employees investing too conservatively

Overexposure to risky assets at or near retirement

Not participating in the company's defined contribution plan

- *Yes, offers TDFs*
- *No, but plans to offer TDFs*
- *No, and no plan to offer TDFs*

However the message is delivered, repetition is important, says Foley: “Otherwise it gets lost in the shuffle.”

The next step is to tailor participant education as nearly as possible to the individual’s needs — “assume every participant is an individual,” says Credico — and widen it to include every aspect of their financial profile, including personal savings, household debt, real property and expected income from Social Security and other sources. Helping them achieve financial wellness — providing advice on how to create a budget and a plan to reduce their overall debt, for example — encourages participants to take a more calculating look at their DC plan loans, for example.

Plan sponsors that offer target date funds are as likely as those that do not to see participants failing to make best use of their DC plan.

At Ford, a third-party provider supplies free online advice and evaluation of participants’ investment mix as well as classroom training and, three times a month, on-site, one-on-one sessions with an adviser. For a fee, the firm will take over and manage participants’ accounts, a service 10 percent have adopted, says Kopp. At Delta, 16 percent of 401(k) participants use a third-party provider to access some of these services, says Tahvonen. Ford also uses Willis Towers Watson’s FiT Age tool to gauge employees' savings behavior and retirement readiness.

The holistic approach is especially important at companies like Ford, where many employees are building up retirement income through a defined benefit plan as well as their 401(k) accounts. Later this year, the automaker plans to launch a financial wellness program that will include instruction on budgeting, reducing debt and setting up an emergency savings fund, among other topics.

The mere fact that some plan sponsors are beginning to see financial wellness as a component of a retirement benefits program centered on a DC plan underscores the distance they have traveled since the early days of 401(k)s. To build on the progress they have already achieved, plan sponsors must make fuller use of the data they possess about their employees and plan participants. Communicating effectively on an individual level — to build financial literacy, familiarity and willingness to plan for the decades after retirement — requires knowing the employee better. This in turn means working more closely with consultants, recordkeepers and perhaps the functional areas of the business itself.

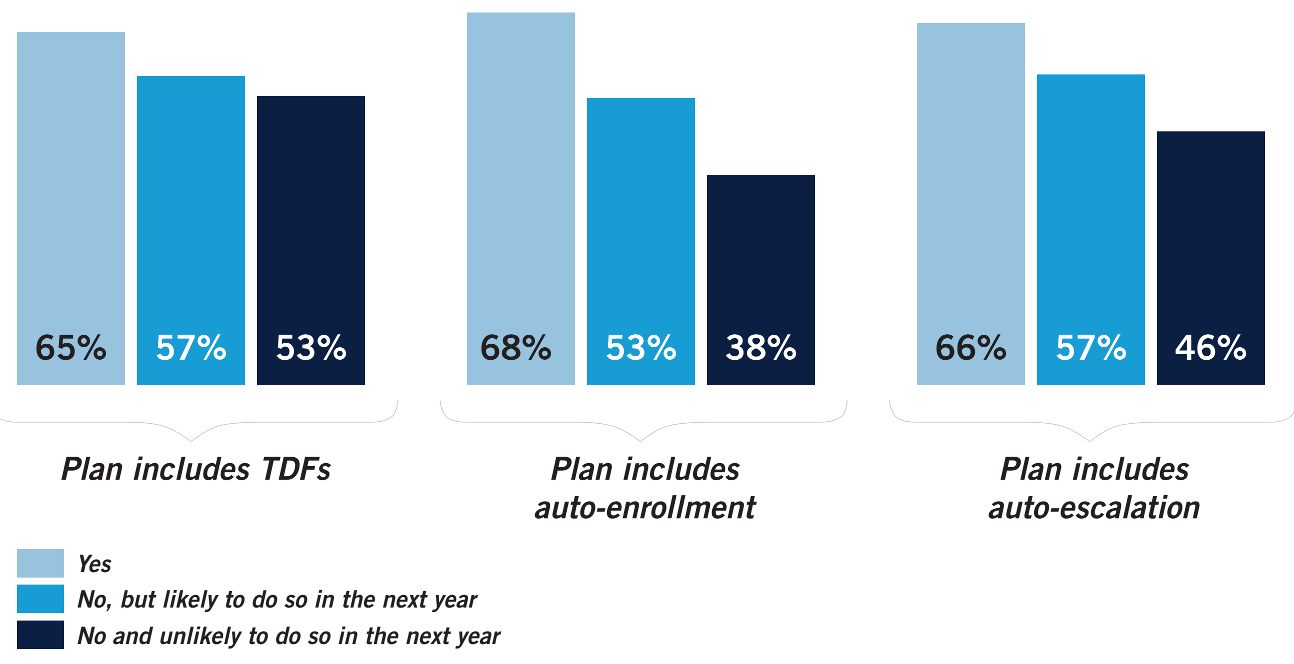
CONCLUSION: THE ROAD AHEAD

Features like auto-enrollment, auto-escalation, TDFs and more generous matching contributions have made an enormous difference for employers that once struggled merely to get better than half of their workers to participate in their DC plan. This came through most dramatically in the study when plan sponsors that offer automatic enrollment were asked how they rated the overall strength of their plan compared with those that do not auto-enroll and are not planning to start. Of the first group, 68 percent rated their plan as excellent; of the second, only 38 percent. The pattern was similar for plans that offer auto-escalation and TDFs and those that do not (*see Figure 14*).

Plan sponsors that offer automatic enrollment, auto-escalation and target date funds are more likely to report excellent plan health ...

Figure 14: MARKS OF EXCELLENCE

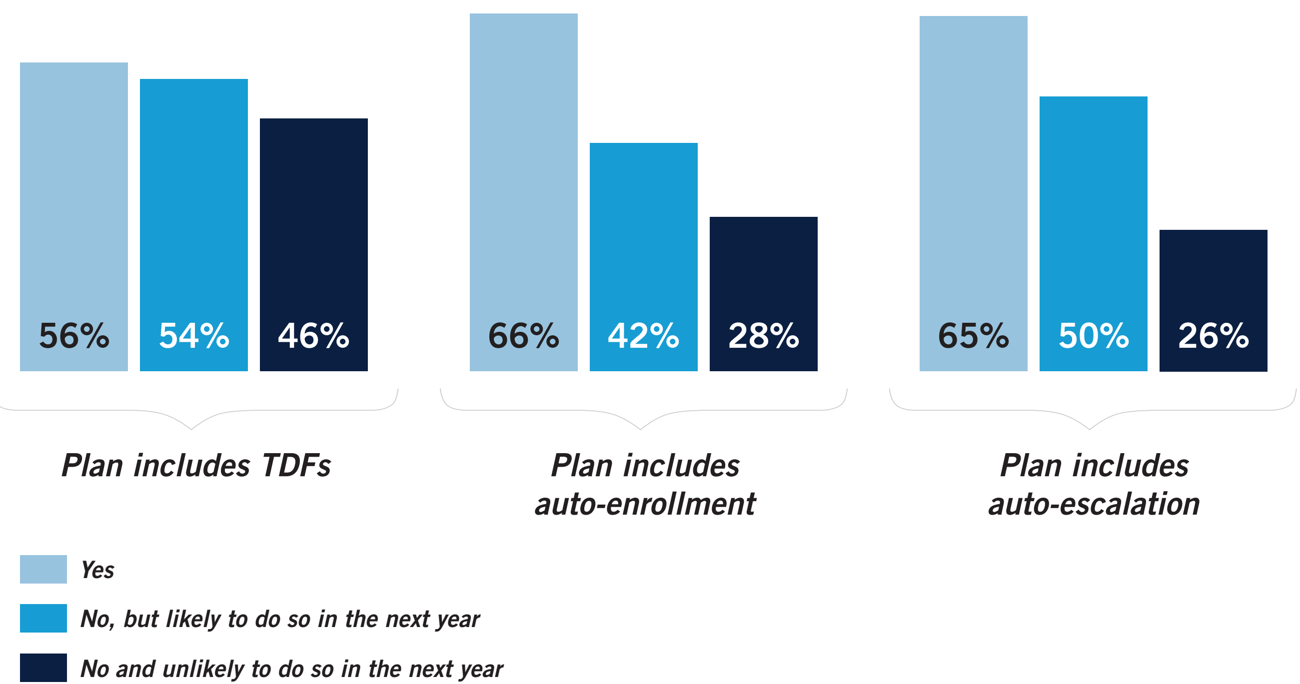
Do you rate your DC plan's overall plan health excellent or near-excellent?



Yet they have further to go to achieve plan wellness. Boosting contribution levels and persuading the minority of employees who still do not participate to start saving will require more sophisticated approaches to education and communication than most plan sponsors have used thus far — some of which may not yet exist. This study indicates that plan sponsors and consultants are applying more creativity to the challenge; the next few years will show whether it bears fruit.

… and that they are effective at helping employees achieve a successful retirement.

Do you rate your DC plan effective or very effective at helping employees achieve a successful retirement?



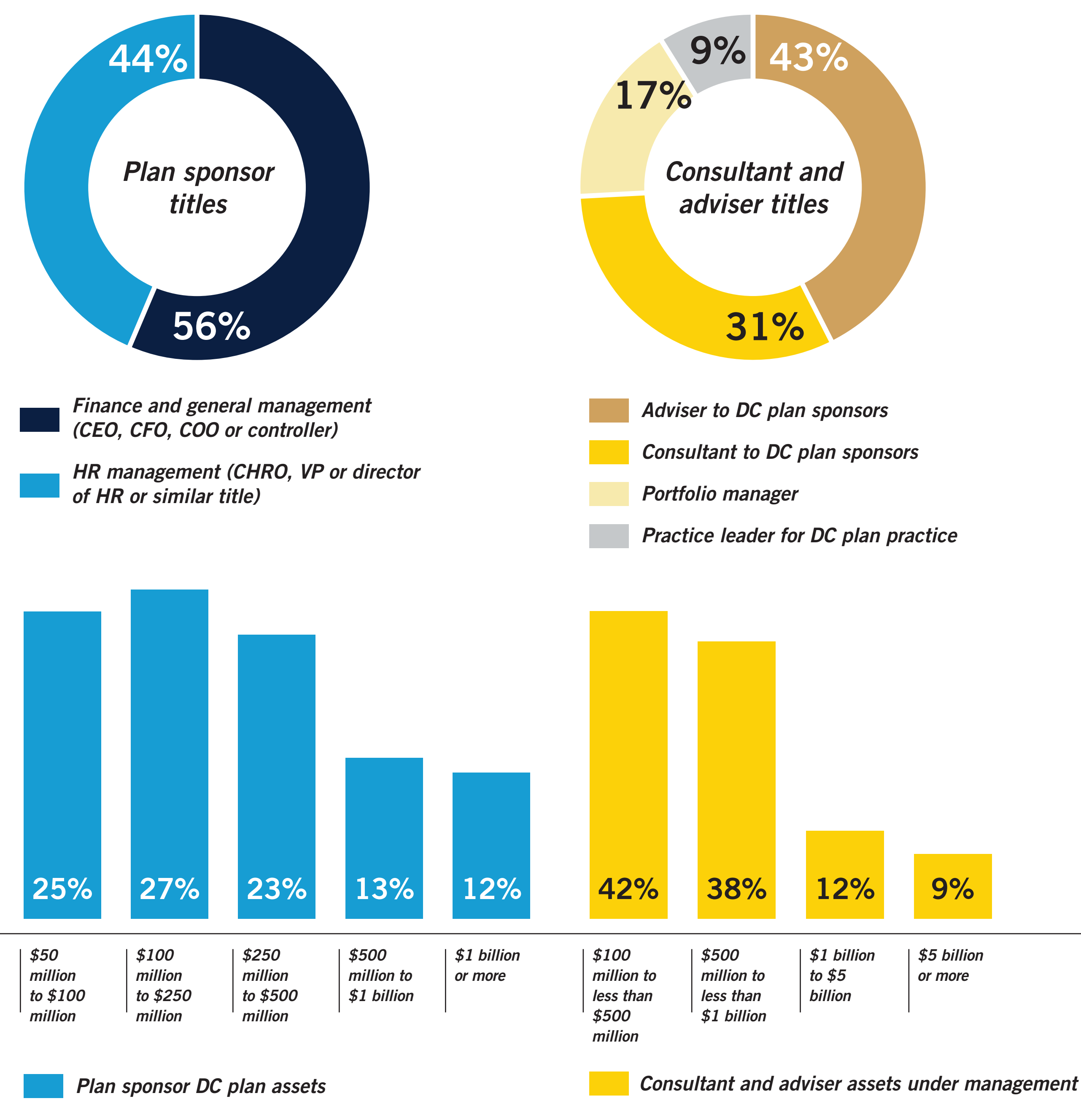
Plan design must continue to follow a more holistic model that focuses employers more intently on how the plan can best serve their employee demographic. "Plans have definitely improved their profile a lot in recent years," says Lucas, "by streamlining their fund lineups, making greater use of auto-enrollment and auto-escalation and reenrollment, relying less on revenue sharing and keeping fees down. But we still see plans run to minimize fund risk rather than to maximize the investment outcome. Too often, decisions are made not based on the demographics of the plan, but on prevalence. I can't tell you how many times, in a meeting, the plan sponsor was considering auto-enrollment and he asked the adviser, 'How many of your other clients are doing it?'"

Even plans that have improved participation and are watching employees escalate their contributions year after year may not see them accumulate enough to retire comfortably, either because escalation is not steep enough, the employer match is too small, the match is not enticing enough or some combination of these. Plan sponsors will have to try harder. "The biggest problem with the system, still, is getting people to save enough, and getting them to not spend the money when they leave," says Credico.

ABOUT THE RESEARCH

In January 2016, *Institutional Investor's* Custom Research Unit, in collaboration with Prudential, surveyed senior decision-makers at 511 defined contribution plan sponsors and 295 consultants and advisers who focus on serving DC plan sponsors. We supplemented this study with interviews with more than a dozen plan sponsors and advisers.

Demographic highlights of the survey respondents are below:



DISCLOSURES AND DEFINITIONS

AUTO ENROLLMENT: An automatic contribution arrangement that can be used as a feature in a retirement plan allowing employers to enroll employees in the company's plan automatically upon meeting eligibility requirements.

AUTO ESCALATION: A plan design option that allows a plan sponsor to increase participant deferrals annually by a set increment.

QUALIFIED DEFAULT INVESTMENT ALTERNATIVE (QDIA): An investment vehicle to which a fund manager may direct retirement plan contributions in the absence of direction from the plan participant.

PENSION PROTECTION ACT OF 2006: Pension law that, among other things, established QDIAs to protect employers from liability of losses suffered by automatically enrolled employees.

RISKS: Investing involves risk. Some investments are riskier than others. The investment return and principal value will fluctuate; shares, when sold, may be worth more or less than the original cost; and it is possible to lose money. Past performance does not guarantee future results. Asset allocation and diversification do not assure a profit or protect against loss in declining markets.

The target date is the approximate date when investors plan to retire and may begin withdrawing their money. The asset allocation of the target date funds will become more conservative as the target date approaches by lessening the equity exposure and increasing the exposure in fixed income type investments. The principal value of an investment in a target date fund is not guaranteed at any time, including the target date. There is no guarantee that the fund will provide adequate retirement income. A target date fund should not be selected based solely on age or retirement date. Participants should carefully consider the investment objectives, risks, charges and expenses of any fund before investing. Funds are not guaranteed investments and the stated asset allocation may be subject to change. It is possible to lose money by investing in securities, including losses near and following retirement.

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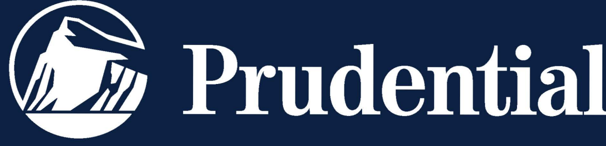
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