

Improving DC Plan Investment Governance: A Call to Action

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A Call to Action

Defined Contribution (DC) plans have grown to become the primary retirement benefit vehicle offered by employers. Passive reliance on automation, peer-based governance evaluation approaches, sub-optimal plan designs, inadequate attention to poor participant decision making and inefficient investment option structures are not working well. This is our call to action for DC plan sponsors:

Conduct DC Risk Studies. Challenge service providers to assess the risks, adequacy and efficiency of your DC plans.

Optimize Your Plan Design. Seek the best mix of non-elective and matching contributions. Encourage strong personal savings rates by reshaping the matched savings component of your plans, and leverage behavioral economics to your advantage.

Streamline and Diversify Investment Option Structure. Maintain a manageable investment option structure to avoid participant confusion along with a customized target date fund series if scale is available. Increase diversification within each investment option by utilizing a wider set of investments.

Reduce Investment Costs. Take control of the mix of active and passive management in the core line-up and target date fund. Use active management more effectively by pairing risk-taking active managers with passive core funds.

Adopt the Autos. Pair auto-enrollment with auto-escalation to increase participation and encourage strong savings rates. Default the escalation stopping point at 10% of pay or more.

Re-Enroll Employees. Periodically bring non-participants back into the plan through re-enrollment, and offer current participants the opportunity to default into efficient investment alternatives.

Reduce Leakage. Use plan design, education and communication to encourage the appropriate use of loans and withdrawals, while discouraging participants from “cashing out” their account at termination or retirement.¹

Offer Investment Advisory Solutions. Provide access to financial help on a broad range of topics and across a variety of communication vehicles.

Reduce Total Plan Cost. Use economies of scale and best-in-class unbundled solutions, challenging all service providers to deliver the highest level of service and product quality at a reasonable cost.

Demand Enhanced Governance Monitoring Tools. Use “dashboard” tools to routinely monitor the efficiency of the plan design and the investment program, with forward-looking analysis to measure progress toward retirement income adequacy for plan participants.

¹ Aon Hewitt's “Leakage of Participant's DC Assets: How Loans, Withdrawals and Cashouts are Eroding Retirement Income,” 2011.

Retirement Readiness and Investment Outcome Dilemma

Hewitt EnnisKnupp and Aon Hewitt have been working closely with plan sponsors since the inception of Defined Contribution plans, and so have been in a position to observe their evolution. As more employers choose to sponsor DC rather than Defined Benefit (DB) plans as their primary retirement benefit, several troubling trends have emerged:

1. Employees are not saving enough;
2. Leakage from DC plans remains high; and
3. DB plan assets tend to outperform DC plan assets.²

Employers want to help employees accumulate adequate retirement resources by providing retirement benefits that are competitive and sustainable for the organization. Retirement plan sponsors are in a unique position to help participants save for retirement and be better positioned to retire “on time,” ultimately benefiting both the employee and employer.

Ignoring the emerging generations of workers who may not be financially prepared for retirement will create significant challenges for society. It’s time to improve the DC investment and retirement readiness paradigm and refocus plan management.

Challenges and Opportunities Defined

Even as DC plan *results* fall short, DC plan *governance*³ often lags the typically more stringent process associated with DB pensions. In an effort to manage annual pension expense and required cash funding of long-term, volatile DB plan liabilities, pension plan sponsors have typically adopted rigorous policies of DB plan governance. DC plans, on the other hand, have often been viewed as “less complex,” with less vigorous governance beyond managing the investment fund lineup. Strong governance must be the foundation for addressing all of the shortfalls of current DC plan practices. Figure A presents the issues and foreshadows our proposed solutions (a governance perspective).

² CEM Benchmarking.

³ “Governance” refers to the mechanisms used to ensure appropriate policies and processes are followed.

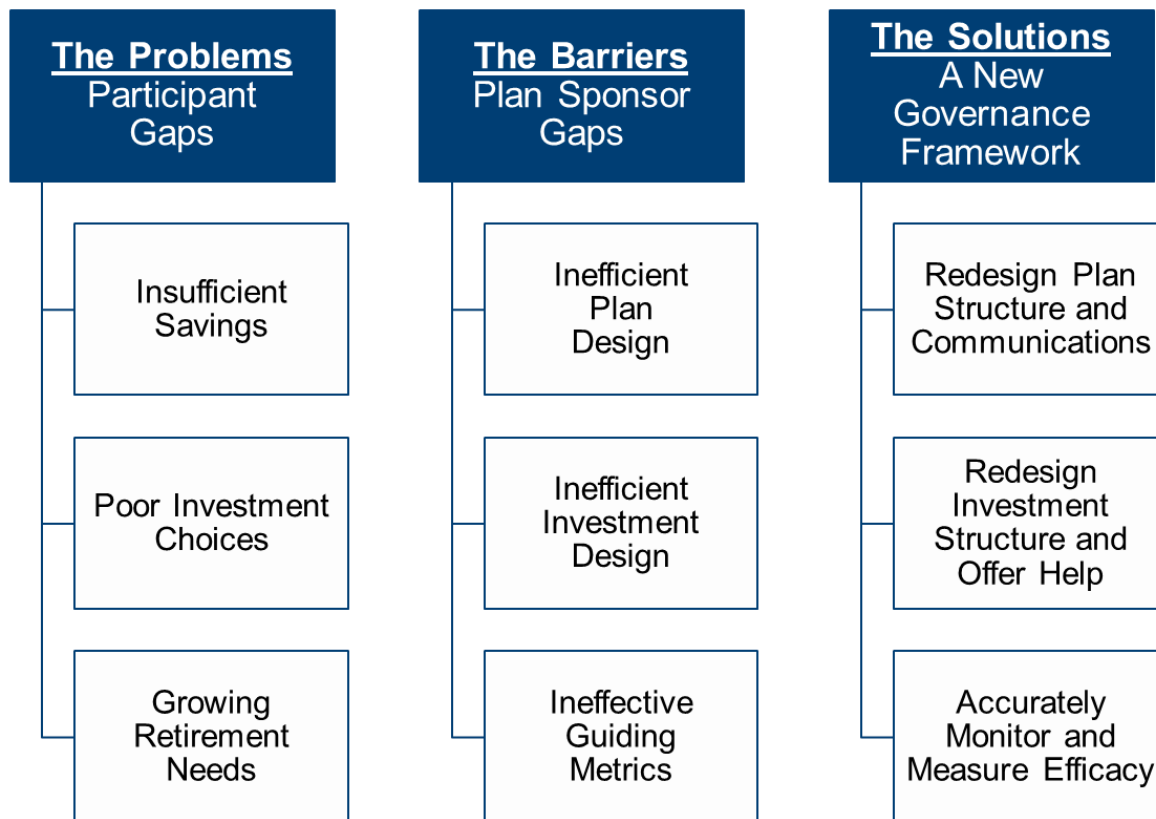


Figure A: Governance Perspective

The decisions of plan sponsors today are shaping the retirement readiness of future generations of retirees. Our proposed solutions provide a framework of governance that addresses savings, risk and costs, along with specific recommendations and a call to action. Where do we start?

The Big Picture

On average, current defined contribution participants are missing the mark. The average participant is expected to have a retirement income deficit of 3.8 times pay at age 65.⁴

Improving investment returns by an average of 100 basis points per year can eliminate roughly half of the projected shortfall, while increasing annual contributions of 4 to 5 percentage points of pay can fill the rest of the gap as illustrated in Figure B. Granted, improving annual returns by 100 basis points may seem ambitious, but if professionally managed DB assets tend to outperform DC assets by 100 basis points or more⁵, perhaps striving for this level of improvement is attainable. In addition, increased savings rates of 4 to 5 percentage points may seem difficult, yet the projected increases from automated plan features

⁴ Aon Hewitt's "The Real Deal—2012 Retirement Income Adequacy at Large Companies."

⁵ "Investment Returns: Defined Benefit vs. 401(k) Plans," by The Center for Retirement Research at Boston College, 2006.

and leveraged plan design may bring these results within reach. Achieving these outcomes will require a disciplined, long-term approach by employers and employees alike.

Figure B: Projected Retirement Income Adequacy (Age 65) – Multiples of Pay for Average DC Participant



Rather than following peer practices and competitive norms, DC plan sponsors should re-focus their energies on financial outcomes as a metric for gauging plan success. We believe that in addition to annual cost and competitive positioning studies, a thorough governance process should include measuring and monitoring plan efficiency to achieve positive, long-term results for both employers and employees. Recommendations for measuring efficiency and monitoring retirement income adequacy include:

Efficiency. Employer contributions to a DC plan should result in a positively-leveraged total contribution for the year. For each dollar of employer contribution, a leveraged result should deliver more than a dollar's worth of value into the retirement plan annually. Positive leverage occurs through employee contributions and positive asset returns. Leverage is reduced by various forms of leakage and negative asset returns.

For example, if an employer contributed 7% of pay into each employee's DC accounts annually, resulting in a total of 14% of pay after employer and employee contributions, return on assets, and leakage, the "efficiency" of the plan would be 200% for the year. A single "efficiency metric" can provide helpful insight when measuring the impact of various initiatives for the DC plan such as automation, education on the impact of leakage, and access to financial advisory services. We recommend including an efficiency metric in the ongoing monitoring of DC plans.

Income Adequacy. DC plan participants need access to the right tools and resources to help them replace approximately 85% of their pre-retirement income by age 65, plus inflation during retirement. When expressed as a multiple of pay, this means that (after Social Security), the typical American worker who is not covered by a pension plan should aim to accumulate 11.4 times pay from personal savings and employer-sponsored benefits in order to retire by age 65.⁶ This amount will provide sufficient personal financial resources, on average, to meet financial needs through retirement, including the cost of employee-paid retiree medical coverage. Individual results will vary, due to differences in pay and age.

The key factors influencing retirement income are savings rates, investment returns and retirement age. On average, a 25-year-old whose employer provides only DC plan retirement benefits needs a total annual contribution (employer plus employee) of approximately 15% of pay to retire at age 65 with adequate resources to maintain their pre-retirement standard of living.⁷ If a DC-only employer contributes 7% of pay in the form of a match and/or non-elective contribution, this means the employee needs to contribute another 8%. If employees don't start saving until age 30, then the employee would need to save 11% of pay instead of 8% of pay, on average. These averages provide a good starting point for analysis and discussion. These values are not sensitive to key factors such as competitive practices for specific industries or differences in age and/or pay across employee groups.

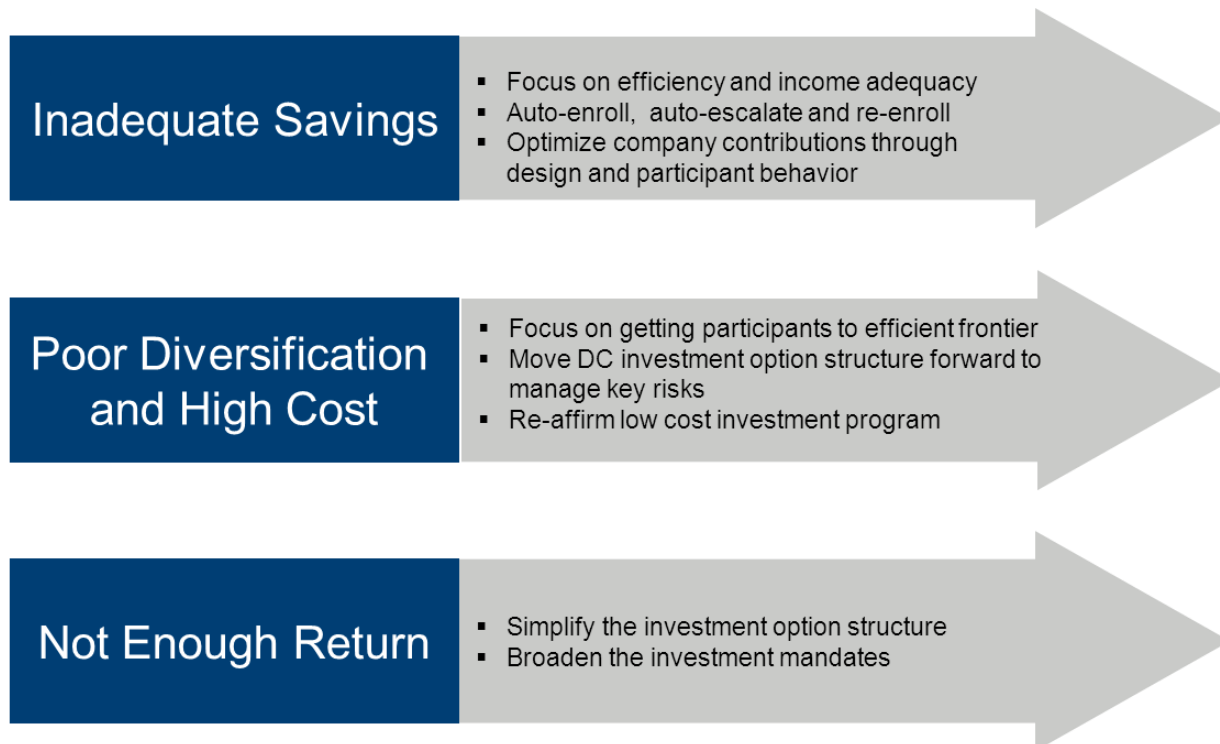
⁶ Aon Hewitt's "The Real Deal—2012 Retirement Income Adequacy at Large Companies."

⁷ Aon Hewitt's "Universe Benchmarks Report," 2012.

Solutions in Plain Language

We believe that the shortfalls of the current DC paradigm (inadequate savings, poor diversification and high cost, and not enough return) can be addressed, in an operational perspective, through the solution summarized in Figure C.

Figure C: Problems and Solutions: An Operational Perspective



Inadequate Savings

Employee retirement savings rates are volatile and remain low relative to historic norms,⁸ posing a challenge to achieving retirement goals. We address several possible solutions to this problem below.

Auto-Enroll, Auto-Escalate and Re-enroll. Automatic enrollment, when paired with automatic savings rate escalation, can provide critical momentum toward adequate retirement income. Defaults aimed at total annual retirement contributions of 15% of pay or more need to become the norm rather than the exception. Specific targets may be recommended, either higher or lower than the 15% average, depending on company demographics and compensation levels and employer-provided retiree medical subsidies. Consistent employee re-enrollment needs to become more commonplace, serving to reinforce the importance of regular savings.

⁸ National Bureau of Economic Analysis.

Optimize Company Contributions Through Design and Participant Behavior. The average DC plan sponsor currently provides a matching opportunity of 3.8% of pay, plus 2.8% of pay through non-elective contributions (e.g. deferred profit sharing, ESOP, etc.), for a total average potential DC allocation of 6.6% of pay per year. Even modest changes to a matching formula can encourage participants to save more, as the majority of employees choose to save at the maximum match threshold for the plan.⁹ For example, an organization that matches 50% on up to 8% of pay savings is likely to experience a higher average savings rate than a plan that matches 100% on the first 4% of pay. In this example, a match on 8% of pay will not only result in more employees saving at 8% rather than 4%, but the total amount contributed (employee plus employer) will be significantly more, leading to increased retirement income adequacy. In this way, plan sponsors can harness the power of behavioral economics to improve results for employers and employees without increasing the cost to the employer of the matched savings plan design. Note that ADP/ACP Safe Harbor Plans would need to carefully consider the implications of matching on more than 6% of pay.

Plan sponsors can also optimize their DC plan design through consideration of other factors such as matching versus non elective contributions, variable versus fixed contributions, and the role of pre-tax, Roth and after-tax contributions.

Reduce Leakage While Providing Flexible Distribution Options.

It's no longer common for an employee to work for only one employer throughout his or her career. It is therefore essential that terminating employees view DC monies as long-term retirement benefits rather than as consumable income. It is not only the smaller account balances that tend to get cashed out at termination of employment. In fact, a recent study showed that 10% of participants with balances of \$100,000 or more received a cashout distribution. Nearly 75% of employers report that they are concerned about employee cashout behavior, and many have seen an increase in cashouts over the past few years.¹⁰ 94% of plan sponsors are concerned about excessive loan usage, yet fewer than one quarter have plans to curb loan activity. Reducing loans, withdrawals, and cashouts are important steps toward improving retirement income security. Removing cash from the retirement plan decreases participants' expected wealth at dramatic rates: by as much as 67% in some cases. It is especially detrimental for younger employees given the greater potential for future compounding. As job tenure declines, it is critical that savings plans maintain a retirement focus.

Reducing Leakage

Specific ideas to reduce leakage

- Add or increase loan fees
- Reduce the number of loans allowed
- Reduce or eliminate in-service withdrawals
- Restrict balances eligible for loans or withdrawals
- Educate employees on the impact of leakage

In addition, we recommend plan sponsors move beyond focusing on lump sum distributions and consider offering installment payments and income solutions designed to provide payments for the lifetime of the participant and his/her spouse or other beneficiary.

⁹ Aon Hewitt's "Universe Benchmarks," 2012.

¹⁰ Aon Hewitt's "Leakage of Participant's DC Assets: How Loans, Withdrawals and Cashouts Are Eroding Retirement Income," 2011.

Poor Diversification and High Cost

Through our DC plan studies, we have observed that many participant investment portfolios suffer from inefficient diversification and excessive cost.

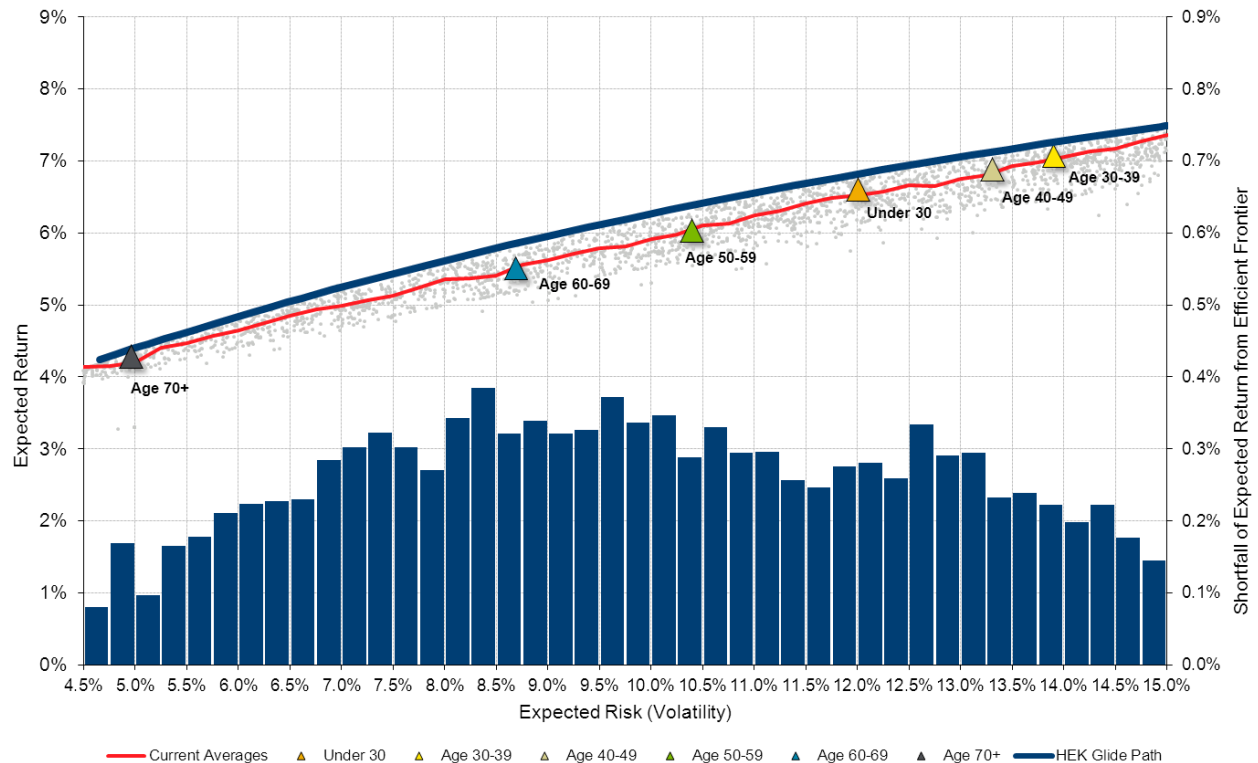
Focus on Getting Participants to the Efficient Frontier. Illustrated in Figure D are the investment elections of 10,000 DC plan participants. As shown, many diverge substantially from the efficient risk/return portfolio mixes they could achieve due to imperfect portfolio construction. Participant results are adversely affected by two basic stumbling blocks: 1) participants target insufficient risk/return levels and 2) participants make poor asset allocation choices at a given risk level, i.e., they don't build efficient portfolios.

The first issue is depicted by the median risk/return election of the "Less Than 30" age cohort. While individual risk preferences vary, as a group, we would expect those under 30 years of age to be targeting a higher risk/return level than the other age cohorts. In addition, the "Less Than 30" cohort is perhaps the most homogenous portion of the participant population, i.e., they are the furthest from retirement (most similar expected retirement needs) and have the lowest income and savings balance dispersion across the constituents (similar asset/income levels).

The other age cohorts are behaving as expected, with the older generations targeting lower risk/return levels than the younger generations. There is room for improvement, nevertheless, given the performance sacrifice at the elected risk level, which may be as much as 1% per annum, leading to a loss in potential retirement asset accumulation of more than 20% over a full career. **This risk/reward compromise would cost participants about 4 years of projected retirement income!**

These findings highlight the need for employers to offer investment advisory services to plan participants in order to improve the efficiency of individual investment choices. The investment advisory services could either be embedded in existing investment choices (such as lifetime income solutions in target date funds that might automatically increase as the target date approaches), or made available for voluntary use by employees, on demand. Ideally, a plan sponsor should be able to measure and monitor increased efficiency of individual investment choices, with more participants being at or closer to the efficient frontier for their plan's investments over time. Plan sponsors should consider offering investment advisory services across a variety of communication vehicles, such as online, telephone, in person, seminars, webinars and printed materials.

Figure D: Efficiency of DC Participant Portfolios



Scatter plot and curves show the current individual, current average, and potential efficient expected return, or each level of risk, according to the vertical axis on the left. Columns show the average shortfall between current expected return and potential efficient expected return, at each level of risk, according to the vertical axis on the right.

Move DC Investment Option Structure Forward to Manage Key Risks. The vast majority of DC participants do not have the investment knowledge, interest or time to maximize success. Thus, with any well designed solution or product, the plan structure should meet participants **where they are** by providing an approach that is easily understood and readily adopted.

We continue to believe, therefore, that a tiered investment structure is a useful construct for helping participants form the most efficient portfolio. However, to further improve financial outcomes, we believe DC plan sponsors would benefit from narrowing their investment option structure to only include investment options that focus on growth, income, inflation protection and capital preservation strategies, augmented with customized target date funds. While we promote reducing the number of investment options participants must navigate in the core options tier, we also recommend broadening the underlying investments to improve diversification and include new market exposures (i.e., betas) that will improve projected retirement income results.

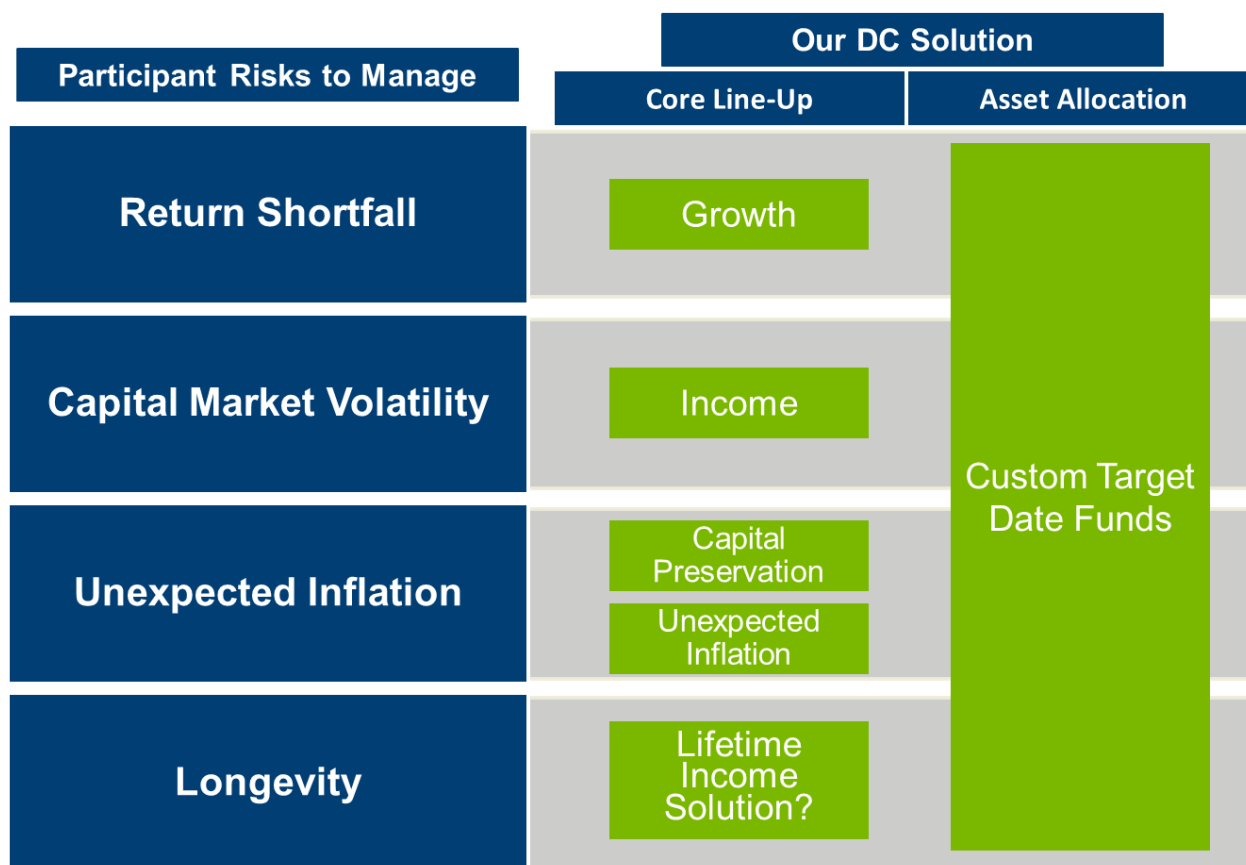
Figure E illustrates a well-crafted investment option structure which we believe can help mitigate key risks while maintaining simplicity and manageability. Though lifetime income solutions are not covered in this

paper, we believe they are an important part of the DC solution. Our forthcoming research will cover this topic more directly, building on the governance and design beliefs discussed in this paper.

Managed account solutions also offer a compelling solution, especially as participants near retirement age and their needs become more unique.

In addition, we continue to believe that custom target date funds offer a more efficient and effective solution for the average plan participant. However, this topic has been covered at length in recent years (see our recent paper on target date funds) .¹¹ For this reason, what follows is a more in-depth review of the core line-up.

Figure E: Moving the DC Investment Option Structure Forward To Manage Key Risks



¹¹ Hewitt EnnisKnupp “Are Custom Target Date Funds Right for Your Plan?” 2012, and “Fiduciary Considerations with Target Date Funds,” 2012.

Re-affirm Low Cost Investment Program. It has been consistently demonstrated that cost is a key element in driving investment success. We continue to encourage all DC plan sponsors to scrutinize and re-negotiate their investment costs to ensure maximum efficiency. Plan sponsors may experience reduced asset management fees through unbundling, economies of scale and institutional pricing.

As a result of the U.S. Department of Labor fee disclosure regulations, 35% of sponsors have recently completed a review of DC fund operations, including fund expenses and revenue sharing. Among plans that did not perform a DC fund operation review, 87% of sponsors are very or somewhat likely to do so in the next 12 months. Cost-cutting is top of mind for many sponsors. Nearly one-third of employers have recently changed their funds to reduce cost, and 52% of the remaining plans may do so in the next 12 months. Due to the popularity of target date funds, employers are planning to scrutinize the fund manager and the glide path. In 2013, more than half of all plan sponsors with target date funds are very or somewhat likely to perform a comprehensive review of the fund manager and a nearly equal number of respondents plan on a comprehensive review of the fund glide path.¹²

In addition, we continue to suggest unbundling investment costs from administrative fees to ensure optimal investment fee schedules relative to current circumstances.

Not Enough Return

Table A illustrates a more effective investment option structure designed to help increase participants' total return while targeting the key risk management objectives that they face throughout their working careers: return shortfall, capital market volatility, unexpected inflation and longevity (in that order over a lifetime of preparing for and entering retirement).

TABLE A: Core Investment Option Structure Further Explored

Strategy	Objectives
Growth	Provide excess return above safe haven investments by capturing the return premium of return-seeking betas as well as active management skill
Income	Provide income return commensurate with investment grade bonds; limited downside risk over a short investment horizon
Capital Preservation	Preserve capital on a nominal basis with little to no downside volatility
Inflation Protection	Preserve the real value of capital with limited downside risk over an intermediate investment horizon

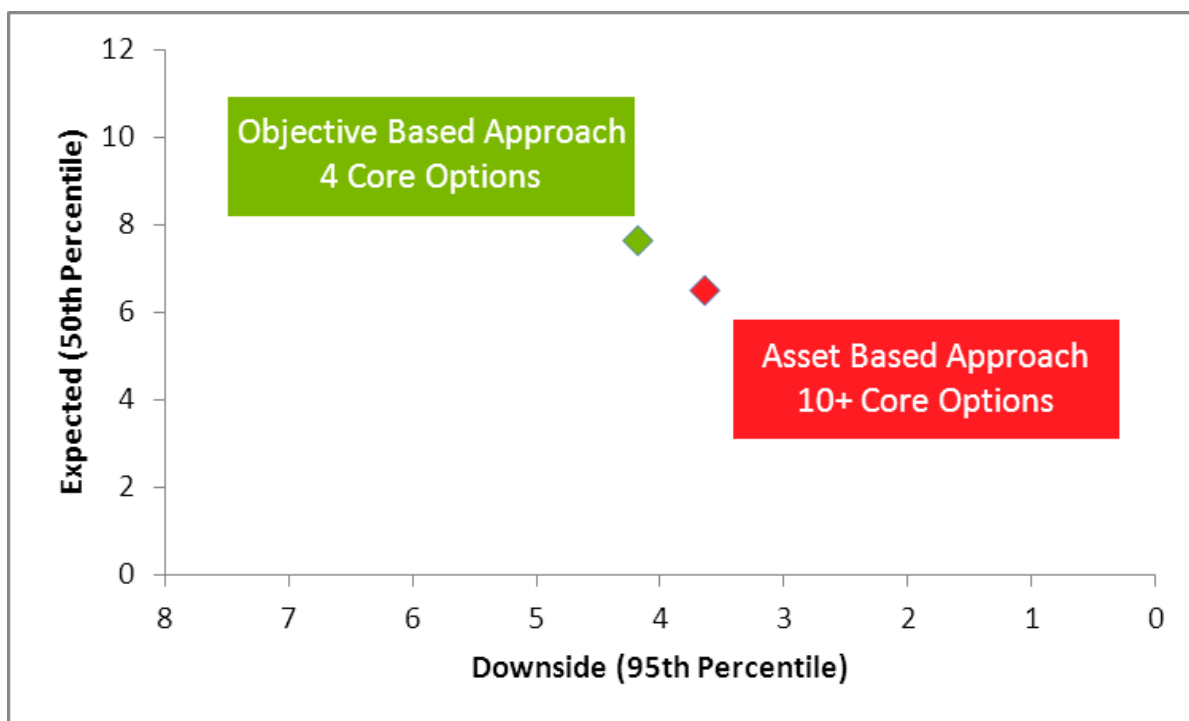
¹² Aon Hewitt's 2013 "Hot Topics in Retirement."

Simplify the Investment Option Structure. The two most common investment design mistakes made today are: 1) providing too many higher risk/return choices like stocks, commodities, REITs, high yield bonds, emerging market bonds, etc., and 2) not providing enough inflation-hedging solutions.

It is perhaps the greatest unintended consequence of the choice proliferation trend of the last two decades that the average participant simply does not know how to effectively allocate their retirement savings across multiple stock funds. Our DC studies illustrate this issue very plainly.

Figure F illustrates the projected impact of simply mapping the current core fund line-up of more than 10 options to a more objectives-based solution of four options. Not only does the expected balance at retirement as a multiple of pay go up from 6.5x to 7.4x, the downside risk is reduced.

Figure F: Projected Retirement Balance as a Multiple of Final Pay



For this reason, the most effective change to the core line-up is simplifying the various risky investment elections. This can be achieved without sacrificing the complexity and diversity of the underlying investments. To the contrary, it allows the plan to offer a more diversified set of investment options.

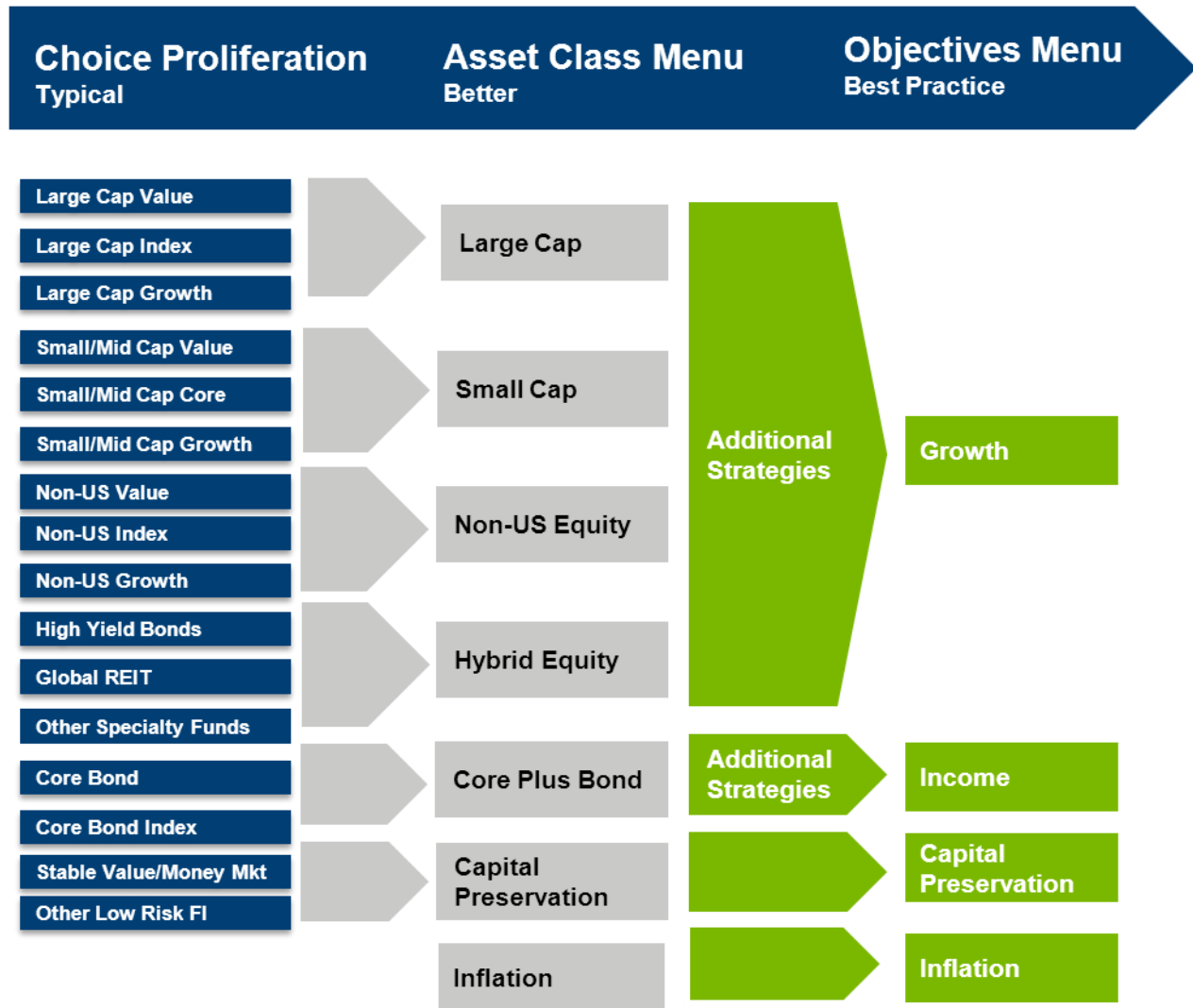
The second most effective change is the addition of an inflation-hedging option to help those that are approaching retirement. At the point of retirement, participants are facing their lowest risk tolerance, they have completed their working years, and they have the most years of retirement ahead of them. Having achieved retirement, their greatest risk will be unexpected inflation, assuming they have saved sufficiently to meet their spending needs, and they have lowered their allocation to risky assets (such as stocks).

Most plans do not include an inflation-hedging solution such as TIPS (Treasury Inflation-Protected Securities). Our research shows that a portfolio of intermediate duration TIPS with a small allocation to commodities would be expected to provide participants with an inflation-hedging solution that has low to modest volatility and tracking error relative to unexpected inflation over a short investment horizon (one to three years). While these investments are often criticized for their short-term tracking error, we believe this is well within participants' investment horizon and risk tolerance, i.e., history shows that they will remain invested long enough to weather the short-term tracking error versus realized consumer price inflation.

Broaden the Investment Mandates. We further believe the migration must continue from a “Choice Proliferation” paradigm to an “Objectives Menu” approach as illustrated in Figure G. We anticipate that many plan sponsors will continue to evolve to this “Objectives Menu” through an “Asset Class Menu” approach. In doing so, plan sponsors will be able to reduce participant confusion and poor decision making that can result from having too many investment choices. And for those participants who prefer additional investment choices, plan sponsors can offer a self-directed brokerage window.¹³

¹³ According to Aon Hewitt research “2013 Hot Topics in Retirement,” 27 percent of DC plan sponsors currently offer a self-directed brokerage window, and another 9% are very or somewhat likely to add in the next 12 months.

Figure G: Anticipated Evolution of Investment Option Structures



In summary, we believe this investment option structure will provide participants with a more diversified, efficient and intuitive asset allocation.

Conclusion

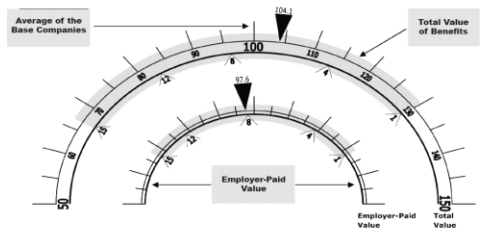
With the DC Plan currently serving as the primary sponsor-funded retirement income tool for the US workforce, inadequate retirement savings, poor investment choices, and growing retirement income needs are central realities faced by most DC plan sponsors. Now is the time for DC plan sponsors to fully embrace the responsibilities and opportunities associated with plan sponsorship.

We look forward to facing these challenges together, to improve plan governance and retirement benefit outcomes of the future.

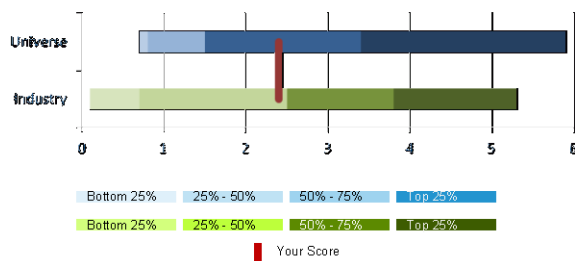
Appendix

Figure H – DC Dashboard Example

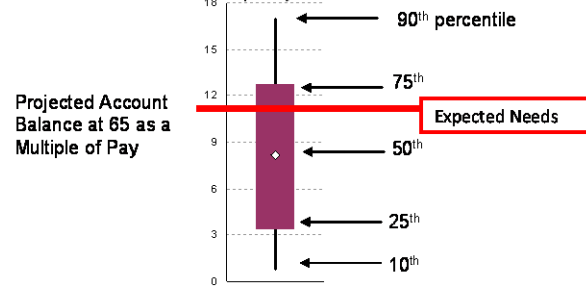
Plan Competitiveness



Efficiency



Retirement Income Adequacy



Investments

Overall Score

Quality (70%)

Structure (30%)

Scale



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