Goldman Sachs Asset Management

White Paper

Re-Tooling 401(k) Plans for Success: Targeting Participant Behaviors

Many consider September 20, 1980—the birthday of the 401(k) plan—a pivotal day in modern history. However, the 401(k) plan, the vaunted social experiment in individualizing the retirement planning process, may not be able to meet the lofty expectations of its proponents. Simply stated, nearly 30 years later, the 401(k) plan is not meeting the retirement investment needs of millions of plan participants. The 401(k) plan has evolved over the years from being a supplemental savings program to being the primary retirement funding vehicle for most American workers. In 1979, 62 percent of workers in retirement plans participated only in defined benefit pensions; by 2005, 63 percent participated only in 401(k) plans.[1] Without changes in the 401(k) model, the retirement needs of many will not be met. This failure could have serious social and economic repercussions.

[1] Employee Benefits Research Institute

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In *Next Generation Investing: Designing a Secure Retirement Plan*, we highlighted the framework that Defined Benefit (DB) plans are using and ways that framework may be applied to the defined contribution participant. The goal for this paper is to review the weakness of the current 401(k) system and identify potential alternatives that may stabilize and strengthen the 401(k) plan for many individuals. The goal is to provide actionable steps that address the various investing behaviors of 401(k) participants.

Back to the Future: Defined Contribution Plans Adopt Defined Benefit Approaches

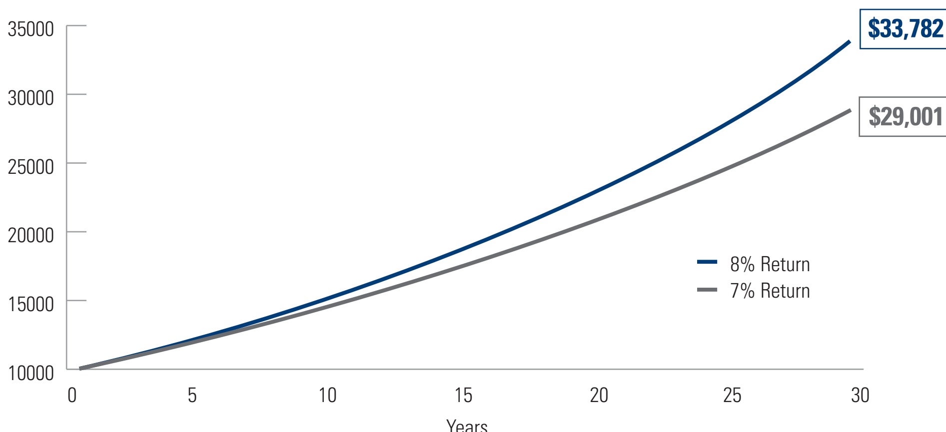
In order to understand the weaknesses in the current 401(k) system, it is important to recognize the differences between the 401(k) and defined benefit plan environments. The defined benefit pension system evolved after World War II and remained the primary pension delivery mechanism until the 1990s, when the 401(k) plan supplanted the defined benefit plan as the primary retirement savings vehicle. It is beyond the scope of this paper to address the forces responsible for the decline of the defined benefit plan and the rise of the 401(k) plan. However, it is important to understand certain features of the defined benefit model that have been used to provide adequate retirement benefits for many individuals.

One of the reasons Defined Benefits have been able to provide adequate retirement benefits, has been the returns they have been able to generate. Overall, studies have shown the investment returns achieved by DB plans are higher than those achieved by DC plans. Here's an example. Defined benefit plan assets are professionally managed whereas 401(k) plan assets are typically participant-managed. A study by the Center for Retirement Research at Boston College found that over the period 1988-2004, the investment return of defined benefit plans outperformed 401(k) plans by one percent.

> 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. Part of the explanation may rest with higher fees, which are deducted before returns are reported to participants. But the one percentage point shortfall understates the investment problem in 401(k) plans, since an aggregate number does not reflect the fact that more than half of participants in 401(k) plans do not follow a prudent investment strategy of diversifying their holdings.[2]

Although a one percent difference may not sound like much, the illustration below shows the difference that one percent can make over a 30 year period:

Difference Between an 8% return and a 7% return, based on an initial investment of $10,000



Source: Goldman Sachs Asset Management

[2] Alicia H. Munnell, Mauricio Soto, Jerilyn Libby, and John Prinzivalli, *Investment Returns: Defined Benefit vs. 401(k) Plans*, Center for Retirement Research, September 2006

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Another reason Defined Benefits have been able to provide superior retirement benefits is how they are administered. Administering and maintaining a defined benefit plan is a complex and costly undertaking for an employer. However, despite the cost and complexity, the defined benefit plan is elegantly simple from the perspective of the individual participant. The simplicity is based on how the defined benefit plan operates. While individual models differ, generally the employee provides service to an employer for the requisite number of years, retires, and, under an annuity option, receives a monthly check for as long as he/she lives. Effectively, once employees satisfy basic eligibility requirements, they do not have to "do" anything to participate in a defined benefit plan; they do not have to complete a form to elect to reduce their pay, they do not have to understand investment theory, nor make investment decisions. Their benefits simply begin automatically when they retire.

Contrast the defined benefit plan participant's experience with that of the typical 401(k) plan participant's experience. First, if an eligible employee in a 401(k) plan does nothing, he/she will not participate in the 401(k) plan (unless the employer utilizes an automatic enrollment feature discussed later). In other words, workers must sort through what may be a morass of paperwork they receive once they are eligible to participate, and execute the appropriate forms before they can contribute. For many employees who are not immediately eligible to participate in their employer's plan, it may be months, or as long as a year, before they even receive the paperwork that needs to be completed in order to enroll. This enrollment information can be complex and confusing and little support may be provided to help the participant navigate through the paperwork. Despite this, the individual must successfully complete the forms and submit them to the right individuals in the benefits or human resources area.

For participants, the 401(k) plan decision-making process can be daunting. Participants are asked to choose whether to reduce their compensation, if so, by how much; and to make investment decisions with respect to the amounts contributed. Investment concepts such as diversification, rebalancing, asset classes, time horizons, and the nature of risk are critical investment concepts that may not be well understood by many.[3] Although plan sponsors have increasingly made financial planning tools and calculators available to their plan participants to help them make these important decisions, few have taken advantage of them.

The weakness in the 401(k) model is manifested in some lackluster statistics. First of all, the participation rate in conventional 401(k) plans is relatively low. While everyone eligible in a defined benefit plan automatically participates, the average plan participation rate in 401(k) plans in 2007 was 82 percent.[4] Employees simply are not signing up to participate in 401(k) plans at the levels expected. And, even if an employee chooses to participate, deferral rates are low. The average overall deferral rate in 2007 was 5.6 percent.[5] A third of 401(k) plan participants fail to defer enough to receive the full employer matching contribution, if one is offered in their plans, and 60 percent may be receiving the full employer match, but are not saving to the pre-tax maximum level allowed.[6] Those who are participating are generally not setting aside enough money to adequately fund their retirement. The average 401(k) account balance at the end of 2007 was $65,454.[7]

[3] Lusardi, Annamarie and Mitchell, Olivia S., "How Much Do People Know About Economics and Finance? Financial Illiteracy and the Importance of Financial Education," *University of Michigan Retirement Research Center Policy Brief*, March 2008

[4] *51st Annual Survey*, Profit Sharing/401(k) Council of America, 2007

[5] Ibid.

[6] *The Financial Engines' National 401(k) Evaluation: Who Benefits From Today's 401(k)*, Financial Engines, 2008

[7] *EBRI Issue* Brief No. 324 • December 2008 • www.ebri.org

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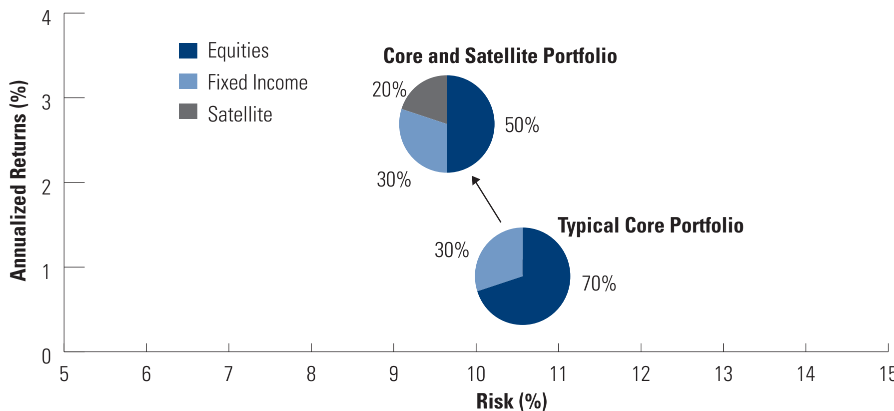
Asset class choice is another problematic area within 401(k) plans. Most plans limit their investment lineups to traditional asset classes (e.g., stocks, bonds, and money market instruments) or what we call "core" investments. This limited menu may be easier for participants to understand but it can also limit their ability to diversify. Institutional investors typically have a broader range of asset classes available to them from which to diversify. Alternative asset classes, or "satellites", are often less correlated — their tendency to move somewhat independently — to the core assets and do not move in the same direction, at the same time, as traditional asset classes. They can benefit investors during various market cycles by providing a higher level of diversification, which can potentially reduce risk. These alternative asset classes, which are rarely offered in defined contribution plans, may include emerging markets, debt instruments, commodities, venture capital, buy-out funds, gold and precious metals, etc. The average institutional investor's allocation consists of 60 percent stocks, 27 percent bonds and 12.5 percent alternative investments, whereas the average 401(k) plan participant's allocation consists of 68 percent stocks, 30 percent bonds and just three percent alternatives.[8] (As discussed in our first white paper, *Next Generation Investing: Designing a Secure Retirement Plan*, we provided examples of how broader diversification may affect hypothetical participant outcomes.)

As the following graphic illustrates, research has shown that the addition of new asset classes can improve returns for a given level of risk, although past performance is no guarantee of future results.

Typical Core and Core/Satellite Portfolios: Hypothetical 10-year risk/return

January 1999–December 2008



Periods ending December 31, 2008. These hypothetical portfolios are intended to demonstrate the benefit of implementing a "Core and Satellite" asset allocation strategy and are not representative of any Goldman Sachs product. A "typical core" portfolio consists of 70% core equities [includes an 85% allocation to core U.S. equities that was modeled with the S&P 500 index and a 15% allocation to core international equities that was modeled with the MSCI index] and 30% core bonds [includes an allocation to core fixed income that was modeled with the Lehman Aggregate index]. This is representative of many portfolios we encounter in practice; it is not a recommendation. A diversified "core and satellite" portfolio consists of 20% of the "hypothetical satellite combination" [funded from the equity component of the "typical core" portfolio. The specific allocations were 42.5% core US equity, 7.5% core international equity, 30% core fixed income, and 20% in the hypothetical satellite combination. The hypothetical historical returns were created with the benefit of hindsight using the percentage allocations indicated above. Any changes will have an impact on the hypothetical historical performance results, which could be material. Hypothetical performance results have many inherent limitations and no representation is being made that any investor will, or is likely to achieve, performance similar to that shown. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently achieved.

Inefficient or risky diversification levels by participants can exacerbate shortfalls in 401(k) plan accounts and, unfortunately, a large percentage of participants fall short when it comes to achieving appropriate levels of diversification. Over two-thirds (69 percent) of participant 401(k) accounts are to some degree inefficiently and/or inappropriately diversified.[9]

[8] *Pension & Investments and Strategic Insight* as of May 31, 2007

[9] *The Financial Engines' National 401(k) Evaluation: Who Benefits From Today's 401(k)*, Financial Engines, 2008

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Active management of their portfolios is not a process most 401(k) plan participants understand or engage in. Most participants select an investment strategy and never modify it. Ninety percent of participants do not rebalance their portfolios.[10] Unfortunately, when participants have taken an active role in their asset allocation, they have tended to trade on short-term market movements.[11] Comparatively, defined benefit plan sponsors frequently use consultants to build portfolios for their plans, and typically have investment committees that meet regularly, and use tools and processes, to monitor and analyze their portfolios, and rebalance them when appropriate. Broader ranges of investments are utilized. These individuals and committees are connected with industry associations and employ the latest in investment theory to build and maintain efficient and diversified portfolios.

Finally, another hurdle facing participants in defined contribution plans is the process of converting retirement assets into sustainable retirement income. According to Olivia S. Mitchell, Executive Director of Wharton's Pension Research Council, the financial industry has "devoted substantial attention to the accumulation portion of the life cycle—focusing people on saving more for retirement and diversifying their retirement savings. What has been sorely missing is a concerted analysis of risk management during the retirement payout phase."[12] A 2008 Gallop Poll found that more than half of 30- to 64-year-olds in the United States say they are worried they will outlive their money after they retire.[13] Plan participants have not yet begun to understand asset draw-down strategies.

Changes and Improvements to the 401(k) System

Fortunately, the industry has made progress in addressing some of the structural problems within 401(k) plans. In 2006, Congress responded to some of these concerns by enacting the Pension Protection Act of 2006 (PPA-06). PPA-06 created incentives and safe harbors that permit participants to be automatically enrolled in their 401(k) plans, and have their deferral levels automatically increased on an annual basis. Furthermore, Congress and the Department of Labor (DOL) created and sanctioned qualified default investment alternatives (QDIAs) for use in self-directed 401(k) plans. The QDIA is a default plan investment option that employers may use when participants fail to provide investment guidance *[To read more about QDIAs, review the Appendix]*. PPA-06 began the process of making the 401(k) enrollment and decision-making process less burdensome to the individual by making it more automatic. The effect of these changes was to make defined contribution plans operate more like traditional pension plans in certain respects; although the law changes of PPA-06 were a good start, additional issues remain that must be addressed.

In the 401(k) plan environment, good investment returns with limited volatility are essential in order to maximize the number of participants who will accumulate sufficient assets to fund successful retirements. As was noted earlier, participant investment returns need improvement. While Congress streamlined the enrollment process by creating automatic enrollment and automatic escalation provisions, and began to address the problem of poor investment selection with QDIAs, plan sponsors should consider doing more to address the investment return issue.

[10] *Building Futures Vol III, A Report on Corporate Defined Contribution Plans*, Fidelity Investments, 2007

[11] *Rebalancing Activity in 401(k) Plans* by Julie Agnew and Pierluigi Balduzzi, 2006

[12] *You've Worked Hard, Saved and Just Retired: How Do You Manage Your Finances Now?*, Knowledge@Wharton, June 13, 2007

[13] http://www.gallup.com/poll/104605/Many-Americans-Fear-Theyll-Outlive-Their-Money.aspx

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Profiling Participants

Before addressing the investment return challenge, it is essential to first identify the types of investors participating in 401(k) plans. The characteristics and behaviors of various participant groups must be understood before alternatives appropriate for each participant profile can be considered.

The first step to improving individual outcomes is to understand participant behaviors and outlooks on plan participation and investing. One approach that may aid in the assessment involves segmenting 401(k) plan participants into sub-groups based on their approach to the investment decision-making process. For example:

- **"Do-It-For-Me" —** This group generally does not want to make, or perhaps feels unqualified to make, investment decisions. This group is completely comfortable delegating investment decisions to others and typically represents the largest segment of the employee participation.
- **"I-Need-A-Little-Help" —** These individuals want to be involved in the decision process to make sure it meets their needs but don't feel they have the level of expertise or time to explore their options. They are looking to an advisor to select quality investment options for them.
- **"Do-It-Myself" —** Although this group is typically a small percentage of plan participants, they tend to be the most vocal. These individuals understand key investment concepts and issues. They are confident. They want choices, options, and information. This group sets the standard and pushes the envelope.

Understanding Fiduciary Obligations of the Plan Sponsor

Under the Employee Retirement Income Security Act of 1974, as amended (ERISA), fiduciaries are held to a prudent man standard of care. Under the prudent man standard, the DOL evaluates plan fiduciaries' actions against those of a hypothetical prudent man acting under similar circumstances. Under the prudent man standard, there is an overriding expectation that a plan fiduciary have in place and follow a prudent investment decision-making process. Therefore, it is important for a plan fiduciary to clearly document the decision-making process for the plan, and the rationale applied in making key decisions.

Plan investment decisions can be virtually infinite. Fiduciaries must review investment decisions regularly to ensure they continue to meet the needs of the participants and adequately protect the plan sponsor and other fiduciaries.

Improving investment performance for participants is an important objective for plan sponsors and other fiduciaries. Resolving to achieve this objective within a prudent fiduciary decision-making framework is important. Institutional-level investment alternatives and strategies that have served defined benefit plans may , in many cases, be readily adaptable to the 401(k) environment. For example, leveraging an employer's defined benefit plan investment research, and applying similar oversight and review mechanisms, can streamline the fiduciary oversight process and reduce costs. Furthermore, these strategies, because they are already utilized by experts within the pension field, can help defined contribution plan fiduciaries meet the required "prudent standard." In particular, employing the defined benefit plan concepts of pricing, leveraging, and the use of extended asset classes to address the 401(k) investment return dilemma can be quite effective.

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The plan sponsor's role is one of evaluating, deploying, and monitoring investment solutions for each group. This process can be costly and time consuming. A key objective of a plan sponsor should be the leveraging of investment options across all three groups. Leveraging the investment options offered to participants has several advantages. First, the monitoring process for investments is simplified; and second, the increased asset levels involved should provide sway in reducing fees and expenses. Therefore, leveraging investment options within the plan can be a cost-effective way to address less than optimal investment return issues.

Participant Groups	Defined Contribution (DC) Investments
"Do-It-For-Me" Group	Prepackaged Options: *Option 1: Target-Date Funds* ■ Proprietary target-date funds, or ■ Customized target-date portfolios using existing DC options *Option 2: DC managed account*
"I-Need-A-Little-Help" and "Do-It-Myself" Groups	"Core" Investments ■ High quality, limited investment options that span across a wide range of asset classes ■ Promote asset class and not the manager ■ Utilize institutional asset managers when possible ■ Use multiple managers for large asset classes "Satellite" Investments ■ Pre-packaged option that combines satellite strategies ■ Stand-alone satellite asset classes (e.g. international real estate, commodities, etc.) Note: Limits on the purchase of each satellite investment (e.g. no more than 10% of account value can be purchased in any individual satellite investment), should be considered
"Do-It-Myself" Group	Self Directed Options ■ Self directed brokerage ■ Mutual fund window

Investment Strategies for Participant Groups

Developing an effective defined contribution plan investment lineup requires meeting the needs of all plan investors, while applying the latest thinking in portfolio construction. This theory can be applied by returning to the previously identified participant groups. Within this framework, defined contribution plans may want to consider a tiered investment structure as outlined in the following table.

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Pre-packaged Options

Recall that the "Do-It-For-Me" group has little interest in making investment decisions, and is generally not willing to spend time learning investment theory or concepts. To a large degree, a QDIA investment strategy can meet this group's investment needs. Since this group often represents the vast majority of plan participants, they also offer the greatest liability. The plan's QDIA strategy is important not only in meeting the needs of the "Do-It-For-Me" participants, but also in controlling fiduciary liability for the plan sponsor.

If a plan sponsor seeks to utilize a QDIA strategy, it is essential that he/she fully comprehend what constitutes a QDIA. This understanding can help protect the plan sponsor from potential liability, and can help in the QDIA selection and monitoring process. Understanding QDIAs requires an understanding of a practical reality of 401(k) plan administration. In the "real" 401(k) plan world, sometimes participants elect to make salary deferrals but do not provide specific investment instructions for the contributions. This lack of direction poses a predicament for plan fiduciaries. In this situation, the plan sponsor could invest the dollars in the plan's QDIA. In other words, if the participant fails to make an investment election, the QDIA becomes the plan's default investment vehicle.

Plans have been using default investments options for years. Why, then, is it important that a plan's default investment option qualify as a QDIA? Using a QDIA as the plan's default investment reduces the fiduciary's liability under the ERISA 404(c) rules. Most 401(k) plan sponsors elect to follow the ERISA 404(c) rules because doing so reduces the plan sponsor's fiduciary liability with respect to the investments selected by plan participants. Under ERISA 404(c), the liability for investment performance is shifted from the plan sponsor and other plan fiduciaries, to the plan participants. Under the ERISA 404(c) rules, as modified by PPA-06, QDIAs offer fiduciary safe harbor protection and therefore are attractive default investment options for plan sponsors seeking protection from fiduciary liability under ERISA 404(c).

Use of a QDIA can be an important element of an overall fiduciary liability containment strategy for plan fiduciaries, and an investment strategy that could apply for all three participant groups. For more information on what types of investments qualify as a QDIA, please refer to Appendix A located at the end of this paper.

Many QDIAs Are "Target-Date" Funds

Often a target-date fund will be the plan's QDIA. The unique nature of target-date funds makes them a popular investment choice.

In addition to the potential to increase investment returns and to reduce risk that target-date funds may offer, the simplicity inherent in the set-it-and-forget-it nature of target-date funds makes them a potential investment option for the plan's QDIA and the "Do-It-For-Me" crowd. Recall from earlier paragraphs of this paper the discussion surrounding the ability of defined benefit plans to deliver retirement results and a simplistic participant experience. In the defined benefit plan model, participants provide service for the employer, retire, and receive their promised retirement benefit. The goals of the target-date fund are similar: deliver effective retirement results and a no-fuss participant experience. From the participants' perspective, the target-date

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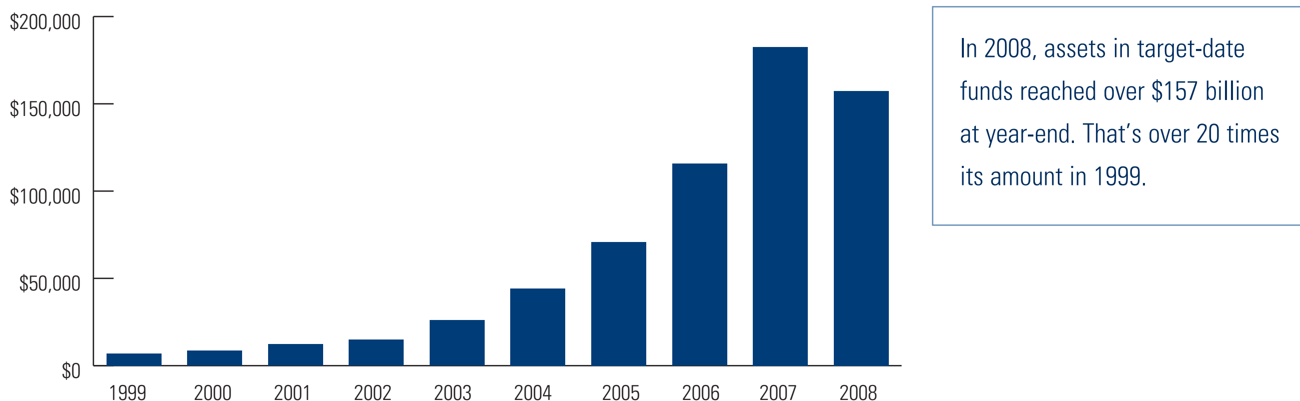
investment choice is one of "set it and forget it." The fund's characteristics and risk profile change as the fund approaches the target-date. This occurs automatically. Theoretically, individuals in a target-date fund need not concern themselves with making ongoing investment decisions such as asset allocation, rebalancing, and glide path (described later). However, the employer provides no guarantees with the target-date fund.

Target-date funds, while a relatively new type of investment option, may be effective in increasing investment returns. Research by the Pension Research Council reveals a number of the "before" and "after" effects of adding target-date funds to plans' investment menus. The study involved 250 plans and approximately 250,000 participants. With respect to investment returns, on average, participants in the study experienced a quarter of a percent increase in their systematic rates of return after investing in target-date funds.[14] Although this result may seem small, it could result in thousands of additional dollars at retirement, which could greatly affect participants' ability to meet their retirement income needs. Looking at it in another way, a 0.25 percent deficit over a long investment time horizon, can add up to substantially lower wealth. A seemingly small inefficiency of 0.25 percent compounded annually leads to almost 10 percent less wealth after 40 years, given the same starting balance.

FRC Net Sales



Source: Financial Research Corporation

Despite their popularity, target-date funds pose unique challenges for employers and their advisors. The key challenge is the target-date fund evaluation and monitoring process. Target-date funds (and QDIAs) are subject to the same fiduciary standards of scrutiny as other plan investments, and must meet prescribed benchmarks. In addition, the fees and expenses associated with target-date funds must be appropriate relative to the value provided.

[14] Olivia S. Mitchell, Gary R. Mottola, Stephen P.Utkus, and Takeshi Yamaguchi, *The Dynamics of Lifecycle Investing in 401(k) Plans*, Pension Research Council, October 2007

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Sponsors of larger plans may consider having the target-date funds customized with the plan's core investment options. Benefits of a plan-customized, target-date fund include the ability to:

- Control the underlying fund managers;
- Customize the funds to the organization's special circumstances, for example, by taking into consideration a business' generous defined benefit plan;
- Leverage the plan's core investment options, which can help maintain consistency, allow for lower pricing through volume discounts, and reduce time spent on monitoring core funds; and
- Promote consistency with the management approach utilized within defined benefit plans.

The availability of a broad range of target-date funds presents many challenges for employers and advisors. For example, funds with the same target-date, such as 2030, may have significant differences in their underlying composition and investment philosophies. This diversity makes benchmarking and evaluating target-date funds difficult. Evaluating target-date funds is more subtle and complex than, for example, evaluating large cap growth funds.

Part of the problem with the target-date fund evaluation process is their relative youth. Over the last several decades, a generally agreed upon evaluation process and metric for target-date funds has developed based on the evaluation process of traditional funds such as large cap growth and small cap value. However, applying the same screening and monitoring criteria to this new investment genre is not optimal. The metric and evaluation mechanisms of target-dates funds remain in their infancy. This puts additional onus on plan fiduciaries to ensure their selection process is appropriate and well documented.

What are some of the unique aspects of target-date funds? At a high level, the general premise of the target-date fund is one that requires the underlying portfolio to become increasingly conservative as the target-date approaches. Traditionally, this has meant a decrease in equity positions and a corresponding increase in debt positions over time. While all target-date funds adhere to this general concept, the actual execution of this philosophy can be vastly different among target-date fund managers.

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Target-Date Considerations

Glide Path

The concept of glide path has received a lot of focus in the target-date fund evaluation process. The glide path is the degree by which the fund becomes increasing conservative as it approaches its target date. However, ideally, an evaluation of the glide paths of two target-date funds should be an "apples-to-apples" comparison. For example, obviously one cannot compare a 2020 target-date fund to a 2040 target-date fund. The comparison must be of like target-date funds (e.g., one 2020 fund with another 2020 fund). Moreover, the 2020 funds should have similar investment philosophies in order to produce a valid comparison. Comparing a fund with a large equity position at the target-date to a fund with a lower percentage of equities at the target-date also makes comparison difficult. The following illustrates this issue.

Example

The ABC 2020 target-date fund assumes an individual retiring in 2020 remains in the fund until death. Consequently, the ABC 2020 target-date fund actually has a much longer time horizon than the name implies.

Conversely, the XYZ 2020 target-date fund assumes an individual retiring in 2020 will roll the money over to an IRA, and create a retirement income stream from the IRA. Therefore, comparatively speaking, the XYZ 2020 target-date fund time horizon is shorter than the one for the ABC target-date fund.

Neither philosophy is right or wrong–just different. But comparing the ABC target-date fund to the XYZ target-date fund would not necessarily be an apples-to-apples comparison because of the differing time horizons.

Asset Classes

The types of asset classes used are another dimension of the target-date fund evaluation process. Some target-date funds invest in a relatively narrow range of traditional asset classes. Other funds use a broad range of nontraditional asset classes or "satellites" such as real estate and commodities. A consideration of the range of asset classes and types included in the fund should be part of the evaluation process. Our research has shown that proper use of these satellite asset classes can have a significant positive effect on participants' ability to meet their future retirement income needs. In fact, proper exposure to these satellite classes may have a much more significant effect on participant outcomes than the glide path used by the fund.

Manager Experience

There have been dozens of new target date funds added to the marketplace in the last couple years. Since these funds do not have the long-term track records typically used to evaluate funds, it is important to review the experience and track record of the managers operating these funds. Of particular importance is how long they have been managing asset allocations funds or models, and how well they have done.

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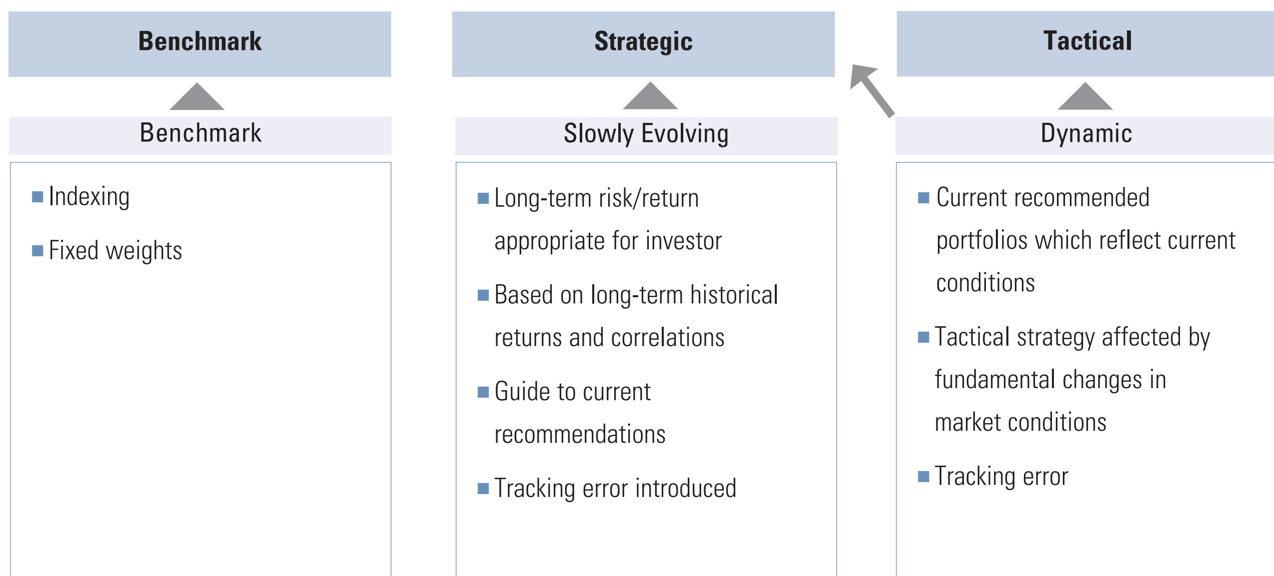
Tactical vs Strategic Allocations

Strategic asset allocation offers a sound foundation from which active or "tactical" asset allocation strategies can be applied based on changing conditions. With tactical asset allocation strategies, managers make shorter-term decisions based on current market conditions. (Source: Dr. Richard Marston, "Allocation in Practice," IMCA/Wharton CIMA Program, 2002.

Some believe that asset allocation should move beyond benchmarking and offer strategic or active strategies. It should first take a quantitative/analytical approach, considering risk and return based on Modern Portfolio Theory. A dynamic approach should then evolve, which requires portfolio optimization on a continuous basis and considers a number of factors as outlined below:

Three Levels of Asset Allocation



Sources: Dahlquist, Magnus, and Campbell R. Harvey, "Global Tactical Asset Allocation," January 31, 2001. Dr. Richard Marston, "Allocation in Practice," IMCA/Wharton CIMA Program, 2002.

Active vs. Passive

An active or passive asset management process is another variable within target-date funds that should be considered during an evaluation. Each approach has advantages. For example, a passive management process may result in lower fees and expenses. An active management approach may result in higher returns and less down-market volatility. Again, neither approach is right or wrong—just different. Comparing active to passive management styles should include a value consideration, particularly in down-market scenarios.

Fees and Expenses

The value consideration necessitates an assessment of fees and expenses. Does the fund provide value based on its fees and expenses? The fees and expenses issue should be carefully correlated with the value consideration of a fund. This is particularly important in light of recent DOL fee and disclosure changes to the Form 5500 annual reporting rules, which will require additional disclosure to plan sponsors of direct and indirect fees and other compensation received by service providers to ERISA plans for plan years beginning January 1, 2009, and imminent changes to the ERISA Section 404(c) regulations, which may include additional disclosure requirements.

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Core Investment Options

The "I-Need-a-Little-Help" and the "Do-It-Myself" groups usually want to go beyond prepackaged investment options. Selecting the overall platform lineup for a plan is an important process that carries significant fiduciary responsibility. Choosing whether to include target-date funds is one of the many actions in the due diligence process. Another determination that is just as important is the decision to, or not to, include other investment choices that may be appealing to more investment-savvy participants.

Historically, fund choices for defined contribution plans have been limited to the traditional style box. These choices are usually considered the core offering and, ideally, are the building blocks from which other investment options, such as target-date choices, are constructed. As with any investment, they, too, are subject to the fiduciary review and assessment process.

Nomenclature for the core investment options in a plan can be problematic for plan participants. Many will find the fund names confusing or even misleading, making it difficult for them to determine which combination of funds will optimize their potential for returns. Under generally accepted investment theory, proper asset allocation is a critical component of increasing investment returns. If the names of the asset choices are not reflective of where that asset fits in terms of the style box, proper asset allocation can be hindered. Consideration should be given to how the funds are named in the employee communication material. For example, assume the plan offers a fund named "ABC Value and Growth Fund." Based on the name, it is impossible to determine where that fund fits within the style box. An alternate approach would be to identify the fund based on where it fits within the style box. Consequently, the fund would be listed in the employee communication material as "Mid-cap blend fund." Such a naming approach reinforces the importance of the asset allocation theme, which should be a cornerstone of any effort to increase investment returns.

Satellite Asset Classes

The Importance of Extending Traditional Asset Classes

As was stated previously, typically, plans tend to offer a rather narrow range of investment options, generally consistent with the traditional style box.[15] In light of recent dramatic market fluctuations, a broader range of asset classes may be advisable to protect against down markets and increase overall investment returns. Satellite asset classes have been used within the defined benefit and foundation community to mitigate the effects of market volatility, although historical performance is not an indication of future returns. In keeping with fiduciary standards and obligations, it is incumbent upon plan administrators to, at a minimum, evaluate whether including satellite asset classes in the plan's overall investment portfolio would be prudent.

There are at least two potential advantages that plan sponsors may derive from utilizing extended asset classes:

- Increasing the degree of non-correlated asset classes and therefore reducing the volatility in a diversified portfolio; and
- Improving the potential for increased returns.

The degree of correlation is an important factor in strategies designed to help protect portfolios from down-market risk. While down-market protection may be less important for younger individuals, it is critically important for individuals closer to retirement age.

[15] "2007 Defined Contribution Survey," *PLANSPONSOR*

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Careful deployments of satellite asset classes provide real benefits in the right situation. For example, a commodity position can potentially be a strategy for hedging overall down-market risk. However, too large of a commodity position could result in an unbalanced portfolio. Therefore, plan-imposed constraints on certain asset classes may be prudent, e.g., limiting commodities to 10 percent of an individual's portfolio may be appropriate. The ability of a recordkeeper to execute constraints can be an important consideration in the overall platform evaluation process.

Self-Directed Brokerage Accounts

Every organization has a small fraction of employees who are active in the market. When it comes time to planning for their retirement, this "Do-It-Myself" employee group wants to have the same flexibility and type of investment options as they are afforded in their brokerage account.

A Self-directed brokerage accounts works for this employee segment because it provides the broadest range of investment choices and provides ample opportunity for extensive diversification. Integration is an important consideration with any brokerage window. The brokerage account information must be compiled and integrated with other financial data to ensure the plan's accounting and reporting are accurate. Plan sponsors that make this option available need to clearly communicate the risks and costs of this option to participants who choose to utilize it.

Summary

So what have we learned? In this paper we discussed:

- How Defined Contribution plans can learn from their Defined Benefit predecessors and deploying best practices to optimize participant outcomes.
- The importance of understanding participant behaviors and the role it plays in plan design and investment selection.
- Once you understand how participants are reacting to their retirement planning vehicles, you can begin to think about specific, most likely pre-existing investment strategies that target the investment needs of each segment.
- Target date funds and their fast growing prominence in the retirement planning landscape.
- What are the various considerations when it comes to developing target date funds and how can we optimize their effect.

We all know that improving investment returns is essential for 401(k) participants and should be an overriding goal of employers. Since different employee groups have unique asset allocation needs and levels of sophistication, it is essential to understand their unique behaviors as plans are designed and select solutions that target their individual needs. Success on this point has been demonstrated for years in the defined benefit industry. Now it is the DC market's turn to prove that its model can stand the test of time in improving participant outcomes.

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Appendix – What Makes a QDIA?

PPA-06 and subsequent DOL regulations set forth the types of investments that may constitute a QDIA, and the process by which a fiduciary implements a QDIA. A QDIA for a plan may include life-style or target-date funds, balanced funds, or managed accounts.

The DOL regulations define a life-cycle or target-date QDIA as follows.

An investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such products and portfolios change their asset allocations and associated risk levels over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. Asset allocation decisions for such products and portfolios are not required to take into account risk tolerances, investments or other preferences of an individual participant.

In order for a target-date fund to be a QDIA it must be an appropriate investment based on the demographic of the participant group. For example, a 2020 target-date fund may be an appropriate QDIA for a group with an average age of 52; whereas it would not be an appropriate QDIA for a group with an average age of 26.

The DOL regulations define a balanced-fund QDIA as follows.

An investment fund product or model portfolio that applies generally accepted investment theories, is diversified so as to minimize the risk of large losses and that is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income exposures consistent with a target level of risk appropriate for participants of the plan as a whole. Asset allocation decisions for such products and portfolios are not required to take into account the age, risk tolerances, investments or other preferences of an individual participant.

The DOL regulations define a managed-fund QDIA as follows.

An investment management service with respect to which a fiduciary, applying generally accepted investment theories, allocates the assets of a participant's individual account to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures, offered through investment alternatives available under the plan, based on the participant's age, target retirement date (such as normal retirement age under the plan) or life expectancy. Such portfolios are diversified so as to minimize the risk of large losses and change their asset allocations and associated risk levels for an individual account over time with the objective of becoming more conservative (i.e., decreasing risk of losses) with increasing age. Asset allocation decisions are not required to take into account risk tolerances, investments or other preferences of an individual participant.

A second important consideration in the QDIA decision-making process relates to fees and expenses. The QDIA rules are clear; certain fees and expenses are not permitted and fees and expenses must be part of the fiduciaries' evaluation of potential QDIAs. From a practical perspective, the records documenting the QDIA selection process should include entries related to the fees and expenses of the investment. A consideration of fees and expenses does not necessarily mean a plan sponsor is required to choose the cheapest QDIA alternative, only that the individual or entity must evaluate if the fees and expenses are reasonable for the value the plan would potentially receive.

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The portfolio risk management process includes an effort to monitor and manage risk, but does not imply low risk.

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