2017 JOINT SPRING MEETING

GROUP LEGAL SERVICES ASSOCIATION

SOLO, SMALL FIRM, AND GENERAL PRACTICE DIVISION

STANDING COMMITTEE ON GROUP & PREPAID LEGAL SERVICES

MAY 18-20, 2017

SCOTTSDALE, ARIZONA

SPECIAL TRUSTEES TOPIC

REAL-WORLD APPLICATIONS OF ERISA BEST PRACTICES

FRIDAY, MAY 19, 2017
9:15 – 10:15

PRESENTER: SCOTT DUNBAR

D. Scott Dunbar
Mercer Investment Consulting, LLC

Scott Dunbar is a Partner and Senior Investment Consultant with Mercer Investment Consulting, LLC, the investment consulting arm of Mercer, Inc. In addition to filling a leadership role in the Mercer's Wealth Practice in the Western U.S., he serves as lead investment consultant on a number of investment engagements.

With more than 30 years of experience advising organizations on investment and retirement issues, Scott is a seasoned consultant and relationship manager. His prior experience includes consulting and leadership roles at national consulting firms including Aon Hewitt and Buck Consultants, and at a regional investment boutique.

Scott's current clients include retirement plans in the technology, healthcare, and forest products industries as well as governmental and Taft Hartley trusts. He also advises on several global cash management and pension mandates.

Scott graduated in 1978 from the University of Oregon with a degree in Accounting and Quantitative Methods (with honors) and earned his Juris Doctorate degree (Cum Laude) in 1983 from Northwestern School of Law at Lewis and Clark College. He is an inactive member of the Oregon State Bar, and is a licensed CPA (retired) in the State of Oregon.

HEALTH WEALTH CAREER

ABA-GP SOLO/GLSA 2017 JOINT SPRING MEETING

REAL-WORLD APPLICATIONS OF ERISA BEST PRACTICES

MAY 2017

D. Scott Dunbar
Partner, Mercer Investment Consulting, LLC

ERISA FIDUCIARY RESPONSIBILITIES
A BRIEF OVERVIEW

- ERISA Fiduciary Responsibilities
  - Loyalty
  - Prudence
  - Diversification
  - Avoiding conflicts
  - Following plan documents

- A Fiduciary can be personally liable for:
  - Losses and lost opportunity costs.
  - Attorney fees.
  - DOL fines or excise taxes.
  - Breaches by other fiduciaries.

INVESTMENT BEST PRACTICES
5 KEY ELEMENTS TO SUCCESS

Please refer to the Appendix for details

SAMPLE INVESTMENT MEETING CADENCE

Quarterly	Annual	Every Few Years

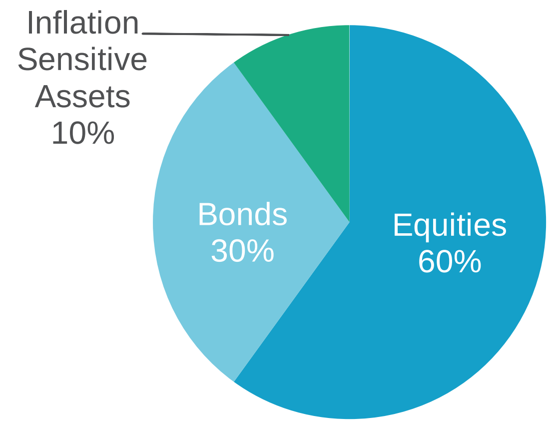
• Review investment performance of plan and individual funds
• Review managers (e.g., staff changes, litigation, compliance with separate account mandates, etc.)
• Manager terminations and replacements
• Vendor updates (e.g., recordkeepers)
• Confirm asset allocations within ranges (DB plans)
• Review cash flows and funding status (DB plans)
• Current trends (regulatory, legal and market updates)
• Interim updates to governance processes and documents
	• Review IPS and other governance documents
	• Committee fiduciary education
	• Review fees (e.g., DOL fee disclosures, participant fees, potential for share class changes, etc.)
	• Menu structure review and confirm QDIA (DC plans)
	• Interim review of asset allocation targets based on significant market changes (DB plans)
		• Review “journey plan” and refresh asset allocation or ALM study (DB plans)
		• Review target date funds (DC plans)
		• Review capital preservation option (DC plans)
		• Review all vendor contracts (including fee/service benchmarking or full RFPs)
		    • DC recordkeeper
		    • DB administration
		    • Actuarial, legal, audit, and investment consulting
		    • Custody and securities lending

PRACTICAL APPLICATIONS
A POP QUIZ

1. ASSET ALLOCATION

- The return of an investment portfolio is based on the amount allocated to each “asset class” reflected in the portfolio, plus or minus the active management premium (“alpha”) generated by the individual investment managers.
- The asset allocation is generally defined as the desired amount (“target allocation”) allocated to each asset class.

Sample Asset Allocation Model



Question 1: What percentage of overall investment return is driven asset allocation decisions as compared to manager “alpha”?

- ❑ **80%**
- ❑ **90%**
- ❑ **100%**

1. ASSET ALLOCATION
THE PRIMARY DRIVER OF INVESTMENT RETURNS

ANSWER: all of the above

- Depending on the research you look at, asset allocation drives 80-100% of the investment return for a portfolio
- While this could be construed as a rationale for moving to a 100% passive (index fund) manager lineup, it certainly supports including passive funds in the portfolio, at least for asset classes where individual managers have had a more difficult time beating the indexes (e.g., U.S. Large Cap)

Practice implications

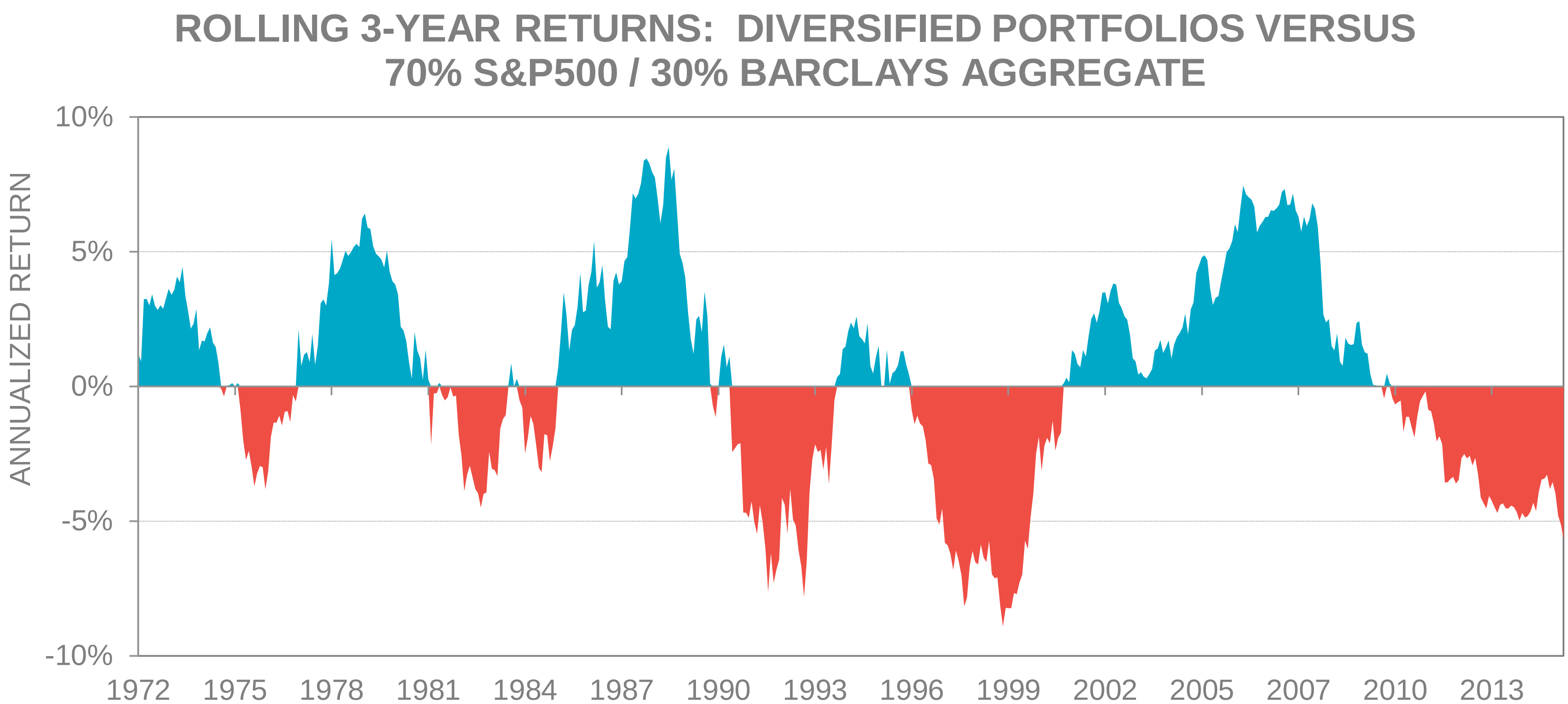
- Do the Committee members understand the theoretical underpinnings of Modern Portfolio Theory?
- Are asset allocation decisions based on a thorough and rigorous asset allocation study prepared by an expert having sufficient relevant experience?
- Have you considered how investment structure will interact with the Plan's liabilities?
- Is the asset allocation appropriately documented in the Investment Policy Statement?
- How much time is spent in Committee meetings reviewing manager performance as compared to broader investment strategy issues?

2. DIVERSIFICATION

Question 2: Is it generally better to have investment allocations weighted toward the U.S. equities and bonds, as compared to a more broadly diversified portfolio including international stocks?

- ❑ Yes
- ❑ No
- ❑ It depends

2. DIVERSIFICATION
SIMPLE ISN'T ALWAYS BEST



Note: Diversified portfolio: 45% global stocks, 10% private equity, 5% real estate, 5% natural resources, 15% hedge fund of funds, 2.5% HY bonds, 2.5% LC EMD, 15% core fixed income. In cases where an asset class did not have a representative index for the full period, we used the closest substitute we could identify.

2. DIVERSIFICATION
SIMPLE ISN'T ALWAYS BEST

ANSWER: it depends

- Since 2009, a simple US-based portfolio has outperformed a more diversified, global portfolio
- In other time periods, a US-based portfolio has underperformed
- Investment performance is not the only measure of "success" for a portfolio – diversification can also reduce portfolio volatility, improve cash flow, and reduce the risk of drawdown (e.g., portfolio losses in an event similar to the global financial crisis)

Practice implications

- Are the objectives for your portfolio clearly documented in your IPS?
- How might the objectives differ for a defined benefit plan as compared to a defined contribution plan?
- How do you measure "success" in achieving the investment objectives – does it include measures of volatility and drawdown?
- What benchmarks are used to measure success?
- Do your benchmarks include comparison to peers? To a simple 70/30 benchmark? To your Policy Index?

3. SELECTING INVESTMENT MANAGERS

- Whether picking managers for a DB investment portfolio or a DC menu, it's important to base decisions not solely on performance – this is where outside investment expertise can be particularly helpful
- A well-defined manager research process includes a number of factors
- Manager research also plays an important role in determining whether to terminate and replace an existing manager

IDEA GENERATION
How strong is the manager's ability to generate value-adding investment ideas?

PORTFOLIO CONSTRUCTION
How effectively are these investment ideas translated into weightings within portfolios?

IMPLEMENTATION
How much of the value-add is given back in the form of transaction costs and opportunity costs?

BUSINESS MANAGEMENT
Well-managed investment firms are more likely to maintain and enhance the competitiveness of their investment strategies over time.

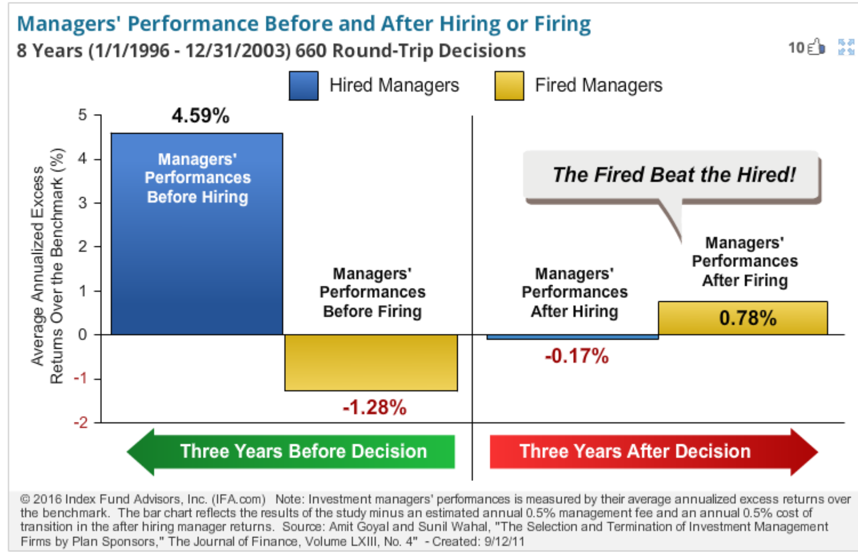
Question 4: After a Committee makes a decision to terminate and replace a manager, the new manager…..

- ❑ **Performs substantially better than the prior manager**
- ❑ **Performs about the same as the prior manager**
- ❑ **Performs worse than the prior manager**

3. SELECTING INVESTMENT MANAGERS
BE CAREFUL WHAT YOU WISH FOR

ANSWER: the new manager often does more poorly

- All active managers will have periods of underperformance – due to market cycles, styles being out of favor, etc.
- Good managers will generally “revert to the mean” over time
- When replacing a manager, it’s important to understand what’s driving the underperformance



Practice implications

- Are manager selection and evaluation guidelines documented in the IPS?
- Are the guidelines flexible enough to accommodate periods of underperformance by otherwise good managers?
- Is the Committee’s evaluation process supported by a rigorous research process?
- Are hire/fire/replace decisions appropriately documented in the minutes?

4. HEDGE FUNDS

- Hedge funds are private investment pools that invest in “non-traditional” assets or employ investment strategies that are not typically used by traditional mutual funds
- These investments have recently received a fair amount of bad press from the likes of Warren Buffet and CalPERS

Question 4: Does it make sense to invest in hedge funds?

- ❑ **Yes**
- ❑ **No**
- ❑ **It depends**

4. HEDGE FUNDS
NOT ALL HEDGE FUNDS ARE CREATED EQUAL

ANSWER: it depends

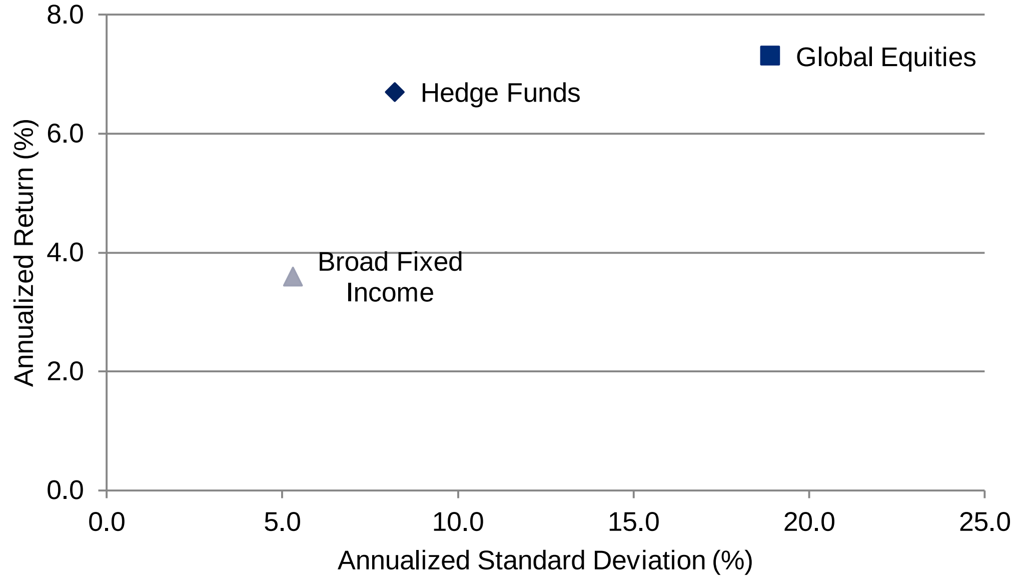
- There are many types of hedge funds:
  - Multi-strategy: tactically shift allocations between strategies as the opportunity set changes
  - Focused single strategies: Long/Short equity, Event Driven, Global Macro, etc.
  - Hedging strategies: tail-risk hedging, managed futures, etc.
- Not all hedge funds are alike – each tends to have a unique risk/return profile
- May not be appropriate for all funds – depends on the size and type of trust or investment pool being managed
- Need to consider include high fees (“2 & 20”), illiquidity risks, and liquid alternatives

Practice implications

- Have you considered the advantages/disadvantages hedge funds as part of your asset allocation process?
- Is the IPS sufficiently clear on how hedge funds fit within the portfolio?
- Are manager selection and evaluation guidelines documented in the IPS?

4. HEDGE FUNDS
THE RISK/REWARD TRADE-OFF

- Hedge funds offer a unique ability to diversify the traditional equity, credit and interest rate risks that dominate a typical asset allocation
- Hedge funds provide exposure to non-traditional return drivers and play an important role in a diversified portfolio.
- By introducing new return drivers, the total portfolio relies less on the direction of capital markets
- Hedge funds can be a powerful diversifier, stretching the efficient frontier and improving risk-adjusted performance.
- A skillfully managed portfolio of hedge funds is expected to generate attractive risk adjusted returns relative to global equities over a full market cycle.



Source: Mercer's US 20-year capital markets outlook as at January 2017

5. REBALANCING TRUST INVESTMENTS

- Without rebalancing, allocations to asset classes will tend to drift away from the target allocation and upset the tradeoff between risk and return. For example, if equity prices increase and prices of bonds and other assets decrease, a portfolio that starts at 60% equities may quickly change to 70% or even higher.
- A rebalancing policy takes the emotion out of asset allocation decisions when markets are rising or declining dramatically.

Question 5: What is the optimal rebalancing schedule for an investment portfolio?

- ❑ **Daily**
- ❑ **Quarterly**
- ❑ **Annual**
- ❑ **Whenever the allocation goes outside a reasonable range from the target allocation**
- ❑ **It depends**

5. REBALANCING A PORTFOLIO
NOT ONE SIMPLE ANSWER

ANSWER: it depends

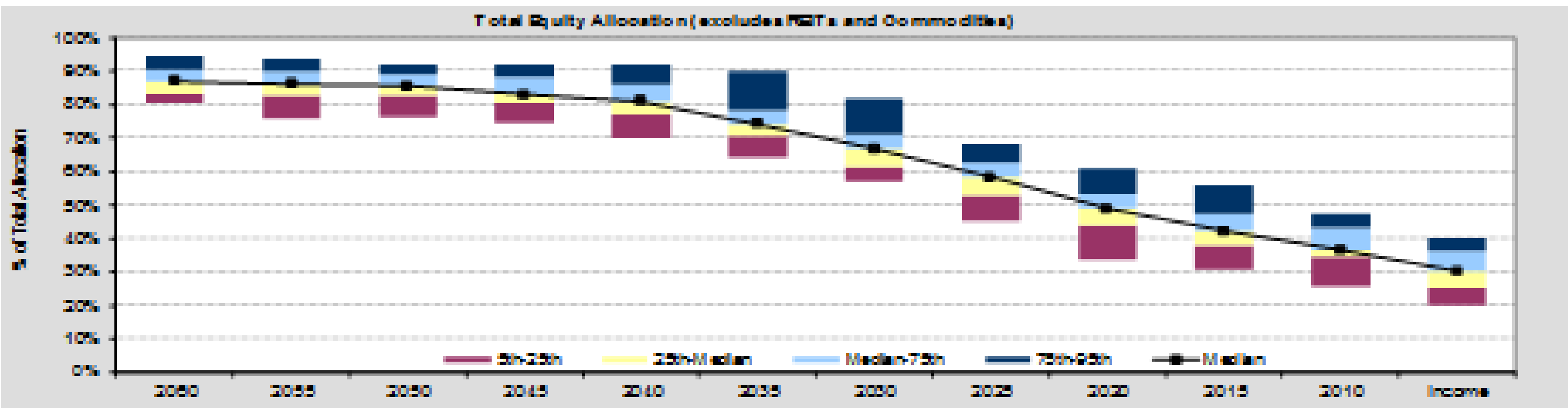
- Studies show that the optimal rebalancing schedule depends on many factors, including the types of asset classes included in the portfolio, expected returns, cash flows (+/-), trading costs, and risk tolerance
- Modeling of rebalancing alternatives (both timing and amount) is best evaluated during the asset allocation study process.

Practice implications

- Has a rebalancing approach been considered during the asset allocation process?
- Does the IPS state the allowable ranges around the target allocations for each asset class?
- Does the IPS address timing and amount of rebalance transactions?
- Who is responsible for recommending and approving rebalancing transactions?
- What processes are in place for less liquid asset classes such as private equity, private real estate and hedge funds?

6. TARGET DATE FUNDS

- Target date funds are a packaged solution for participants that desire a “do it for me” approach to investing
- The fund consists of several underlying funds reflecting many different asset classes
- The mix of underlying funds is designed to reflect an appropriate risk profile for individuals retiring as of a certain date (e.g., a 2050 fund for individuals that will reach age 65 around the year 2050)
- The mix of underlying funds is adjusted automatically as the participant grows older



6. TARGET DATE FUNDS

Question 6: Which factors does the DOL suggest be considered when selecting or reviewing target retirement date funds?

- ❑ How well the TDF's characteristics align with the eligible employees' ages and likely retirement dates
- ❑ Principal investment strategies and risks
- ❑ Underlying asset classes and investments
- ❑ The fund's glide path (i.e., how allocations change over time)
- ❑ Whether the most conservative allocation will occur at or after the target date (i.e., "to versus through")
- ❑ Fees and expenses, at the fund level and at the underlying fund level
- ❑ Whether the underlying funds consist solely of the vendor's proprietary funds
- ❑ Whether a "custom" solution may be more appropriate
- ❑ All of the above

DOL REQUIRES A THOROUGH EVALUATION

ANSWER: all of the above

- The DOL includes all of these factors, and several others, in its published guidance
- The DOL also suggests:
  - Establishing a process for comparing and selecting TDFs
  - Establishing a process for the periodic review of selected TDFs
  - Developing an effective employee communications process
  - Documenting the selection and review process

Practice implications

- Have TDFs been considered as an investment option in the plan?
- Was a through evaluation process followed when they were selected?
- Has an ongoing evaluation process been implemented?
- How is the usage of TDFs monitored and evaluated?
- What steps has the plan sponsor undertaken to assure the TDFs are effectively communicated to participants?
- Is the TDF used as the Qualified Default Investment Alternative?

7. OUTSOURCED INVESTMENT MODELS

- Outsourcing of fiduciary responsibilities to third party investment advisors is one of the fastest growing segments of the investment industry
- Referred to under a variety of names, including OCIO, discretionary, delegated, or implemented consulting
- Can take different legal forms (e.g., ERISA Section 3(38) or 3(16) - as compared to a traditional Section 3(21) advisory model)
- Not all service models are created equal – the scope and level of responsibility assumed varies by firm and even from client to client

Question 7: After a plan sponsor outsources investment responsibilities to a third party, they no longer have any fiduciary responsibilities, right?

- ❑ **Correct**
- ❑ **Wrong**

FIDUCIARY RESPONSIBILITY REMAINS

ANSWER: wrong

- Even if all investment and operational aspects of the plan have been delegated to a 3rd party, the Committee still is responsible for selecting the provider and for adequately reviewing their work on an ongoing basis
- The devil is in the details of the service agreement – if any aspect of the relationship requires Committee approval, those approvals remain subject to fiduciary responsibility

Practice implications

- Has the Committee looked at the benefits of an outsourced investment provider?
- If an outsourced provider is in place, was a through evaluation process followed when they were selected?
- Has the outsourcing agreement been reviewed to determine which fiduciary responsibilities are impacted, and which remain with the employer?
- Has an ongoing evaluation process been implemented?

8. CYBER SECURITY

Question 8: Cyber security isn’t really that big of an issue for qualified retirement plans, right?

- ❑ Correct
- ❑ Wrong

8. CYBER SECURITY

HOW BIG IS THE CYBER PROBLEM?

270%

in identified victims and exposed losses [1]

Average time to resolve cyber attacks has increased by

221% [2]

Cyber crime costs the global economy annually up to

$500 BILLION [1]

122

successful attacks per week [3]

90%

of large corporations report a breach [4]

Cyber attacks on business have increased by

144% [2]

1 Merrill Lynch CIO Reports
2 CYREN Cyber Threat Report, 2015
3. Ponemon Institute
4. Security Breaches Survey – PwC 2015c

8. CYBER SECURITY

CYBER SECURITY BECOMES RETIREMENT PLAN ISSUE

ANSWER: Wrong. Cyber is a big issue

- Cyber security is at the forefront for a number of reasons:
  - Recent high profile, high-cost employee data breaches
  - Increased participant demand for multiple access points (e.g., mobile, tablet)
  - Increasingly sophisticated cyber attacks
  - DOL ERISA Advisory Committee recently held hearings on cyber threats

Practice implications

- Has the Committee considered a cyber review? Questions to ask include:
  - When were data-security provisions in vendor contracts last updated?
  - Are vendor contracts up to date with your organization's latest data-security policies?
  - Do contract provisions fully protect your organization, and fully address participant exposure in the event of a data breach?
  - Are you comfortable that your vendor's policies and procedures are up to date with current industry best practices?
  - Are you comfortable that internal procedures conform with your organization's policies?

9. PARTICIPANT COMMUNICATION

Question 9: Participants have a pretty good understanding of the plan sponsor’s role in managing a retirement plan

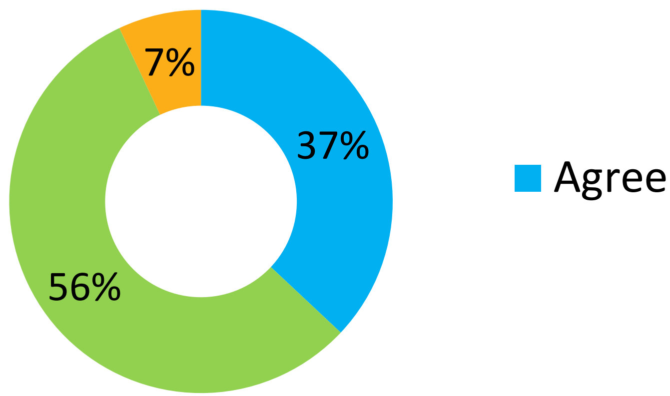
- ❑ Agree
- ❑ Disagree

9. PARTICIPANT COMMUNICATION
PARTICIPANTS CONFUSED OVER EMPLOYER ROLE

ANSWER: Wrong

- 62% of participants believe that their employer has no legal responsibility to ensure investment advice provided through their 401(k) plan is in their best interests
- Nearly half believe their employers are not very, or not at all involved in selecting the 401(k) plan investment options - i.e., that the recordkeeper makes all decisions regarding the plan
- Yet most participants doubt that decisions are made in their best interests

“My 401(k) plan provider acts in my best interests”

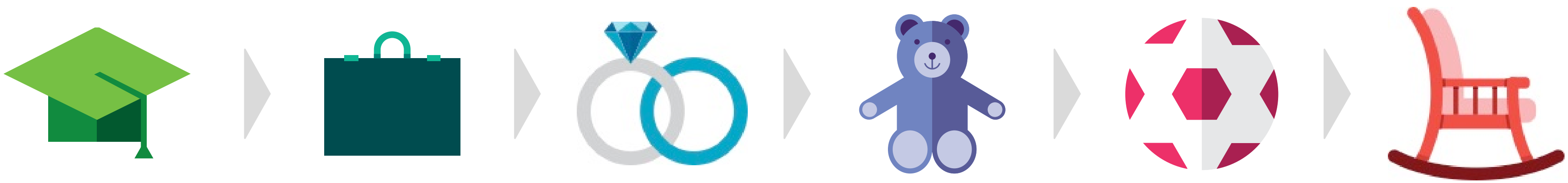


Betterment / Forester poll of 305 full time employees eligible for 401(k); conducted during June – September 2016

10. FINANCIAL WELLNESS
A LIFELONG JOURNEY

Consumer Finance Protection Bureau's (CFPB) Four Elements of Individual Financial Wellness

Have control over day-to-day, month-to-month finances	Have the capacity to absorb a financial shock	Are on track to meet financial goals	Have financial freedom to make choices to enjoy life



FINANCIAL WELLNESS NEEDS

- Participant enters workforce
- Life event occurs and an intervention is needed
- Phase of employment changes (e.g., nearing retirement, leaving company)
- Participant enters retirement, drawdown phase

Comprehensive employer financial wellness programs help employees with:

ASSETS	LIABILITIES	INCOME/EXPENSES	INSURANCE

10. FINANCIAL WELLNESS

Question 10: As the plan sponsor, the “financial wellness” of my participants doesn’t really affect us

- ❑ Agree
- ❑ Disagree

10. FINANCIAL WELLNESS

WHY EMPLOYERS/TRUSTEES SHOULD CARE

7 OUT OF **10**
AMERICAN WORKERS say financial stress is their most common cause of stress.[1]

80%
OF EMPLOYEES report an increase in their health care costs in the past two years and **56%** are saving less for retirement as a direct result of more health care costs.[2]

22%
OF US EMPLOYEES admit to missing at least one day of work in the past year to deal with a financial problem.[3]

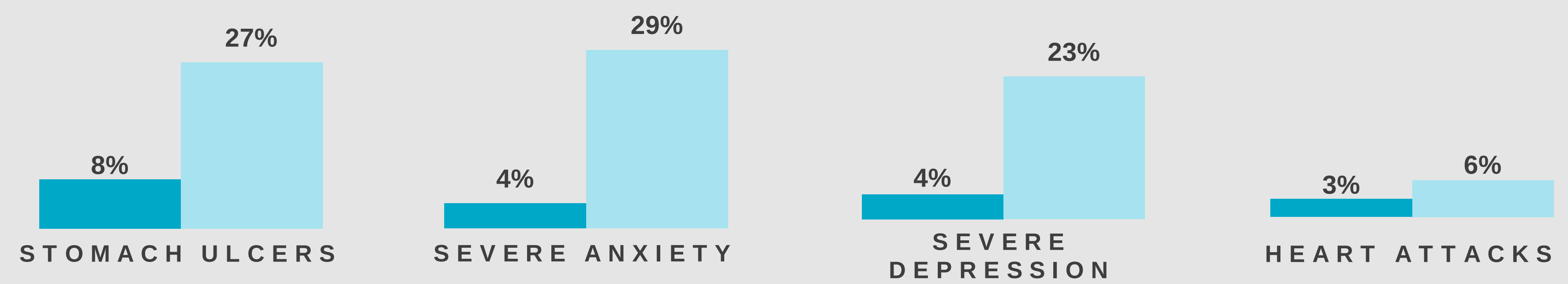
$40,000
IS THE MEDIAN retirement plan account balance for working-age families.[4]

[1] American Psychology Association, *Stress in America: Are Teens Adopting Adults' Stress Habits?* (2014)

[2] Bank of America/Merrill Lynch, *Workplace Benefits Report* (2013)

[3] MetLife, Inc., *10th Annual Study of Employee Benefits Trends: Seeing Opportunity in Shifting Tides* (2012)

[4] National Institute for Retirement Security, *The Retirement Savings Crisis: Is It Worse Than We Think?* (2013)



People With Low Levels of Financial Stress
People With High Levels of Financial Stress

Source: Associated Press-AOL health poll, Debt Stress: The Toll Owing Money Takes on the Body

APPENDIX

ATTACHMENT 1

GOVERNANCE BEST PRACTICES OVERVIEW

EXECUTIVE SUMMARY

In 2015 Mercer completed an extensive survey of our clients and consultants to compile a report on best practices. The Interviews were with 12 senior consultants encompassing information on 104 clients. Our review is organized around the following key strategic areas of operation for the Investment Committee. Survey results are summarized on the following pages.

GOVERNANCE ROLES & RESPONSIBILITIES

Issue	Best Practice
Investment Committee Structure	• 5-10 members • Chair provides leadership • Vice-Chair to support Chair • Dedicated focus on portfolio management and related issues • Diverse investment expertise beneficial • Specific roles identified • Formal board delegation
Committee Meeting Format	• Quarterly • In-Person • Two hour minimum • Additional meetings as needed to address strategic issues • Intra-quarterly communication between Chair, staff and/or consultant
Tying Roles to Board and Enterprise Priorities	• Formal board delegation • Board representation included in committee composition • Committee decisions presented to board annually • Liaison with Finance and Development departments
Fiduciary Calendar and Annual Strategy Session	• Annual “work plan” to ensure complete portfolio review • Annual meeting focused on strategy • Chair, staff and consultant review “work plan” to set agenda
Measuring “Success” and “Risk”	• Define success and risk • Assess committee views on best and worst outcomes • Put quarterly review in context of targeted outcome • Tie measures of success to organizational mission • Incorporate scenario planning and stress tests

MEETING CADENCE, CONTENT & PROTOCOLS

Issue	Best Practice
Content & Focus of Quarterly Meetings	• Trend toward focusing on strategic issues • Trend toward insourcing (CIO/Staff) or outsourcing manager selection and implementation • Devote less time to tactical, manager-related issues • Focus on long-term results
Quarterly Presentation Materials	• Investment Policy Statement provides portfolio management framework • Portfolio review should confirm adherence to IPS • Action items should be clearly identified • Asset allocation and performance data should highlight compliance with Policy • Supporting data should not be a distraction • Manager performance and key alternative asset classes should be reviewed annually or semi-annually rather than quarterly
Prioritizing Meeting Content	• Meeting content should be dictated by annual strategy session outcomes • Chair focuses meetings • Spend majority of time on strategy and accomplishment of strategic objectives

COMMUNICATION

Issue	Best Practice
Pre-Meeting Preparation	• Chair, staff and/or consultant hold call prior to meeting to review agenda • Hold follow-up call four weeks prior to meeting to review assignments and deliverables • Distribute preliminary draft materials two weeks prior to meeting to allow for changes
Meeting Follow-Up	• Consultant and/or staff distributes bulleted summary of action items and decisions to Chair and interested parties

INVESTMENT PROCESS

Issue	Best Practice
Investment Policy Statement Review	• Formally review IPS and strategic asset allocation annually • Set asset allocation ranges to allow for market fluctuations • Prescribe rebalancing policy • Set boundaries within which Staff and Committee operate
Determining Overall Portfolio Objectives	• Set portfolio objectives in IPS • Purpose • Time horizon • Risk tolerance • Liquidity • Express individual viewpoints and develop consensus • Define success
Implementing an Overall Risk Framework	• Manage risk consistent with long-term objectives and short-term needs • Hold regular conversations about risk • Scenario planning and stress testing • Determine risk capacity
Asset Allocation, Asset Class and Manager Review	• Periodically review portfolio as if it were being newly instituted • Review asset allocation context quarterly • Conduct detailed, formal asset allocation review biennially
Adopting Risk and Return Assumptions	• NFP clients routinely accept consultant risk and return assumptions • Pension and other larger clients review consensus expectations and set independent expectations
Benchmarking	• Conduct annual review to ensure benchmarks remain appropriate

INVESTMENT PROGRAM

Issue	Best Practice
Asset Allocation and Manager Review	• Utilize committee to focus on asset allocation • Utilize staff and consultant to provide first level manager oversight • Review manager roster to determine overlap or gaps
Manager Implementation	• Identify appropriate combination of active and passive management • Identify appropriate traditional asset class vehicles and structure • Identify appropriate alternative asset classes vehicles and structure

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MAKE
TOMORROW,
TODAY

DEFINED BENEFIT TOP AREAS OF FOCUS FOR 2017

GET READY FOR CHANGE

Rising interest rates and equity markets have improved funding ratios, which does create opportunities for plan sponsors to take actions such as executing risk transfer actions, locking in gains and cutting risk or reducing contributions and expense. However, the proposed policies of the US President Elect could create a meaningfully different market environment than investors have faced since the financial crisis. As such, plan sponsors should carefully evaluate next steps to optimize outcomes for their plans.

> Looking ahead, we believe that improved funding ratios and signs of global economy reflation requires actions to adjust your pension risk strategy.

1

HAVE YOU PREPARED A COMPREHENSIVE JOURNEY PLAN?

The most critical tool for managing risk in pension plans is a sound journey plan. A journey plan should be much more than a de-risking glide path; it should capture the full course of actions as the plan matures. A sponsor's goals for risk transfer, funding, closing/freezing and other activities, in addition to investment management actions, should be considered and evaluated. With ever-dynamic investment and insurance markets, opportunities for risk transfer activities can arise quickly, and funding opportunities may present themselves as the plan sponsor's cash flow and capital budgeting outlooks evolve. All this calls for both a well-thought-out and socialized game plan as well as nimble, execution-ready administration and governance with a blueprint for actions and an ultimate destination clearly laid out.

2

ARE YOU READY TO RESPOND TO GROWTH PORTFOLIO OPPORTUNITIES AND CHALLENGES?

There are ongoing changes in the environment for risk assets that may provide an opportunity for investors to improve their results. The evolution of the banking system since the financial crisis has pushed traditional credit providers, primarily banks, out of some lending segments, creating opportunities for sophisticated institutional investors to provide credit at attractive rates through private debt, structured credit and similar strategies. Since the recent US election, the growing potential for "reflation," an increase in inflation from low levels driven by both low rates and growth, has emerged. This could have significant effects across many assets, with low-yielding bonds expected to perform poorly, and some lower-growth equity areas, particularly yield-oriented areas, might struggle as well. Conversely, real assets, such as real estate, could hold their value if inflation is the primary driver of an increase in interest rates.

3

WHAT ABOUT RE-RISKING?

Most DB plans have an established de-risking glide path, but many have no formal procedure if their funded status declines. "Re-risking" involves moving back down the glide path and increasing the growth allocation. For some plans, increasing the certainty of plan costs and stabilizing the funding position are the most critical objectives, so re-risking might not be appropriate. For other plans, the assets are structured to help improve the funding position, and greater risk might be needed to accomplish this objective. Plans that adopt a policy on risk in advance of a funded status decline are able to react promptly and appropriately if a meaningful decline in funded status occurs.

4

ARE YOUR BONDS FIT FOR PURPOSE?

As pension plans de-risk and fixed income allocations increase, it becomes increasingly important to tailor the bond portfolio to each plan's specific liabilities and journey plan. It is also important to partner with a manager who can help execute your journey plan and be flexible and opportunistic. Some of the more customized needs of a de-risking plan include structuring the bond portfolio for immunization and/or transfer to an insurer. Opportunistic areas include dynamic interest rate hedging, where the level of interest rate exposure in the portfolio is adjusted to capture the benefits of rising interest rates on funded status.

5

DOES YOUR FUNDING POLICY INCLUDE BORROWING TO FUND?

The opportunity to capture the benefits of funding a plan through borrowing — such as increased tax deduction, decreased Pension Benefit Guaranty Corporation (PBGC) fees and stabilizing the pattern of contributions — is still available despite the recent rise in rates. PBGC variable-rate premiums (VRPs) are 3.4% of the plan's unfunded obligation for 2017 and increasing to 4.4%+ after 2019, making the case for increased contributions to close the gap very compelling. This, in effect, represents a substantial tax on pension deficits, amplifying the case for voluntary prefunding. Generally, borrowing to fund may be beneficial when the sponsor's after-tax borrowing rate does not exceed the pension discount rate plus the VRP tax. Issuing debt does not necessarily add to the total debt burden; rather, it can be viewed as a potentially favorable restructuring.

6

IS A 2017 CASH-OUT RIGHT FOR YOU?

The economics for a potential cash-out window remain potentially compelling. This has been a common project for many plan sponsors, with a focus on deferred vested participants, and the opportunity also exists for active employees with frozen benefits through a spinoff/termination arrangement. The economic cost of the plan's obligation should consider the maintenance costs of the plan not reflected in accounting liabilities — for example, PBGC fees, investment and operational expenses. When these frictional costs are considered, lump-sum cash-out programs can be executed at a substantial discount. Further, knowing that new mortality tables will likely be prescribed in 2018 makes for a time-sensitive window to review a potential cash-out in 2017. Reviewing the business case through four lenses — economic, HR and participant, portfolio and cash, and accounting implications — is important to understanding all aspects and the potential fit.

7

IS THERE AN OPPORTUNITY TO TRANSFER RISK TO AN INSURER?

Despite a stagnant interest rate environment for most of 2016, many pension sponsors are eager to either fully terminate their DB pension plans or simply reduce risk and "right size" the plans by purchasing a group annuity contract from an insurance company. We anticipate this trend will accelerate if markets and rates continue to rise. Understanding the plan sponsor's unique implications and impact on the pension journey will help determine the conditions that will define an opportunistic transaction. Market and plan dynamics will have an impact on relative pricing, and engaging the insurer marketplace early in the process will help bring clarity to the potential financial outcomes and pricing sensitivities. Articulating the business case, and working through many of the readiness steps in advance, will enable plan sponsors to move quickly to promote efficient execution of a transaction if and when a transaction is compelling. In some cases, larger plan sponsors are considering phased approaches with an initial focus on smaller benefit retirees, where the trade-offs are most compelling. With a vibrant insurance market underwriting both retiree-only and termination annuity contracts, many sponsors are seeing favorable pricing despite current interest rates. This trend is expected to continue in 2017, and new insurers are potentially looking to enter the space and further increase the competition.

8

ARE YOU EFFECTIVELY MANAGING ALTERNATIVE ASSET CLASSES?

Alternatives and private assets can add value to a long-term investor like a pension plan, since the plan can exchange liquidity for an expected long-term return premium relative to liquid investments. However, illiquidity can create challenges as plans move along a de-risking glide path or make substantial distributions. Although some alternative assets have reasonable liquidity, such as many hedge fund asset types and some real estate investments, others, such as private equity, offer very limited ability to redeem an investment. For truly private illiquid investments, trying to sell an interest to another investor is likely to result in a meaningful markdown in value. This means that plans should evaluate their illiquidity budgets (they may be larger than expected) and test those budgets throughout their strategic timelines.

Some particular considerations include:

- Investors should incorporate liquidity considerations into their plans for executing their glide paths.
- Sponsors whose long-term plans are to settle significant liabilities on a set schedule should plan ahead and begin reducing their commitments well before the settlement events are anticipated.
- Plans should develop "illiquidity budgets" to ensure they are utilizing their ability to invest in illiquid assets while also ensuring they are able to execute their long-term plans.

9

IS YOUR DATA READY?

Accurate pension plan data is a critical component for any pension de-risking project. Annuity placement, cash-out and plan termination projects can be executed only if participant data and benefits are complete and available electronically. Consider data quality and cleanup needs as early as possible so that the most efficient plan can be built to resolve issues. A data assessment will provide you with the necessary information to build a data readiness plan that is personalized to your needs, goals and timeline. With data gaps and challenges addressed early in the process, sponsors will be able to monitor the market and make quick decisions to begin de-risking projects. In addition, they will reap the benefits of a smoother administration process while awaiting the next steps in their journey plans.

10

DO YOU NEED A DELEGATED MANAGER?

A plan may benefit from delegating responsibility for some or all of the plan's investments to an overall manager who can oversee and direct both the fixed income and growth portfolios to achieve the journey plan objectives. Complex investment strategies, such as sophisticated liability hedging approaches, alternative asset classes and evolving risk transfer approaches, all highlight the benefits of an integrated pension governance model that allows an investment committee to delegate authority in certain areas to dedicated experts. This type of governance model allows the plan sponsor to focus on strategy — while the increasing complex dynamics of the journey can be managed day to day by experts with specialized resources and tools. More details on the services that a delegated investment manager, or an outsourced chief investment officer (OCIO), can provide can be found in our white paper, "A Blueprint for Defined Benefit OCIO Services."

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TOP PRIORITIES FOR DC PLAN SPONSORS MOVING INTO 2017

In a world where change is a constant, it's important to retain vigilance over your defined contribution (DC) plans. However strong your governance structure is, all plans need to evolve with changes in legislation, regulations, industry trends and the changing needs of individuals. What may have been ideal three or five years ago may not be as ideal today.

With this in mind, we encourage DC plan fiduciaries to consider the following as we move into 2017.

1

ARE YOU TAKING ALL COMPONENTS OF AN INDIVIDUAL'S FINANCIAL NEEDS INTO ACCOUNT BEYOND JUST RETIREMENT?

For many individuals, dealing with immediate needs is more critical than making extra retirement contributions, so any retirement savings approach should be cognizant of that. Even actions that appear detrimental in the long term to retirement savings may be appropriate given short-term alternatives. Hence, guidance and tools are necessary to empower individuals to cost-effectively manage their broader financial situations.

It is important to bear in mind that there is more to retirement savings than just having resources for retirement. Retirement savings can play a key role either as a source of funds in times of extreme hardship or as an incentive in relation to, say, student debt, which gives people comfort and confidence in making decisions to save for retirement.

2

DO EMPLOYEE STUDENT LOAN REPAYMENTS HAVE A PLACE WITHIN YOUR DESIGN IN ADDITION TO MATCHING EMPLOYEE RETIREMENT CONTRIBUTIONS?

Forty million Americans currently hold $1.3 trillion in student loan debt, which many are struggling to repay.[1] For many Americans, paying back their student loans is more of a concern than saving for retirement. Yet, if they focus on their student loans, they miss out on their employers' 401(k) match.

Although there are complications with integrating employee student loan repayments within your 401(k) plan design, they can be addressed. Would this assist in making your 401(k) plan more appreciated by your employees?

[1] The Office of Federal Student Aid, Q4 2015 Statistics.

3

WHAT SIGNALS DOES YOUR CONTRIBUTION AND MATCHING DESIGN SEND ABOUT SAVING? SHOULD YOU EXTEND YOUR MATCH? DO YOU REALLY NEED A SAFE HARBOR IF YOU'RE USING AUTO-ENROLLMENT?

One record-keeper reported that if a company offers three contribution choices to a participant in a simplified enrollment process, the most popular will always be the lowest contribution choice irrespective of what that number is. Whether or not you agree with this finding, what messages is your design sending to your participants? By matching up to, say, 4%, are you suggesting to participants that achieving the full match at 4% will be enough to save for retirement?

Look at the behavior of your participants and assess whether your design is influencing the choices being made. Assess whether these are the correct influences. How could the design be more effectively structured to influence the preferred behavior?

4

IS YOUR EXISTING MANAGED ACCOUNT PROGRAM SUITED TO YOUR PLAN, PARTICULARLY IN LIGHT OF THE NEW FIDUCIARY RULE?

Is it clear why you selected the managed account provider you have in place? Or was it simply because that was the option offered by your record-keeper? Could you defend the choice if questioned by participants?

With the impending implementation of the Department of Labor (DOL) Fiduciary Rule, plan sponsors should fully understand exactly what fiduciary role the managed account provider will be accepting. Understanding potential conflicts of interest and what type of advice the managed account provider will provide (particularly related to distributions) will also be crucial for plan sponsors.

5

HOW APPROPRIATE IS YOUR TARGET DATE FUND FOR YOUR PLAN AND ITS PARTICIPANTS?

When the DOL issued "Target Date Retirement Funds — Tips for ERISA Plan Fiduciaries,"[2] it stated that "You should consider how well the TDF [target date fund]'s characteristics align with eligible employees' ages and likely retirement dates." Have you done this? Even if you had, has your participant group changed? Is your target date fund still a high-quality offering? A lot has changed in the past five years. What may have been "best in class" may not be so today.

If you are offering a custom target date fund, have you looked at ways to improve risk-return efficiency? Multi-asset-class idiosyncratic funds are an example of a cost-effective way to increase diversification and improve the efficiency of a target date fund.

[2] http://www.dol.gov/ebsa/newsroom/fsTDF.html

6

DO YOU UNDERSTAND THE UNIQUE NEEDS OF YOUR PARTICIPANTS (AND NONPARTICIPANTS)?

A common theme is ensuring your design is appropriate for your participant base. Participant analytical techniques have significantly evolved, so consider all of the following:

- Perform a cluster analysis — to understand the variety of segments within your participant base.
- Assess participants' financial courage (this has a big impact on the effectiveness of education-type initiatives).
- Consider how participants are using existing investment options.
- Assess participants' relative retirement preparedness.

Analyze nonparticipants as well; maybe it will help you understand what you need to do to get them participating (typically, if you rely on your record-keeper, the nonparticipants will get ignored).

7

SHOULD YOU DELEGATE YOUR FIDUCIARY RESPONSIBILITIES?

We all live in a world where time is precious and we all have increasing demands on our time. With this as a backdrop, what is in the best interests of the plan and its participants?

- Which responsibilities should you as the sponsor keep?
- Which responsibilities would be better served by delegating to a third party?

8

ARE YOU ADEQUATELY MANAGING CYBERSECURITY RISK?

Cyber experts say that it is not a question of if you will have a cyberattack; rather, it is a question of when. In the same way that plan sponsors have policies and procedures in place regarding investments, conflicts and plan expenses, a strategy to address and mitigate cybersecurity risks is recommended.

9

IS IT TIME TO CONSIDER (RECONSIDER) RETIREMENT INCOME OPTIONS?

We are seeing an increasing number of retirement plan sponsors opening up to the idea of retirees taking partial withdrawals from the 401(k) plan.

In addition, the Retirement Enhancement and Savings Act of 2016 includes a number of retirement-income-relevant provisions:

- Provide a much-waited-for safe harbor for the selection of an annuity provider:
  - Provide greater specificity on measures a fiduciary should take.
  - Allow reliance on an insurer's representations related to state insurance status and requirements.
- Require DC plan sponsors to annually provide participants with estimated annuity income generated from plan balance, based on DOL assumptions and guidance.
- Allow greater portability for "lifetime income investments."

Given these developments, we expect more retirement income conversations to take place.

10

HAVE YOU CONSIDERED THE IMPACT OF THE DOL FIDUCIARY RULE?

The recent election result has raised questions as to whether the DOL Fiduciary Rule could be repealed, but, as things stand, key provisions will be in place effective April 10, 2017. Already, we are seeing financial institutions changing their advice services in light of the rule.

As 2017 unfolds, it will be important to understand:

- Whether the DOL Fiduciary Rule will roll out as initially anticipated
- The impact the rule has on you as a plan sponsor
- How your vendors (including your record-keeper) are changing their services to accommodate the rule

Very possibly, the service you initially selected a vendor for may now be quite different, or the vendor's competitors may have changed. With so many changes, should that vendor be reassessed?

11

IS THE INVESTMENT FEE STRUCTURE APPROPRIATE?

We believe the fee focus may have gone too far and that a focus on fees alone is inappropriate; we believe the key is whether the additional expected benefits outweigh the additional fees incurred.

However, for a specific investment strategy, it is in the best interests of participants to pay the lowest fees possible. Investment managers are continually adding new share classes or introducing collective investment trusts, so it is important to establish a process to continually review the investment vehicle you are using to see whether it is the most efficient.[3]

[3] It is worth noting that there has been litigation focused on plan sponsors allegedly failing to switch to lower-cost share classes timeously.

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Arnerich Massena
Building Better Portfolios

The Paternalization of Participant-Directed Plans

Arnerich Massena, Inc.

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The retirement plan industry has been refining and improving the defined contribution system over the last few decades, and many workers now have access to a variety of high-quality investments and in-depth investment education to assist them in planning for retirement, thanks to their employer-sponsored retirement plans. But even with these advantages, many participants are falling far short of their retirement goals. Studies of participant investment behavior indicate that much of the problem lies with the participants themselves.

In this paper, we'll examine the research covering participant investment behavior and how the industry and plan sponsors can address the issue so that the answer to the question, "Is the defined contribution system successful?" becomes an unqualified, resounding yes.

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The Paternalization of Participant-directed Plans

> "The likelihood of investment success increases as the participant's involvement in investment decisions decreases."
>
> ~ *Chang, Simon, Allen, 2005*

Is the defined contribution system successful? The best answer to this question may be a qualified yes. Most experts agree that the system is well-designed, with the proper incentives and structure in place to make it possible for American workers to achieve a secure retirement. However, workers are experiencing significant shortfalls in retirement savings. What is going wrong? Evidence is showing that the flaw in the system may point back to the participants and their investment choices. This is not to lay blame on these individuals, but to recognize that retirement plan participants may be finding themselves overwhelmed by the investment decision-making required of them.

The retirement plan industry has been refining and improving the defined contribution system over the last few decades, and many workers now have access to a variety of high-quality investments and in-depth investment education to assist them in planning for retirement, thanks to their employer-sponsored retirement plans. But even with these advantages, many participants are falling far short of their retirement goals. Studies of participant investment behavior indicate that the much of the problem lies with the participants themselves: "…evidence indicates that as a whole they are woefully unprepared to make their own investment decisions." *(Douthit)*

Some portion of the retirement savings shortfall can be attributed to participants simply not saving enough money. But a significant factor in chronic shortfalls is poor investment results, largely due to poor investment choices. The DALBAR Quantitative Analysis of Investor Behavior attributes a huge 45-55% of poor returns to psychological investor behavior. *(Dalbar, 2013)* The psychological investor behavior that contributes to poor investment outcomes refers to a variety of issues that are explored in some of the research to follow. Participants experience an initial struggle to develop an appropriate asset allocation, often fail to rebalance frequently enough, and make emotional decisions that try to time the market, all of which impact their investment results.

In this paper, we'll examine the research covering participant investment behavior and how the industry and plan sponsors can address the issue so that the answer to the question, "Is the defined contribution system successful?" becomes an unqualified, resounding yes.

The research

A number of studies over the years have compared the investment returns of participant-directed accounts to the returns of index funds, market returns, committee- or trustee-directed defined benefit accounts, and asset allocation accounts like risk-based and target-date funds. Participant-directed accounts, in aggregate, consistently underperform over long periods of time in nearly every comparison. Furthermore, studies that take a close look into participants' asset allocation strategies reveal a lack of diversification that is likely to damage participants' long-term outcomes.

> "MANY PLAN FIDUCIARIES, PARTICIPANTS, AND THEIR ADVISORS, AS WELL AS REGULATORS, HAVE COME TO A HARSH REALIZATION: PLAN PARTICIPANTS GENERALLY ARE NOT SUCCESSFUL INVESTORS."
>
> *~ CHANG, SIMON, ALLEN, 2005*

One of the most thorough, oldest, and well-known studies was performed by the Center for Retirement Research in Boston College by Alicia Munnell, now a renowned behavioral finance researcher. This study, "Investment Returns: Defined Benefit vs. 401(k) Plans," compared 401(k) plan returns to pension returns over the period 1988-2004. The study set out to test the hypothesis that individuals are not very good at investing their money by comparing participant-directed funds with pensions funds managed by professionals. The result? "The bottom line is that over the period 1988-2004 defined benefit plans outperformed 401(k) plans by one percentage point. This outcome occurred despite the fact that 401(k) plans held a higher portion of their assets in equities during the bull market of the 1990s." *(Munnell et al, 2006)* One percent may not seem significant, but consider that, for example, $50,000 invested for 25 years will earn almost *$57,000 more* at a 7% rate of return than at a 6% rate of return.

The underperformance, however, was not the only issue the study uncovered. "The other is that despite a reasonable mix for 401(k) assets in the aggregate, nearly half of 401(k) participants are either nearly fully invested in stocks or hold no stocks at all. That is, nearly 50 percent of participants are not diversified in their retirement accounts." *(Munnell, 2006)*

Towers Watson has been studying and comparing defined benefit and defined contribution plan investment returns for more than ten years. Their conclusions are similar: "DB plans outperform DC plans by roughly an average of 1 percentage point per year." *(Towers Watson, 2009)* "DB plans have been earning higher returns than their DC counterparts since 1999." *(Towers Watson, 2011)* In the most recent study, Towers Watson discovered an anomaly to this pattern; DC plans outperformed DB plans during the bull market of 2009, their heavier weight to equities resulting in better performance. However, that same larger asset allocation to stocks hurt DC plan performance during bear markets. "During a bear market, DB plans outperformed their DC counterparts by roughly 2.5 percentage points." *(Towers Watson, 2011)* Because participants tend not to rebalance their portfolios, outperformance during up markets can turn against them on the other side of the market cycle. Other studies found a similar phenomenon; participant accounts fared slightly better during bull markets due to an overweight of stocks, but suffered more during bear markets for the same reason.

The DALBAR Quantitative Analysis of Investor Behavior (QAIB) makes a slightly different comparison, examining "average investors," the universe of all mutual fund investors, who represent participant-directed assets, versus "asset allocators," or those invested in an asset allocation fund such as a balanced fund, target-date, or risk-based fund. The "asset allocators" are divided into quartiles, based on four-year performance returns, to allow separate comparisons to different tiers of allocators.

The QAIB demonstrates a huge gap between average investors and asset allocators during down markets. For instance, "the analysis shows that in a down year (2008) where average equity investors lost 41.66%, the average asset allocation investor lost significantly less, 30.53%. This is an eleven point advantage for the asset allocation investor in the down market." *(Dalbar, 2013)* The return for the same period for the top quartile of allocators was -21.63%, a 20% advantage over average equity investors for the period. That the top tier of asset allocators had such an impact on return should serve as a reminder of the importance for plan sponsors to be diligent in their selection of asset allocation solutions. The QAIB, unlike Towers Watson, found that even in up markets, as characterized by 2012, average investor returns suffered relative to asset allocators; the average investor return in 2012 was 8.83%, compared with asset allocation returns ranging from 10.19% to 13.68% in the top quartile. *(Dalbar, 2013)*

Vanguard conducted research on performance during the five-year period from the end of 2007 to 2012, comparing defined contribution participants' investment returns to the professionally managed allocations of target-date funds. The study found that participant returns varied widely during the period, given participants' broad range of investment strategies. "Some participants may invest their entire portfolio in equities, while others invest exclusively in low-risk assets, such as money market or stable value funds.... As a result, participant total returns tend to be dispersed or distributed over a wide range." *(Lamancusa, et al, 2013)* Annualized investment returns for participants managing their own investments ranged from -1.7% to 6.3%, with the median being 2.3%.

During that same period, participants who were invested in a target-date fund experienced returns ranging from 1.7% to 3.7%. The narrower dispersion was also reflected in the volatility of portfolios; target-date investors experienced much less volatility (as measured by standard deviation) than do-it-yourself allocators. The study's authors note that "we believe that this reduction in dispersion of outcomes is attractive to plan fiduciaries, as it demonstrates both improved investment discipline and risk control in participant portfolios. This result also is gradually mitigating concerns about the quality of investment choices being made by inexperienced plan participants." *(Lamancusa, et al, 2013)* Higher volatility is generally punitive to wealth accumulation, as it can result in larger drops in value of an investor's portfolio.

Fidelity also recognized that participants who were investing on their own were struggling. "A recent Fidelity survey of 3,100 NetBenefits® participants found that 77% admitted to not having the time or investment knowledge to be confident in their investment decisions, yet many try to make their own investment choices." *(Fidelity, 2013)* Fidelity took a look at do-it-yourself participants' asset allocations with some surprising results. Thirty-three percent of participants held more than 90% of their assets in stocks, including 27 percent of baby

"In short, the practice of allowing participant direction within a 401(k) plan is generally not a good one for helping plan participants retire comfortably."

~ Chang, Simon, Allen, 2005

boomers, despite being close to retirement. On the other end of the spectrum, 12 percent of participants were holding less than 10% of their assets in equities. Almost 90 percent of do-it-yourself participants had not made a change to their investment allocation in the past year, suggesting that they may not be adequately monitoring or properly rebalancing their accounts. *(Fidelity, 2013)*

The conclusion that people are beginning to draw from these studies is that participants in defined contribution plans may need more help making appropriate investment choices. Concerns about underperformance and poor diversification echo participants' own requests for more help and more advice. It may be time to consider returning to a more paternalistic approach to retirement savings.

> "The rapid growth in professionally managed allocations — most notably, target-date funds, but also traditional balanced options and managed account advice services — is contributing to a reduction in extreme risk and return outcomes for participants. It is also gradually mitigating concerns about the quality of portfolio decision-making within DC plans. Plan sponsors should consider greater adoption of these strategies to encourage better risk control and investment discipline in DC participant portfolios."
>
> ~*Lamancusa, et al, 2013*

PATERNALIZING PLANS

Imagine yourself as a new employee at your first enrollment meeting. An investment expert stands up in front of a PowerPoint™ presentation and describes the difference between stocks and bonds, then begins to talk about something called "asset allocation," a term you've never heard before. As you listen to phrases like "asset classes" and "equity funds," you begin to think about what you're going to have for dinner. It all sounds great, but when you're handed an enrollment form, you look at the list of 35 investment options and feel overwhelmed. You know that you are supposed to diversify, and you took a risk tolerance quiz in the enrollment meeting that identified you as a "moderate" investor. But you're not quite sure how to translate that into choices on the enrollment form. Ultimately, you choose three or four options and divide your contributions evenly among them. When you turn in the form, you are determined to remember to do something called "rebalancing," but the thought flees your mind within moments of returning to your busy desk.

This story may not be representative of all participants, but it encapsulates an experience common to many participants. Over the 1980s and 1990s, defined contribution plans became a primary savings vehicle for many Americans, taking the place of the traditional pension, or defined benefit, plan. With that shift, investment decision-making passed from expert hands into the hands of participants. Early defined contribution plans, intended as supplemental retirement savings, offered a small handful of investment options, making it fairly simple for plan participants to allocate their assets. But as defined contribution plans became a primary savings vehicle, the structures of many plans shifted to accommodate this new reality. In an effort to help participants be successful, many plan sponsors increased the number of investment options available with the hope that a robust plan would result in robust performance.

In essence, we shifted from a defined benefit mentality, in which retirement savings were fully managed for people, to early defined contribution plans, with a few simple options, to very complex plans demanding sophisticated investment acumen to navigate through decisions. For a time, then, education seemed to be the answer. Over the past two decades, participants have been inundated with investment education — in person, in print, and online. Great strides have been made to provide education that is accessible and friendly. However, investment education appears to have done little to improve participants' investment choices and thus investment returns. The direction in which the industry is turning now is toward the paternalization of retirement plans.

"Paternalization" is about benevolent guidance, such as a parent would provide to a child, not about dictating or eliminating choices. Paternalization means offering participants a path by which their retirement savings are managed by professionals, and by which all decisions can be taken care of for them, from enrollment to contribution rates to contribution increases to asset allocation. It is, in a way, a return to the defined benefit mentality, but this time allowing participants to opt out and make their own decisions should they choose to do so.

The increase in popularity of automatic enrollment and automatic contribution is an indication of a growing culture of paternalization in the defined contribution universe. Participants seem to be not only accepting the "do-it-for-me" paternalistic approach, but embracing it. Surveys repeatedly show that a majority of participants want help in retirement planning, and that a significant number are happy to turn over the responsibility to professionals.

How do we extend paternalization to investment choices? A number of options exist to relieve participants of investment decision-making and put asset allocation back into the hands of investment experts. Risk-based portfolios, target-date funds, balanced funds, and managed funds are all potential solutions that, as noted earlier, are likely to provide better, more consistent long-term returns with lower volatility, potentially improving ultimate participant outcomes in retirement.

Investment solutions: A brief comparison

Professionally-managed, one-stop shopping investment solutions for participants have been evolving, and different forms offer different advantages and features (see Table 1 for a comparison overview). Common to most asset allocation options is that employers are able to designate them as qualified default investment alternatives (QDIAs), specifically provided for by ERISA Section 404(c) to alleviate plan fiduciaries from responsibility for participants' default investment in the options, assuming certain conditions are met. This allows asset allocation options to be used not only as options in a plan line-up, but as the default option for participants who do not make a proactive investment decision.

Balanced Funds

Balanced funds are the simplest and most basic of asset allocation options; a balanced fund combines equity and fixed income instruments in a particular percentage mix. Most balanced funds are automatically rebalanced periodically to their target allocations. Balanced funds can satisfy QDIA requirements and provide participants

Table 1 Comparing Asset Allocation Options

	Simple investment portfolio decision	Professionally-managed asset allocation	Fulfills QDIA criteria	Targeted to participant risk profile	Targeted to participant time horizon	Managed glide path
Balanced Funds	✔	✔	✔			
Risk-based Funds	✔	✔	✔	✔		
Target-date Funds	✔	✔	✔		✔	✔
Managed Accounts	✔	✔	✔	✔	✔	✔

with a diversified mix of investments; however, balanced funds are not specifically targeted to participants' risk tolerance or time horizon — they are usually delivered as "one-size-fits-all" options.

Risk-based Funds

Risk-based portfolios are designed to meet specific risk and return objectives that generally do not change over time (e.g. conservative, moderate, and aggressive), and are invested broadly in various asset classes to provide diversification and maximize risk and return efficiency. Risk-based funds are typically rebalanced automatically to their target allocations. These portfolios allow participants to select an appropriate option based on their personal risk profile. However, because the funds maintain a static allocation, participants may need to review their risk tolerance profile periodically to ascertain whether they are invested in the most appropriate selection. When used as a default option, it is typically the "moderate" portfolio that becomes the default investment selection. Risk-based funds may be custom-built using the plan's underlying fund options to create the portfolios.

Target-date Funds

Target-date retirement funds consist of a series of funds named for "target dates" that align with the date participants anticipate retiring. The funds' portfolios are managed to optimize risk and return over time by investing broadly in various asset classes to provide diversification, and adjusting the mix of assets as the target date approaches to become more conservative as the investor nears retirement. Target-date funds provide participants with an investment option that matches their time horizon but is not necessarily customized to their risk preferences.

"'Most participants recognize their lack of investing expertise,' says Bob Wuelfing, president of RG Wuelfing & Associates, a leading retirement industry research and consulting firm. 'When we survey participants about their needs in managing their defined contribution accounts, the most common response we get is 'Tell me what to do.' Many employees are insecure about the investing process, and prefer professional advice to going it alone,' Wuelfing says."

~McLeod, 2008

A number of providers offer suites of off-the-shelf target-date funds, or alternatively, plan sponsors can create custom target-date funds using the underlying investment options in the plan. In either case, it is important for plan fiduciaries to understand how the "glide path," or shift in investment allocation over time, is constructed and managed. In some target-date funds, the funds shift to mostly fixed income by the time the target date arrives, whereas others may continue to invest largely in equities under the assumption that investors will continue to be invested until long after their retirement date. Choosing the right target-date funds with appropriate glide paths will depend upon your participant population and objectives.

Managed Accounts

Managed accounts offer participants an option whereby their personal information is used to construct an appropriate asset allocation. Factors that may contribute to the portfolio strategy development may include deferral rate, account balance, risk profile, age, expected date of retirement, and any additional retirement savings such as a spouse's account. Managed accounts will create a personalized asset allocation based on the inputs, usually using the plan's existing investment options. Rebalancing occurs automatically, and the asset mix may be adjusted as the individual factors change over time. A key fiduciary point of consideration is that participants in managed accounts may incur a significant management fee in addition to the expense ratios charged by the individual funds utilized.

CHOOSING AN ASSET ALLOCATION OPTION

People don't like to ask for help, especially in our culture of fierce independence. The unfortunate result has been nearly a generation of workers experiencing unnecessary underperformance of their retirement savings investments and high anxiety about making retirement planning decisions. Are your retirement plan participants in need of investment assistance — and should your plan offer an asset allocation option to participants? If so, which option would best suit your employees, and provide the solution at a reasonable cost?

"PLAN SPONSORS CAN OFFER A POWERFUL COMBINATION OF EFFECTIVE ASSET ALLOCATION FOR THEIR PARTICIPANTS."

~FIDELITY, 2013

We recommend that you work with your advisor to examine the needs of your participant population and tailor a solution to your plan. You'll want to explore the advantages and disadvantages of different options as they relate to your organization and consider how to best fulfill your fiduciary responsibility. Begin by taking these fundamental steps:

- Review your plan to determine an appropriate level of paternalization.
- Make sure you have one or more asset allocation options in your plan.
- List asset allocation option(s) first among choices on enrollment forms.
- Select an appropriate default option for participants who do not make a proactive investment selection.
- Simplify your investment line-up to reduce the chance participants will make poor investment choices.

The information provided in this paper can provide a starting point for exploring whether paternalization is a path your plan should follow, and where it will lead.

ENDNOTES:

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