



## 2011 ISSUE BROCHURE

# EVOLUTION OF PLAN INVESTMENT STRUCTURES AND ADVISORY SERVICES

*By: NAGDCA Publications Committee and Executive Board*

While today's employer sponsored retirement plans have their histories rooted in structures that were established centuries ago, the modern day defined contribution plan probably has had its most significant developments in the last 20 to 30 years. The first pension plans in America, which actually predate our country's independence, were sponsored by the U.S. military and the colonial militias. The first foray for the private sector into the pension arena took place in the later 1800s with the nation's railroad companies attempting to promote more stable work environments for their employees.

The history of defined contribution plans is a bit more recent. Prior to the Employee Retirement Income Security Act (ERISA) of 1974 and the Revenue Act of 1978, many employers offered profit-sharing plans or "Cash or Deferred Arrangements" (CODAs). These arrangements, in essence, allowed employees to defer some portion of their non-salaried compensation and resultant tax liability. With the passage of the aforementioned Acts, the 401(k), 457 and the modern day defined contribution plans were born; and by the mid-1980s, over half of all larger employers offered some sort of defined contribution plan in addition to, or in lieu of, a defined benefit pension plan.

It is important to note that the legal structure of today's defined contribution plans is not much different than that of the plans established decades ago. However plan operational structures have changed dramatically. This structural shift has in turn led to design and menu differences between the early and more modern plans. When the original 401(k) and 457 plans

were constructed, the design was more simplistic. Many plans actually began with fixed income options as the only investment choices; and when the menus were expanded to allow for equity, the choices again were limited to primarily large company stock fund offerings. Indeed, the days of offering 20 to 30 different investment options ranging from safety of principle to emerging market equities and everything in between were not yet upon us. In fact, the federal law under ERISA only required three investment options and most plans (even if they didn't fall under federal guidelines) didn't stray too far from this mandate.

The related operational element to the limited investment option menu was the way the investment options themselves were priced within the construct of a defined contribution retirement plan. For most of the 1980s and even a portion of the 1990s, the investment options offered within most defined contribution retirement plans were not valued on a daily basis. That is to say, participant account values were updated monthly or quarterly. As a result, changes to investment options only took place to coincide with the availability of the monthly or quarterly valuations. There was no need for daily account access through the Internet and/or the phone, nor was there any ability to conduct transactions through these mediums.

As technology improved during the 1990s, things began to change. Retirement plan record-keepers developed abilities to price investment options within participant accounts on a daily basis. This daily valuation of accounts led to the offering of daily account access and transaction capabilities. Retirement plan service providers rolled out 1-800

account access phone numbers and electronic voice response systems and a new era of retirement plan administration and participant involvement was ushered in. There was an additional technology that also started to bloom in the 90s, and perhaps its impact on today's retirement plans is even greater than that of daily valuation: The Internet.

The expansion of the Internet in the 1990s fostered the initial stages of using this technology as an account access and communications tool. The Internet opened new doors to participants that wanted to get account balance information and make transfers. The 1990s dot-com boom also created a mania around Internet related companies and how to invest in them. This investment mania was not lost on the retirement plan providers and mutual fund companies that rushed to make available additional investment options to participate in the raging bull market for stocks that was moving full steam ahead in the late 1990s. As the stock market continued its upward trajectory, star investment managers were born and retirement participants demanded more access to the highest performing funds and to specialty products focused on the Internet technology of the day. Retirement Plan menus began expanding in part due to this demand and in part due to the service providers and investment managers attempt to gain market share by demonstrating the ability to offer retirement plan menus with a full complement of top investment performers and niche products. Ultimately, the plan menus that were once compiled of 6-10 investment options doubled and tripled in size leaving us today with menus comprised of 20-30 different investment option choices.

Eventually the proverbial dot-com bubble burst and the euphoria of investing in a market that only seemed to go up subsided. Retirement plan sponsors and participants again had to face the reality of a more normal market environment and the best way to promote/implement retirement savings strategies. Focus began to shift away from star investment managers that produce double and triple digit returns and toward retirement plan structures that might be more conducive to promoting healthy savings habits and proper investment asset allocation. Countless studies were developed to assess optimal plan structures, allocations and savings rates; plan sponsors began to reassess the number of funds available to

participants and the options and tools available within the plans and the marketplace.

Today, the focus seems to be on moving toward more simplistic retirement plan structures. While we are not likely to return to the days of monthly valuation and three menu choices, the decision making and savings ease afforded by the structures of old are not lost on plan sponsors. In light of the substantial losses many active managers and supposedly "diversified" strategies experienced during the financial crisis of 2008-2009, there is certainly renewed interest in streamlining fund menus to limit the number of options available in each asset class and offering products that make the asset allocation decisions less complex.

In large part, this focus on the less complex has given rise to asset allocation products such as target risk and target age funds, and decisions by some plan sponsors to automatically enroll and/or invest plan participants directly into these products. Indeed with the passage of the Pension Protection Act and the establishment of the Qualified Default Investment Alternative (QDIA), these funds have become the default investment alternative of choice. Thus replacing the more conservative, less diverse stable value/fixed fund options. Even for plan sponsors that choose an "easy enrollment" single form enrollment process as an alternative to the more direct "auto enroll," these funds tend to be the preferred option for inclusion on the "easy enroll" form.

The overall capabilities of retirement plan administrators have advanced substantially over the last 10-20 years. Changes in the investment climate and regulatory atmosphere over the past few years also appear to be establishing trends defining what investment products will be of importance for plan trustees and investors in the future. Target date products clearly are benefitting from these crosswinds. While the original target date product was brought to market in the early 1990s, the most dramatic growth in the number of available products and the assets invested in these products has taken place in the last five to seven years. The majority of defined contribution plan sponsors now offer a target date product and the majority of retirement plan investment providers make such a product available.

While target date products have enjoyed recent growth through defined contribution plans, some

plan sponsors have recognized that they may not suit everyone. High net-worth and more investing-savvy employees began requesting solutions that were more tailored to their individual needs and other employees simply want someone else to make their investment decisions for them. In addition the financial crisis of 2008-2009 exposed another concern, especially for those with near-term maturity dates: Market crashes just before or as the investor needs to convert the invested assets into income may severely jeopardize the investor's financial security in retirement. A best practice for plan sponsors may be an examination of whether a target date fund has a "to" or "through" retirement philosophy. Is the plan sponsor's general demographic such that its workforce is expected to actually retire at the target date, and thereby assumed to be more conservative, or do changing times necessitate that many employees will continue working beyond "retirement"? As such, is it prudent to invest in a fund where the equity holdings level off at the target date, or is it better to invest in a target date fund where the asset allocation to equities remains significant over time?

As a definition, *advice* may be differentiated from *education* and/or *guidance* in that it tends to be holistic, needs-driven and ongoing, and that the participant receives specific direction concerning what funds to invest in and how to allocate his/her portfolio.

Education and guidance is limited to concepts of investing, kinds of funds, and high-level explanations of various strategies, but offers no suggestions of what specific investment choices should be made.

Private sector retirement plans were the first to explore solutions that included advice as a supplemental service of the plan. But sponsors soon realized that providing these kinds of services would (or, at least, could) make them fiduciaries of their participants' investment decisions and began seeking regulatory relief. That regulatory relief came in the form of Section 404(c) of ERISA, which permits

plans to transfer the responsibility – and the liability – for selecting among the investment options in a participant-directed defined contribution plan to participants if the:

- Participant actually directs the investment of his or her account, and
- Plan satisfies the requirements of the 404(c) regulations.

Section 404(c) essentially protects plan sponsors by providing a fiduciary safe harbor from their participants' investment decisions made through their defined contribution retirement plan.

Public sector employers have long tended to limit discussions about participant investing through their defined contribution retirement plans to education and guidance, and only as applied to their plan assets. This may be due, at least partially, to the fact that defined benefit pension plans still dominate the retirement plans environment; and participation rates in public sector defined contribution plans, especially among governmental 457(b) plans, runs about 35 percent – far short of rates for private sector 401(k) plans. Or it could be that plan sponsors were concerned about the additional liability that comes with providing advice. Whether as a result of one of these concerns or others, the movement toward providing investment advice within public sector plans has not been a priority, but this is changing.

Plan sponsors are beginning to recognize that their participants may not be investing appropriately through their retirement plan accounts. In spite of ongoing educational efforts, some may not understand how to, while others just may not have the desire to stay on top of their accounts. The financial crisis of 2008-2009 revealed just how serious the situation is for their employees. For example, Hewitt Investment Group recently reported on its study of participant investment behavior between Jan. 2006 and Dec. 2008,<sup>1</sup> which exposed striking differences in investment outcomes between participants who received help with their retirement accounts and those who didn't. In recent years, some public sector employees have begun asking for help.

To respond to this changing environment, public defined contribution plans are contracting for services that can advise participants on how they might be more proficient in investing. These services vary, ranging from web-based tools to advice by phone or face-to-face, to managed accounts.

For participants, web-based tools are becoming very effective at collecting the right kind of personal information to provide quality advice to

<sup>1</sup> Hewitt Investment Group, *Help in Defined Contribution Plans: Is it working and for whom*, January 2010.

participants, if the user is willing to gather and then input all the data. The advice provided is based upon the information provided and the onus is on the individual to take action based upon the advice and then to revisit the tool regularly, refresh the data so that the advice can be updated if appropriate, and then take action on the updated advice. Advice-by-phone and/or face-to-face services give participants access to professional investment advisers, who can talk with participants about their long-term objectives and help them design and implement a plan to meet those objectives. The challenge is to make sure that the investment adviser understands the benefits of keeping participant deferred compensation dollars within their plans compared with rolling to an outside IRA.

Because success through these services depends on the individual acting upon the advice, some public sector employers may be concerned that they don't address the main challenge for participant success: They either don't act on the advice or may not have the desire to be responsible for these decisions. This challenge has led to the increased utilization of managed accounts.

Managed account services relieve participants of making investment decisions.

- Their decision-making is relatively limited. The adviser manages each participant's account according to goals established when the participant enrolls in the service.
- Participants gain peace of mind that they are receiving active and ongoing account management, based upon ongoing suitability reviews.
- Any pre-qualification process they may find in the retail market (such as minimum account balance) could be waived as part of the plan's contract with the service.
- Participants gain access to professional advice concerning their finances outside of the plan as well as counsel for their family needs – something they may not be able to otherwise afford.

For plan sponsors, the managed account investment adviser becomes a plan fiduciary – an added level of protection for the employer. In addition, the service typically doesn't cost the plan sponsor anything; participants assume the costs, often through an annual fee or a percentage of the assets being managed.

Plan sponsors must recognize their own fiduciary responsibilities regarding the reasonableness of the managed account program selected. They need to understand the program, and how it works. This is an additional service that can be offered to participants should they choose to utilize it. The plan participants will then decide whether they feel the higher standard of service is worth the additional fee.

In recent years, plan sponsors have responded to participant requests to let them make their own investing selections beyond the options in the plans' menu, by making a brokerage window available to them. Often known as a "self-directed account" (SDA) or "self-directed brokerage account" (SDBA), the brokerage window allows plan participants to trade most listed stocks, mutual funds and exchange-traded funds. Typically the participant is required to sign an indemnification agreement before having access to a SDA site. Self-directed accounts provide participants a level of flexibility that may be too much for some investors to consider, but for those who are willing to accept the increased risks of individual security selection and asset allocation, it can be a viable plan option.

While still an emerging trend, plan sponsors in the public sector appear to be increasingly exploring the value of offering advice, whether via the web, face-to-face, over the phone or through managed account programs, as an additional service for their employees. As budget pressures continue to mount the importance of deferred compensation plans in an employee's overall retirement savings picture will continue to grow. It will be important for plan sponsors to stay informed as products and services evolve to meet the needs of individual plan participants and their families.

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