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CORRESPONDENCE MEMORANDUM

DATE: April 11, 2008

TO: Wisconsin Deferred Compensation Board

FROM: Shelly Schueller, Director
Wisconsin Deferred Compensation Program

SUBJECT: Designation of a Default Fund

Staff recommends that the Board consider changing the designated default fund from the Vanguard Money Market Treasury Fund to the Vanguard Target Retirement Date lifecycle fund series. This memo provides the framework for discussion of this policy item.

BACKGROUND
One of the Board's fiduciary duties is the designation of a default fund to which participant assets are directed when an investment option is removed or replaced, or a participant otherwise fails to make a decision on where their assets should be invested. The designation of a default fund is an important duty because the Board is making an investment decision for participants who fail to make the decision themselves.

At present, when a fund is removed from the Wisconsin Deferred Compensation Program (WDC), any remaining account balances are moved to the default fund, the Vanguard Money Market Treasury Fund. The Board made this decision in May 2005.

Section ETF 70.08 (3), Wisconsin Administrative Code, states that after the Board has determined that a fund is no longer acceptable for inclusion in the WDC, the Board is required to tell the WDC administrator to which other WDC fund any remaining participant account balances from the closed fund should be automatically moved or "swept." The administrative rule does not specify to which fund the money is to be swept; that decision is left to the Board. Attachment B outlines the communication steps taken when a WDC fund is closed.

FEDERAL REGULATIONS AND GUIDANCE
The preamble to section 404(c) of the Employee Retirement Income Security Act (ERISA) states that "plan fiduciaries will not be relieved of responsibility for investment decisions under an ERISA section 404(c) plan unless those [investment] decisions have affirmatively been made by participants…" Like most other public retirement plan sponsors, the WDC is not directly subject to ERISA. However, in practice most public plan sponsors, including the WDC, seek to abide by ERISA regulations as they provide guidance on federal interpretations of situations that are also experienced by public plan sponsors.

Reviewed and approved by Jean Gilding, Deputy Administrator,
Division of Retirement Services

Signature   Date

Board	Mtg Date	Item #
DC	05/06/2008	7

PENSION PROTECTION ACT OF 2006

The Pension Protection Act of 2006 (PPA) included language creating ERISA s. 404 (c)(5), which alleviates fiduciary liability for plan sponsors who meet specific conditions regarding assets invested in a plan's default fund. The PPA also directed the federal Department of Labor (DOL) to issue guidance that plan sponsors could follow when selecting a default fund. In October of 2007, the DOL issued Qualified Default Investment Alternative (QDIA) regulations. Employers following QDIA regulations have no legal liability for market fluctuations when providing a QDIA for employees who fail to select their own investment options. Attachment A, the fact sheet issued by the DOL regarding QDIAs, provides an overview of the major points of the QDIA regulations, including the investment alternatives and conditions that must be met for fiduciary relief.

QDIA requirements include:

1. A product with a mix of investments that takes into account the individual's age, retirement date, or life expectancy (for example, a lifecycle or target retirement date fund);
2. A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (for example, a balanced fund);
3. An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (for example, a professionally managed account); and
4. A capital preservation product, which may be used only during the first 120 days of employee participation.

INDUSTRY PRACTICES

As part of a due diligence effort to determine what is currently considered a "best practice" regarding default fund selections, Department staff queried members of the National Association of Government Defined Contribution Administrators (NAGDCA) regarding its designated default funds. Prior to the passage of the PPA, moving closed funds to a like fund in the same asset class was the default fund of choice of most government-sponsored deferred compensation programs. This has changed. As illustrated in the table below, 56% of the plans responding (14 of 25) to the query have designated lifecycle funds as their default fund. Additionally, of the five s. 457 plan providers currently using a stable value fund as their default, four reported that they are or will be changing their default fund designation "soon." One of these is moving to lifecycle funds and another expects to designate a managed account option as its designated default fund. One of the plans using lifestyle funds is also seeking to change to lifecycle funds.

NAGDCA s. 457 Plan Default Fund Survey Responses

Type of Fund	Fixed Fund	Stable Value Fund	Balanced or Moderate Fund	Lifecycle Fund	Lifestyle Fund
# of Plans Using	1	5	3	14	2
% of Plans Using	4%	20%	12%	56%	8%

The fiduciary protections provided by following QDIA regulations have resulted in many private company retirement plan sponsors also changing their designated default funds. Surveys completed in 2007 appear to indicate that private plan sponsors also have a strong preference for using lifecycle (target retirement date) funds as their default funds.

- A Hewitt Associates survey of 190 private plan sponsors revealed that "among those companies who offer automatic enrollment, almost three quarters (72%) plan to convert their default investment fund to a premixed [lifecycle] portfolio fund. According to another recent Hewitt study, 69% of companies currently default employees into diversified investment options such as target-date portfolios, and another 18% said they planned to do so in 2008."[1]

- "Another study of 41 sponsors of large s. 401(k) plans (those with assets of more than $100 million) conducted by Callan Associates found that the QDIA most likely to be used by the survey respondents was a target-date fund (70.6%), followed by a target-risk fund (17.6%). Managed accounts would not be used by any of the survey respondents as a QDIA, and 11.8% had not yet decided what QDIA would be used."[2]

DEFAULT OPTIONS
Attachment C provides the range of default options available to the Board, along with the pros and cons of each option. In staff's opinion, the two most practical default fund options for Board consideration are a balanced fund or an age-appropriate lifecycle fund.

Staff proposes that the Board consider changing the designated default fund from the Vanguard Money Market Treasury Fund to the Vanguard Target Retirement Date lifecycle funds. The Board would need to tell the administrator what retirement age to use in order to place participants in the correct lifecycle fund. Staff recommends using age 65 as the standard retirement age.

Reasons for recommending lifecycle funds as the default fund include:

- Lifecycle funds provide professionally-managed, well-diversified portfolios that automatically rebalance over a participant's time horizon.

- Designating the lifecycle funds may provide better growth opportunities during a participant's earlier participation years and yet also preserve more of a participant's principal in later years because the lifecycle funds become more conservative as the participant ages.

- Lifecycle funds appear to be an industry "best practice." They are the default fund option used by many s. 457 plan sponsors and because they meet the QDIA requirements, they are also the default fund option used by most private sector s. 401(k) plans.

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[1] http://benefitslink.com/pr/detail.php?id=41707 citing data from "Trends and Experience in 401(k) Plans," 2007, Hewitt Associates

[2] http://hr.cch.com/news/pension/091907.asp 2007 QDIA Survey, April 2007, Callan Associates

RECOMMENDATION
Staff recommends that the Board consider changing the designated default fund from the Vanguard Money Market Treasury Fund to the Vanguard Target Retirement Date lifecycle fund series.

Staff will be available at the Board meeting to discuss this memo.

Attachments

Attachment B

WDC FUND CLOSURE COMMUNICATION EFFORTS

Efforts to inform participants of impending fund option closures begin soon after the Board has made the decision to close a fund. Current efforts include:

- Newsletter articles. Four to five articles in the WDC's quarterly newsletter, *MoneyTalks*, to alert participants of the fund closure and what steps they will need to take to ensure their assets are not redirected to the default investment option.

- Four individual letters sent to the participant.
  1. The first letter is sent approximately 45 days prior to the June 1 date when the WDC stops deferrals into the closed investment option. Participants are provided information on other investment options that are available through the WDC as well as instructions on where they can find additional information or receive assistance to change their deferrals.

  2. A second letter is sent with the deferral allocation confirmation. The letter explains the removal process and that as a result of the participant not changing their deferral allocation, the percentage that they had been deferring to the closed fund has been redirected to the default investment option. The participant is also provided instructions on who to contact if they would like to change their deferral allocation.

  3. The third letter is sent approximately 45 days prior to the December 31 date when the WDC completely closes the investment option. Participants are again provided information on other investment options available through the WDC as well as instructions on where to find additional information or receive assistance in moving their account assets.

  4. The final letter explains the removal process and that as a result of the participants' inaction, their assets that were remaining in the closed fund have been exchanged to the default investment option. This letter is sent with the exchange confirmation. Participants are given instructions on how to move their assets from the default option to another investment option within the WDC.

- Web site information. Through the removal process, information is also posted to the WDC Web site to alert participants of the pending fund closure. WDC staff also address the pending closure of funds when meeting with participants, either through an informational workshop, one-on-one meetings or through telephone contact.

- WDC Web site "pop-up" box. This feature reminds participants that funds are closing and that they should move their account balances and change deferrals. Ideally, participants would then complete the process while online.

- Include a reminder message on the Integrated Voice Response telephone system that reminds participants with assets in the funds that are closing to move their accounts. This message would also remind individual participants of the fund closure and the need to move their balances. Ideally, participants would then complete the process while on the telephone with the WDC call center staff.

Attachment C

DESIGNATED DEFAULT FUND OPTIONS		
FUND	**PROS**	**CONS**
Money Market Fund	• Preserves participants' principal because it is a very conservative option • Requires no changes as this is the current designated default fund	• Does not meet PPA's QDIA requirements • To default a participant to the money market fund may change the participant's asset class allocation and may be contrary to the participant's intent • Could potentially make the Board responsible for any loss incurred by selling out of the participant's deleted fund and the loss of earnings between the participant's selected asset class and the money market fund • Would need to monitor to ensure fund remains a prudent choice and appropriate for participants • May be confusing for participants
Stable Value Fund	• Preserves participants' principal because it is a conservative option • Provides more potential for investment return than a money market fund while not necessarily increasing risk of loss of principal	• Does not meet PPA's QDIA requirements • To default a participant to the stable value fund may change the participant's asset class allocation and may be contrary to the participant's intent • Could potentially make the Board responsible for any loss incurred by selling out of the participant's deleted fund and the loss of earnings between the participant's selected asset class and the stable value fund • Would have trading restrictions: the stable value fund has a 90 day equity wash rule • Would need to monitor to ensure fund remains a prudent choice and appropriate for participants • May be confusing for participants
Balanced Fund	• May preserve more of participants' principal because it is a conservative option • Meets PPA's QDIA requirements	• To default a participant to a balanced fund may change the participant's asset class allocation and may be contrary to the participant's intent • Could potentially make the Board responsible for any loss incurred by selling out of the participant's deleted fund and the loss of earnings between the participant's selected asset class and the balanced fund • Would need to monitor to ensure fund remains a prudent choice and appropriate for participants • May be confusing for participants

Attachment C

DESIGNATED DEFAULT FUND OPTIONS		
FUND	**PROS**	**CONS**
Age-appropriate Lifecycle Fund	• May preserve more of participants' principal because the lifecycle fund will become more conservative as the participant ages • Offers professionally managed, well-diversified portfolio that automatically rebalances over the participant's time horizon • Meets PPA's QDIA requirements	• Option may be contrary to the participant's intent • Could potentially make the Board responsible for any loss incurred by selling out of the participant's deleted fund and the loss of earnings between the participant's selected asset class and the money market fund • Board must tell administrator what age to use as standard retirement age (65) so that participants' assets are placed in the appropriate lifecycle fund • Would need to monitor to ensure fund remains a prudent choice and appropriate for participants • May be confusing for participants
Like Asset Class Fund (e.g., large cap to large cap)	• The participant stays in the asset class they originally selected • Generally, movement between like funds in an asset class should not incur market losses • May reduce the Board's fiduciary risk: the move can be defended by demonstrating that default fund is in the asset class originally selected by the participant • Meets PPA's QDIA requirements	• May not preserve principal • May have to decide on which fund to send default accounts – an asset class may have both active and passive (index) funds • Board would need to monitor to ensure fund remains a prudent choice and appropriate for participants • May be confusing for participants • May be problematic because the Board cannot know for sure if the participant has specifically selected the fund manager and the asset class or just the asset class
Managed Account Service	• Meets PPA's QDIA requirements • Offers professionally managed, well-diversified portfolio that is regularly rebalanced over the participant's time horizon	• Participant must pay a fee for using the managed account service; could be an unanticipated additional expense • May be confusing for participants • WDC does not yet offer managed account services