

PART

One

DC Plans: A Cornerstone of Retirement

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DC Plans Today

An Overview of the Issues

PREFACE: A CAREER AND A NEW FORM OF PENSION PLAN ARE BORN

I started my career in 1981, at the age of 21 . . . which also happened to be the year 401(k) plans were launched. As a new employee at Merrill Lynch Capital Markets, I had the great fortune of working with financial professionals who immediately recognized the power of tax-deferred retirement investing. One experienced colleague told me, “If you participate in this plan, you’ll be a millionaire someday.” That’s all I needed to hear to sign up for automatic payroll deductions into my plan—a practice I have never stopped. Today, I am among the many millions of workers around the world who will fund retirement primarily with my defined contribution assets. I am very fortunate to have been advised to start saving early, and to have ignored others’ suggestions to postpone retirement savings and “enjoy being young.” I’m also lucky that I’ve had access to an employer-sponsored plan funded via automatic payroll deduction, and to have a healthy investment menu from which to choose.

In short, I’ve spent my working years with a defined contribution (DC) pension, versus the “traditional” defined benefit (DB) pension. I believe that my personal experience, as someone who started working just as 401(k) plans came into being, has helped me understand the power and importance of “getting DC right.” In 1989, I joined Hewitt Associates in Lincolnshire, Illinois, and shortly thereafter turned 100 percent of my professional focus toward consulting to DC plan sponsors and research, including creating the Hewitt 401(k) Index to track participant reaction to stock market movements. Since that time, and in the 10-plus years I’ve spent working at PIMCO, getting DC right has not only been a personal but also a professional

passion. As my career is exactly as old as 401(k) plans, this means that DC plans and I have “grown up” together.

Part of growing up for DC plans has been the evolution toward more institutional structures, which some refer to as “DB-izing” DC. This movement includes shifting away from retail-priced packaged products, such as mutual funds and closed-architecture target-date funds, and toward collective investment trusts, separately managed accounts, and custom multi-manager structures. These shifts can be beneficial for plan participants: Using institutional investment vehicles and improving asset diversification may lower plan costs and improve risk-adjusted investment returns for participants. For example, if an investor could earn an additional 100 basis points (1 percent), over a 40-year career, this expense and return difference adds up. Indeed, for someone starting with a salary of \$50,000—and assuming annual real wage gains of 1 percent; contribution rates, including the employer match, of 9.5 percent (in the first 10 years) and 15.5 percent (for the next 30 years); and conservative portfolio returns of 4 percent per year—an additional portfolio return of 1 percent plus the reduction in expenses resulting from the shift from retail-priced products compounds after 40 years into about \$210,000 when retirement starts. This extra sum may be sufficient to boost the retirement income replacement rate by 16 percent throughout retirement (that is, the extra sum can be used to provide yearly income in retirement that is equal to 16 percent of yearly preretirement pay).

To support the ongoing transition of DC plans toward more institutional structures, in 2010 I worked with Lew Minsky, Executive Director of the Defined Contribution Institutional Investment Association (DCIIA), to launch and serve as the founding Chair of this organization. DCIIA is a community of retirement leaders that is passionate about improving the retirement security of workers by improving the design and outcomes of DC plans. DCIIA brings together professionals from across the DC market, including consultants, asset managers, plan sponsors, recordkeepers, insurers, lawyers, communication firms, and others, all working together on this common goal.

Today, as DC plans are poised to become the dominant form of retirement savings around the world, I am inspired to provide a book to help guide the development of successful DC plans primarily for the benefit of employers and workers now and in the future. My hope is that plan sponsors, consultants, and other plan fiduciaries, by engaging with the materials in this book, will take away an empowering framework and insights to help structure and further evolve DC plan design.

DC PLANS: BECOMING THE NEW REALITY . . . NO TURNING BACK

DC plans are a large and growing market globally, representing nearly half the world's \$36 trillion in estimated total pension assets. Over the past decade, the global share of pension assets held in DC plans in the world's major pension markets has increased dramatically, from 39.9 percent in 2005 to 48.4 percent in 2015—and DC assets have also grown at a faster pace than DB assets, at a rate of 7.1 percent per year compared to the slower pace of 3.4 percent per year for assets in DB plans (Willis Towers Watson, Global Pension Assets Study 2016, covering 19 major pension markets). While DC pension assets are increasing around the world, the United States, Australia, and the UK represent roughly 90 percent with 76 percent, 7.5 percent, and 6 percent of the global DC pension assets.

In 2014, we spoke to Brigitte Miksa, Head of International Pensions (and Executive Editor of PROJECT M at Allianz Asset Management AG), about the development of retirement systems around the globe. We discussed the shift in weight among the pillars or sources of retirement income, including the first source of public pensions, such as Social Security, and the second source of occupational programs, both DB and DC. We also contrasted reliance on the different sources of retirement income and DC developments within three market segments: Anglo-Saxon countries, developed European countries, and emerging pension markets.

Looking forward, as each market develops and DC assets grow, Miksa expects the plans in these markets will become increasingly “professionalized,” such that decision-making about asset allocation and more will shift over time to professionals, away from individual participants. (These shifts mirror the evolution toward institutionalized structures for DC plans discussed above.) She told us:

Starting in the early 1990s, many countries initiated pension reforms and we began to see shifts in the dependency on different retirement income pillars. The initial wave of reforms focused on sustainability of the first pillar—government-funded public pensions such as Social Security. With the recent financial crisis, more pressure has been placed on reforming public pensions, and fortunately, these efforts have been quite successful in many cases. For instance, increasing the age for public pension qualification will help with the sustainability of public pensions in many countries.

Another significant global shift is occurring in the second pillar—employer-sponsored or occupational pension schemes. We continue to see rapid movement away from defined benefit pension plans and toward defined contribution systems. This shift started in the Anglo-Saxon countries, including the U.S., Australia, Canada and the U.K., and continues to spread to other developed markets like the Netherlands and Norway, as well as to the emerging markets.

Over the past decade, Miksa told us, more than half of the 34 countries in the Organisation for Economic Co-operation and Development (OECD) have rolled out DC programs. While the Anglo-Saxon countries continue to dominate in their percentage of global DC assets accumulated, other markets are showing rapid development; these include Denmark, Israel, Italy, and Turkey.

As the move away from traditional DB pension plans continues, workers are increasingly reliant on DC pension schemes to build their own retirement income. Employers, too, are reliant on DC plans to both attract and retain talent, and to manage their workforce—reducing the cost and the potentially detrimental effect of retaining workers beyond their desired retirement age. Multinational corporations commonly manage their DC plans worldwide with the aim of providing a valuable retirement savings vehicle as well as local-market competitive benefits (PIMCO’s 2015 Global DC Survey for Multinational Corporations). Over a third of these organizations have a written global retirement plan philosophy, while another third say they are likely to write one over the next year or two. These employers view “the ability to attract and retain talent” as the top return on investment for offering retirement benefits—this motivation is followed by a “sense of doing what’s right.”

SETTING GOALS FOR SUCCESS: INCOME REPLACEMENT TARGETS

Whether you’re a multinational plan sponsor, a single market, or a public employer, we know that for a DC plan to succeed, that plan may need to deliver an old-age income stream to last 20 to 30 years in retirement—or perhaps even longer. Consultants surveyed in PIMCO’s 2016 Defined Contribution Consulting Support and Trends Survey suggest that plan sponsors set an income replacement target at 80 percent of final pay, including Social Security and other income sources. They suggest that a DC plan will need to replace 60 percent of a worker’s final pay for those who lack both a DB plan and paid retiree medical coverage—which is the case for

the vast majority of U.S. workers. We know that the percentage of income replacement will vary broadly based on the income level and personal circumstances of workers. Whatever the percentage, most DC plans share a common goal: to help workers retire at their desired age and with sufficient income to maintain their lifestyle throughout retirement. For organizations that also provide a DB plan, the DC income replacement target may be only 30 percent. What's important is to consider the objective for your plan and set a reasonable target.

In December 2014, we interviewed Philip S. L. Chao, Principal and Chief Investment Officer of Chao & Company Ltd., a retirement plan and fiduciary consulting firm, about their approaches to DC investment design. He shared the following comments:

We begin with a basic question: "What is the objective for this plan?" It is rare for us to set up a new plan; rather, we're typically asked to advise on an existing plan. With that said, it may be surprising how much time we spend on the plan's objective. We ask the plan sponsor to forget about how the plan is designed today; they are encouraged to step back and identify what they are trying to accomplish. This often leads to a refreshing discussion of the DC plan as a benefit program and the outcome they seek for their participants. Yet, plan sponsors are rarely specific about the desired outcome. Instead, we often initially hear they simply want a competitive plan, or they may tell us how a DC plan is the only retirement savings vehicle employees have. We then work with the plan sponsors to articulate and document the objective for the plan. Once the objective is set, then we work on crafting the investment structure to help meet this objective.

Chao goes on to tell us more about setting an income replacement target, saying:

We consider the organization's workforce (i.e., thinking in sole interest of the participants) and the retirement income sources for the typical employee. A law firm's demographics, income distribution and other factors may differ greatly from a retail chain store. The law firm may have higher-paid workers and lower turnover. These are important considerations as we think about the median worker profile. Median is not perfect either, but it's a start. We consider Social Security, likelihood of the existence of other retirement plans, housing wealth, and other retirement income sources.

In general, plans consider a 75% to 80% income replacement as the default target, including Social Security. About half of that need can be covered by Social Security and other income sources. This leaves DC plans to fill in the remaining 35% to 40% of income for the median worker over the course of a working career. This isn't exact and won't fit all workers, but a general target helps us as we consider the plan design. We ask ourselves whether the median participant is likely to meet their income needs. We want the plan sponsor to understand the probability of failure and whether the plan is likely to meet the set objective. This goes beyond investment return and pulls in the average deferral rate, employer contribution amount and other assumptions. Assessing the likelihood of meeting the plan's objective can help plan sponsors evaluate target-date funds and other QDIAs [Qualified Default Investment Alternatives] as well as test the balance in and portfolio construction adequacy of their core lineup.

While DC plans need to focus on meeting participant needs and consultants tell us that the number one driver of plan sponsor decisions is to “meet participant retirement goals,” they also note that the second driver is to “manage litigation risk” (PIMCO’s 2016 Defined Contribution Consulting Support and Trends Survey). Sound plan governance and plan oversight are central to both of these. Before delving deeply into meeting a retirement objective, let’s take a look at litigation and fiduciary duties.

REDUCING DC LITIGATION RISK: PROCESS AND OVERSIGHT

In 2014, we sat with James O. Fleckner, Partner and Employee Retirement Income Security Act of 1974 (ERISA) Litigation Practice Leader at Goodwin Procter LLP, to talk about how plan sponsors can reduce the risk of litigation. Fleckner first provided some background on the Employee Retirement Income Security Act, a 1974 federal law that is intended to “help protect the interests of employee benefit plan participants and their beneficiaries by establishing fiduciary duties of care, plan disclosure requirements and more. This federal statute governs most private employee benefit plans, including defined contribution plans.”

To protect themselves against lawsuits, “Plan sponsors should understand and fulfill their fiduciary duties,” Fleckner comments. These include the duties of loyalty, prudence, diversification, and fidelity to plan documents. Loyalty focuses plan sponsors on doing what is in the best interest of participants, rather than on what may be of value to themselves or their

company. “We’ve seen this duty raised in cases that have alleged that the plan fiduciaries cared more about saving money for the company than they did about doing what was right for the participants,” he notes.

Prudence, in contrast, focuses on the process for making fiduciary decisions; for those lacking expertise to make decisions such as about investments, the government suggests they hire experts. Fleckner also discussed the duty of diversification, which is intended to help reduce the risk of losses. Plan sponsors are guided by the provisions of ERISA section 404(c) in offering at least three diversified investment choices within the plan. And, finally, there is the duty to follow plan documents.

ERISA litigation may arise when it is alleged that a plan sponsor has failed to meet any of these fiduciary duties, or to challenge technical violations of ERISA’s prohibited transaction rules. Unlike in DB plans, where the company bears the cost in the event of an error or misjudgment, in DC plans the participants bear both the upside and downside risk—hence Fleckner commented that “we see few DB lawsuits and many DC cases. Also, since many of these fiduciary duties are left open to interpretation or to the particular facts and circumstances of a given case, this area exposes plan sponsors to litigation risk.”

In the end, says Fleckner, fiduciaries need to demonstrate that they care about their participants: “In defending against any litigation involving those choices, it is most helpful to have a written record of the consideration that the fiduciaries gave in arriving at their decision. That way, we can show the judge that, in fact, the fiduciaries were evaluating options and landed on the ones that they felt were most appropriate for their participants.”

WHO’S A FIDUCIARY?

ERISA requires that a DC plan have at least one fiduciary—that is, a person or entity either named in the written plan, or through a process described in the plan, as having control over the plan’s operation. The Employee Benefits Security Administration (EBSA) explains: “The named fiduciary can be identified by office or by name. For some plans, it may be an administrative committee or a company’s board of directors. A plan’s fiduciaries will ordinarily include the trustee, investment advisers, all individuals exercising discretion in the administration of the plan, all members of a plan’s administrative committee (if it has such a committee), and those who select committee officials. Attorneys, accountants, and actuaries generally are not fiduciaries when acting solely in their professional capacities. The key to determining whether an individual or an entity is a fiduciary is whether they are exercising discretion or control over the plan.”

For plan sponsors who lack expertise in a specific area such as investment oversight, they may want to engage an investment consultant or other experts to help them fulfill their fiduciary responsibility. In 2011, we spoke at length to David Levine of Groom Law Group regarding fiduciary rules played by plan sponsors and outside advisors, including how to understand primary ERISA fiduciary categories, and what responsibilities fit with each.

In the U.S. system, the core concept of *fiduciary*, Levine told us, is contained within a single category—an ERISA “3(21) fiduciary.” Beyond this basic definition are various additional roles, such as the concept of the *named fiduciary*, which generally is a fiduciary named either in a plan document or by a plan sponsor. A named fiduciary is the default plan fiduciary. Others, including advisors, can also be 3(21) fiduciaries. Further, a person can be a 3(16) plan administrator responsible for certain core administrative duties under ERISA. The determination of when a person is a fiduciary or not depends on their exact duties, on whether the duties are discretionary in nature, and on the financial relationship of the person to the plan. The bottom line, Levine says, is that “It’s important to carefully evaluate each situation to determine whether an individual is a fiduciary or not.”

We asked Levine about the plan design and oversight issues that require fiduciary oversight, including selecting the investment lineup and manager. In the case that the plan sponsor would prefer to outsource these duties, what should they consider? Here’s what he told us:

The role and responsibilities for each advisor should be clear and documented within a contract and, depending on the exact circumstances, potentially in the plan document as well. In some cases, the administrative and investment issues are split and managed by different advisors. It’s important that both the investment and administrative issues be addressed, and to clarify who is actually administering the plan. Without clarity, all fiduciary responsibility will, under many standardized plan documents, rest with the plan sponsor—that is, the company.

Within advisor contracts, it’s helpful to identify the exact fiduciary status of the advisor to minimize confusion as to what role the advisor is playing. Of course, each contracting situation is unique, so there is no one-size-fits-all solution.

As plan sponsors and fiduciaries finalize their agreements with providers, you need to understand if this person is really saying, “I will be named as the main fiduciary in the plan document.” Or are they saying, “I will be your co-fiduciary with you,” which really means, “I’m just a fiduciary with your existing plan fiduciary, so we’re all on the hook together”?

The bottom line, Levine told us, is that outsourcing many fiduciary duties to a third party is doable, but “it’s important to really dot the *is* and cross the *ts* because this is where people may get caught, especially if they only focus on the investments and not on the administration.”

HOW TO APPROACH OUTSOURCING DC PLAN RESOURCES

Levine told us that smaller plans will often end up with a prototype plan offered by a third-party administrator or a bundled-service provider; while larger plans may have a custom plan document but still use a third-party administrator, bundled-service provider, or independent recordkeeper. These administration providers will oftentimes manage the administration of the plan, handle all the day-to-day responsibilities, and make nondiscretionary recordkeeping decisions. Whether these providers are fiduciaries will depend on the exact circumstances of each situation, but “An advisor or consultant can play a key role in helping you figure out exactly what fees are being charged and what services are being provided by the recordkeepers and other providers.” Levine adds, “They can help you confirm and document that the fees your plan is paying are reasonable.”

The most common and typically the biggest role played by most advisors is in relation to the plan investments. In this case, the advisor can act as the fiduciary in the selection, monitoring, and retention of investment offerings for the plan. This includes vetting the managers, evaluating risk and return, and determining how the investments have done relative to peers and benchmarks. The advisor can either lead or help go through this process if the default plan fiduciary doesn’t have the time, resources, or skills to do this work internally. A plan might even hire the advisor to assume full control or discretionary oversight of the investments for the plan. In all cases, the plan fiduciary needs to define the breadth of responsibility as well as agree to the advisor’s fees. Says Levine, “Fiduciaries have a duty to properly appoint an investment manager. But once the decision is made, the risk is mostly shifted to the investment manager at that point (subject to a duty to monitor the investment manager).”

When we asked Levine what final words he had with respect to the changing role of plan sponsors and external advisors, he commented that “Too often, plan sponsors are bombarded from so many sides with information about these issues. Good advice and good support from outside parties doesn’t have to be overwhelming to plan sponsors and plan fiduciaries. In fact, it appears to be moving us in a good direction where, hopefully, it will advance the entire system’s objective as we move forward.”

HIRING AN INVESTMENT CONSULTANT

DC investment consulting is a growing profession. In PIMCO's 2016 Defined Contribution Consulting Support and Trends Survey, the 66 participating DC consultant and advisory firms reported serving over 11,000 plan sponsor clients who together represent combined plan assets of over \$4.2 trillion. These firms say they provide a broad range of services, including investment policy development and documentation, investment design, recordkeeping searches, and total plan cost or fee studies. Nearly all said they are willing to serve as a 3(21) nondiscretionary advisor—that is, they will make recommendations with respect to which investments a plan sponsor may want to select. The majority of consultants also are willing to serve in a 3(38) discretionary fiduciary capacity over such functions as manager selection, glide path oversight, and investment management. This allows the consultant to make decisions for the plan sponsor, such as which investment managers to hire. Consultants expect continued growth in discretionary services for clients, as clients may initially hire the consultant as a nondiscretionary advisor and then migrate the consultant to a discretionary role.

While hiring a consultant can help fulfill a plan's fiduciary duty, it is important to note that plan sponsors are not necessarily protected by going with the consultant's recommendation (no matter how well-documented that decision may be). In commenting on a recent lawsuit that followed a line of decisions that held that "independent expert advice is not a 'whitewash,'" Fleckner said: "The court explained that a fiduciary who relies on an expert, like a consultant, should make certain that reliance on the expert's advice is reasonably justified under the circumstances. The court cautioned that the sponsor cannot reflexively and uncritically adopt investment recommendations."

Ultimately, plan sponsors may take a different direction than recommended by their consultant and still meet their fiduciary duty. In fact, "if the sponsor believes that the consultant's recommendation is contrary to the interests of the plan and participants," comments Fleckner, "or it believes that the consultant did not engage in a rigorous enough process, then the fiduciary may be obligated to reject the recommendation. As discussed with any fiduciary decision, the plan sponsor should document its rationale for taking action that differs from the consultant's recommendation."

GETTING STARTED: SETTING AN INVESTMENT PHILOSOPHY AND GOVERNANCE STRUCTURE

In 2015, in collaboration with our UK-based colleague at the time, Will Allport, and a host of multinational plan sponsors, we created a guide to achieving a consistent philosophy and governance structure for global DC

plans, *Global DC Plans: Achieving Consistent Philosophy and Governance* (DC Designs, November 2014). Whether you are a plan sponsor offering a plan only in the United States or via multiple plans around the world, it may be helpful to consider the following five-step process for DC retirement plan design.

1. Establish a plan philosophy and guiding principles
2. Set retirement plan objectives and design
3. Create a governance oversight structure
4. Formulate objective measures of success
5. Outline implementation considerations

We'll look at each of these steps in turn.

Establish Global Philosophy and Guiding Principles

It is sometimes a great challenge for organizations that already have a complex employee benefits and pensions landscape to step back and consider the basic question: "Why do we offer a DC plan?"

Although it seems simplistic, we believe asking this question is a critical first step in establishing a philosophy for DC design. Does an organization want to be paternalistic to its employees, to educate, guide, and empower them toward successful retirement outcomes, to be an attractive employer, and to retain and nurture talent? Or alternatively, does an organization offer pensions simply to satisfy legal or fiduciary requirements, or perhaps simply to meet the market norm? The reality is often a combination of all of the above, but establishing which motivations are most important will aid organizations in creating the guiding principles for all of their pension plans.

While an overarching philosophy to apply to pension benefits is somewhat intangible, the principles through which an organization ensures this philosophy is delivered should be anything but! The guiding principles that each organization should develop need to be clear, rigorous, and tangible. Each local plan will be able to prove whether it meets the requirements of these clear principles. The UK's Pensions Regulator put a great deal of effort into proposing effective principles for high-quality DC design, and we have drawn upon their work and others' in the suggestions that we include in the following.

Suggestions for Core DC Plan Guiding Principles

- **Principle 1:** Plans should be designed to target appropriate outcomes, for example, replace 50 percent of final pay throughout retirement.

- **Principle 2:** Plans should identify, evaluate, monitor, and manage key DC risks, for example, volatility, potential loss (value at risk), inflation, and longevity.
- **Principle 3:** Plans should have a clear governance framework to implement a global retirement benefits philosophy, with clear and transparent accountabilities and responsibilities.
- **Principle 4:** Plans should provide ongoing governance, regulatory oversight, and investment training to plan fiduciaries necessary to competently fulfill their duties.
- **Principle 5:** Plan design, investments, service providers, and fees should be reviewed annually by the organization's global DC plan oversight body or other designated bodies.
- **Principle 6:** Plans should seek recordkeepers that provide timely, accurate, and comprehensive records as well as appropriate disclosure on error resolution, fees, and services.
- **Principle 7:** Plan member communications should educate and guide participants toward informed retirement planning and investment decisions.

Set Retirement Plan Objectives and Design

Having established the overarching philosophy for retirement program design, and the core guiding principles that guide every plan, organizations next need to consider local factors and finalize the retirement benefit objectives for each plan.

This is the point at which most companies recognize that a one-size-fits-all approach to DC design probably will not work. For plans operating in more than one market, understanding the local labor market demands for each country in which the organization is operating is critical. No matter how many markets a plan serves, organizations need a clear view of the design of *first pillar* or *first source* Social Security benefits and the resulting income replacement targets, the competitive landscape benchmarked against other employers competing for the same talent pool, and statutory requirements. These and other considerations will help each plan to define its specific retirement benefits objectives.

Please note we are not suggesting that for multinational organizations, every plan within the organization should have similar objectives, or have the same design or providers. Rather, we would expect to see retirement benefit objectives that are philosophically consistent across all plans, and with the same core principles underpinning their design.

We believe that organizations that have not established the core objectives for each local plan risk a great deal. Without objectives, measuring the

local plan's success—and therefore measuring return on investment for pension costs that affect the financial performance of the entire company—is virtually impossible.

Once objectives are set at the local level, most organizations find the design and investment structures underpinning each local plan are broadly similar, again excepting for local market nuances (for example, providers or legal restrictions).

Create Governance Oversight Structure

The first two steps of the five-step process require high-quality and clear communication across all the retirement benefits teams within an organization. Adhering to the core philosophies and guiding principles would be challenging without effective monitoring, along with engagement of senior leadership and broader stakeholders. Organizations should periodically revisit their guiding principles and objectives to ensure they evolve to meet the changing objectives of the corporation itself, alongside the needs of its employees. To achieve this, organizations should create a governance oversight structure that taps into the expertise of both in-house and retained investment, benefits, and other experts. The oversight structure establishes and evolves the guiding principles and philosophy for DC design, engaging key stakeholders throughout the organization. Critically, the structure allows for monitoring the plans for adherence to those core principles and for measuring the success of each plan relative to its objectives.

Formulate Objective Measures of Success

To effectively monitor DC efforts, organizations should establish clear success metrics. Since most DC plans aim to provide retirement income replacement, a percentage of final pay may be an appropriate success metric. Such a metric may be used internally to evaluate the plans; it need not be communicated to participants for fear they may construe the objective as a promise. Without clear objectives and the means to demonstrably measure progress against them, any retirement benefits program will be effectively “flying blind.”

Outline Implementation Considerations

The final step in the process will be to assess and manage key implementation considerations that will underpin the final plan designs. These will include recordkeeper and custodian capabilities among many other considerations.

A PLAN SPONSOR'S PLAN DESIGN GUIDING PRINCIPLES

In July/August 2011, Judy Mares, at the time Chief Investment Officer of Alliant Techsystems Inc. (ATK), shared in a PIMCO DC Dialogue the five guiding principles that they established to guide the plan changes. She explained the following:

To start, we established a set of five guiding principles to help our policy committee as they thought about the plan design.

- *First, we decided that we wanted to continue to deliver retirement benefits consistent with the company's business objective of providing employees with a solid foundation for retirement income.*
- *Second, we wanted to encourage and facilitate our participants' establishment of a final income replacement rate based on personal facts and circumstances and desired retirement income.*
- *Third, we needed to continue to educate participants about the factors that influence retirement income adequacy, such as cost-of-living increases, medical costs, longevity—the various factors that are key to the development of a financially successful retirement.*
- *Fourth, we sought to offer a plan design and fund lineup that seek to minimize the negative effects of participant behavior. We looked at as many behavioral finance studies as we could get our hands on, and certainly that body of literature suggests that we should imbed structures in the plan that are more opt-out than opt-in.*
- *Fifth, we strove to implement a plan fee and expense methodology that's understandable, transparent and reasonably applied across all participants. We could see that the Department of Labor was moving in that direction. But equally important was the sense that individuals could be better consumers when they know what things cost. Fee transparency helps people understand that component of decision making.*

Finally, we presented these principles to our policy committee and gained approval. Then we started to look at the plan design, asking how the plan design addresses these principles, and whether we should think about doing things differently.

PIMCO PRINCIPLES FOR DC PLAN SUCCESS: BUILDING AND PRESERVING PURCHASING POWER

A key tenet of PIMCO’s own DC principles is that success is defined as “building and preserving purchasing power to meet retirement income needs for the majority of participants, regardless of the prevailing economic environment.” This definition has a subtle but incredibly important undertone, namely that the average outcome for participants is not enough on its own as an objective. Instead, as shown in Figure 1.1, the distribution of those outcomes across participants is critical. Think of it as a principle: *Avoiding failure for some is as important as marginal gains for the majority.* Said another way, we seek good outcomes for all plan participants. This principle requires a success metric (and accordingly an objective threshold to be defined) for avoiding failure, not just for achieving success. In Figure 1.1, we show people on the left standing in a shadow; this represents a probability distribution of those who may fail to reach 30 percent income replacement. You’ll see on this distribution that there are many on the right who may achieve more than 75 percent income replacement. We believe plans should set a target income replacement level and design their plans to minimize the risk of failure (i.e., people in the shadow) even if that means they will reduce extreme winners (i.e., people on the right).

We define *success* as building and preserving purchasing power to meet retirement income needs for the *majority* of the people regardless of the economic environment.



Sample for illustrative purposes only
 The income replacement target illustrates an example of the percentage of their income that most plan participants will need to replace at retirement.

FIGURE 1.1 Consider Distribution of Potential Income-Replacement Outcomes: Identify Both Target and Failure
 Source: PIMCO.

PIMCO believes that using an objective-aligned framework will lead to improved outcomes for DC participants, giving employees greater comfort over their retirement, human resource professionals greater confidence in their ability to perform effective workforce management, and corporate treasurers an improved sense of return on investment for retirement benefits spending.

Moving to an objective-based framework begins with acknowledging the retirement income objective—that is, the ability of the plan to help participants fund future consumption of goods and services. By aligning the investment management to this objective, the asset allocation structure shifts. Similar to DB, DC plans are not focused on maximizing returns. Rather, they aim to meet a future liability, and unlike DB assets that may not be required to keep pace with inflation, DC participants' objectives must meet the pace of inflation. Thus, shifting the asset allocation to inflation-hedging or "real" assets may better align DC assets to the objective and thereby reduce risk of failing to meet the plan's objective.

DCIA Executive Director Lew Minsky shared, in PIMCO's January 2012 DC Dialogue, his views on defining DC plan success:

At the end of the day, designing DC plans and their investment structures to "succeed" means designing them so that participants are more likely to have the money they need to retire and maintain their lifestyle in retirement. For most plan sponsors, defining success in terms of a retirement income target or outcome is a big shift. In the past, plan sponsors focused on other success measures, such as "What is my participation rate?" and "What's the savings rate of the non-highly compensated group that's going to allow me to meet my testing goals and not have to worry about the contributions of the highly compensated groups?"

Redefining success as meeting a retirement income goal involves shifting from a strictly tactical view of DC plan management to a much more strategic view that asks, "Why are these plans in place?" and "What is the policy goal behind having these retirement savings plans?"

Minsky discusses how to achieve an outcome-focused design by referencing a DCIA paper, "Institutionalizing DC Plans: Reasons Why and Methods How". This paper lays out the consultants' "building-block" approach for improving DC plan outcomes. In accordance with this approach, the consultants suggest focusing first on governance, then funding (i.e., increasing contribution rates), restructuring investments to an institutional model, and finally improving participant engagement and distribution options.

Aligning the investment design to the DC plan's retirement income objective will be the primary focus for the majority of this book. Before we turn to that topic in earnest, we must comment on the most critical first step in DC plan success: getting people into the plans and contributing at a sufficient rate.

MAXIMIZING DC SAVINGS: JUST DO IT!

One of the greatest advances in DC plan design is the leveraging of human behavior to improve contribution and investment behavior. Professors Richard Thaler at University of Chicago and Shlomo Benartzi at UCLA helped plan sponsors increase contribution rates with a concept they called "Save More Tomorrow" or SMART. In the June 2007 DC Dialogue, Professor Thaler explained:

The idea is to use simple principles of behavioral finance to design a program that helps people save more.

We have three components in our version of auto escalation [with auto-escalation, your participation level is automatically increased at regular intervals, typically 1 percent a year, until it reaches a pre-set maximum]. First, we invite people to sign up for auto escalation a few months before it takes effect. Second, we link contribution increases to pay raises and, third, we leave things alone until the person opts out or reaches an IRS or plan savings cap. All three components are based on research principles.

We ask people to sign up in advance because we know from other research that they're more willing to entertain self-control ideas if the control occurs in the future. As St. Augustine prayed, "Oh, Lord, make me chaste. But not yet!"

People don't think they can afford to save more right now. Rather, they think they can later, perhaps. Linking savings increase to raises mitigates what we call "loss aversion"; people hate to see their pay go down, but they can imagine taking some of their raise and contributing it to the defined contribution plan.

Then we let the power of inertia work for us. Once people sign up for a plan, they remain in unless they opt out. Fortunately, for both auto enrollment and escalation, the dropout rates are tiny. It's comforting because we worry that somehow we're tricking people into saving more. If people wake up and think that it's a mistake to save 10 percent, and they should return to 3 percent, then some people would return to 3 and ultimately hurt their retirement security.

In fact, people almost never reduce their escalation contribution rates. A small percentage drops out of auto escalation, but typically that's to stop future escalation. It's rare for anyone to set his or her saving rate back to a lower percentage.

All these factors together lead us to think that auto programs help the vast majority of people save more. We don't hear complaints.

In July 2006, shortly prior to the enactment of the Pension Protection Act's (PPA) release in August, we conducted our first PIMCO DC Dialogue interview with Lori Lucas, CFA and now DC Practice Leader at Callan Associates. We titled the piece "Look, Ma! No Hands!" as she focused on how "autopilot" programs such as automatic enrollment and contribution escalation fuel DC asset accumulation without requiring action by the participant. Lori commented: "After years of trying to get people to participate actively in 401(k) plans, sponsors have learned that autopilot programs are most effective because they leverage inertia. The auto programs play into participants' inertia and make the plans work for employees—instead of against them—even if the employees do nothing."

Prior to autopilot programs, American employers spent millions of dollars trying to persuade workers to contribute to their DC plans. Among other reforms, the PPA gave plan sponsors statutory authority to auto-enroll eligible employees into the plan (yet allow participants to opt out if they preferred), thus finally providing sponsors with an alternative to begging workers to opt in. This "just do it" auto-enrollment approach, now adopted by 52.4 percent of U.S. employers (in 2014, according to Plan Sponsor Council of America's 58th Annual Survey), has successfully offset natural human inertia and improved DC participation and contribution rates, with about 80 percent of all eligible participants now making contributions. What's more, auto-escalation of the contribution rate, a feature utilized by almost 40 percent of plans that auto-enroll, may help pump up the percentage of salary that Americans contribute each year to 401(k) and other employer-provided DC plans.

In November 2011, DC Dialogue spoke with financial planner Lee Baker, CFP®, President of Apex Financial Services about automatic enrollment and contribution escalation, as well as retaining assets in the DC plan. He shared the following suggestions:

... automatic enrollment and contribution escalation can help a lot. Rather than putting [participants] into a plan at 3 percent of pay and escalating them up by 1 percent a year, I think they would be

better off to go in at the matched savings rate, often 6 percent, and then escalate up at 2 percent a year. This is a tolerable contribution rate and may help get folks to save over 10 percent of their pay, which they will need to meet their goals. What's important is to make sure they receive the full match.

Baker also encourages plan sponsors to offer participant education. He talks about how participants learn at seminars:

We help people get over these concerns [with investing in a DC plan] by explaining the value of their plan's matching contribution. There is a cost in that you have to give money to get money . . . you have to give up whatever else you could have done with that money. You put a hundred bucks in there and with many plans you're going to get an extra 50 bucks contributed by the employer.

There are always some light bulbs that go off when we say that, because often no one has ever explained it that way before. And here's the kicker. We may say, "You get this match money even if you put your money into the money market, cash, or stable value option."

Sometimes it can take a while, but if you're willing to provide some education, you'll see some attitudes change. Even if they start out investing in the conservative investment option, I would not be at all surprised if, over time, they begin to invest some of their dollars into a more broadly diversified portfolio. While diversification is important, just getting them started and saving in these plans has to be the first step.

Baker also notes the importance and power of retaining assets in a DC plan rather than cashing out or rolling the money over to an IRA. He comments:

Cash-outs are a problem. We believe people need to be educated—they need to understand the dangers of cashing out. You've got to help them understand what's going to happen if they cash out, particularly if they're under age 59 and $\frac{1}{2}$. They're going to give the government a 10 percent early withdrawal penalty, and they're not ever going to see that money again. It's just gone, because they're going to have to pay a huge hunk in taxes right up front.

At one session, one of the participants shared a story about cashing out a past 401(k). She decided to take the cash and buy

a car, but got a really nasty surprise when it came time to do her taxes. Participants need to hear, “Hey, listen, this lady thought she was going to go buy a car, so she took \$30,000 out of her retirement account because she wanted to pay cash for the car. But she was shocked when she ended up with a \$3,000 tax bill the next year.” If nobody’s ever told you, it’s easy to make that kind of mistake.

Baker encourages retirees to retain assets in an employer plan rather than rolling to an IRA, especially for those who have access to a large and well-managed plan. He also notes that “we can do more to help folks that remain in the plan during retirement by improving the distribution flexibility and offering retirement income options.”

In a February 2016 Defined Contribution Institutional Investment Association (DCIIA) paper titled “Plan Leakage: A Study on the Psychology Behind Leakage of Retirement Plan Assets,” they address the problem of leakage out of the DC system as follows:

According to a study by the Federal Reserve Board, \$0.40 of every dollar contributed to the DC accounts of savers under age 55 eventually “leaks” out of the retirement system before retirement. This phenomenon, often referred to as plan leakage, has a disproportionate incidence in those workers least prepared for retirement: of those who cashed out their DC retirement accounts upon a change in employment, 41 percent had less than \$25,000 in household retirement savings.*

*A recent survey of 5,000 retirement plan participants sheds light on leakage patterns, as well as on the thought process of job changers who are confronted with the challenge of “rolling in” retirement savings from a former employer.***

Cash-outs occur at all income levels. Even among the highest income level (those earning over \$150,000 annually), 33 percent reported they have cashed out at least one account during their career. However, cash-outs occur more frequently among those with lower wealth levels. More than 40 percent of workers with a modest level of wealth (defined as those with less than \$25,000

* Robert Argento, Victoria L. Bryant, and John Sabelhaus, “Early Withdrawals from Retirement Accounts During the Great Recession,” *Contemporary Economic Policy* 33, no. 1 (2015): 1–16.

** Warren Cormier, *Boston Research Technologies on behalf of Retirement Clearinghouse, Actionable Insights for Your Mobile Workforce*, 2015.

in household retirement savings) cashed out at least once in their working lifetime compared to only 23 percent of workers with more than \$150,000 in retirement savings.

Approximately half of survey respondents reported leaving their retirement assets in their former employer's plan, a finding consistent across generational groups. Only about 20 percent of all generations expressed a well-thought-out reason for leaving their money in the previous employer plan, such as preferring the prior plan's investment menu or customer service. On the other hand, barriers such as not knowing how to roll over assets, not having time to do so, or not prioritizing the issue were each mentioned by about 20 percent of all generations as reasons for not moving retirement assets to their new employer's plan.

DCIIA's paper concludes that leakage remains an issue and undermines the goal of building retirement security. Removing obstacles or barriers to the rollover process is suggested. Unfortunately, it is much easier for a person to cash out than it is to roll the money into another employer's plan. The U.S. government is working to help minimize these barriers and complexities. While a far smaller issue compared to cash-outs, the failure to pay back loans is another way in which money may leak out of the DC system; this is particularly problematic when a participant loses his or her job and the loan is immediately due—if it goes unpaid, the loan becomes a distribution that is typically taxable to the participant. Offering a program to pay back a loan even after termination or perhaps even with a grace period (e.g., suspend payments for six months) is one way to help address leakage from loans. Among the many advantages of automatic enrollment and contribution escalation programs are that they may help participants start savings at an earlier age, and participants also may remain in the plans longer. In a July 2010 DC Dialogue with Jack VanDerhei, PhD, CEBS Research Director at the Employee Benefit Research Institute, he observed that:

Auto-enrollment can be a huge benefit particularly for the lowest income quartile. Two things we've seen over and over again in our research is that among the younger, lower-income employees, participation rates in traditional 401(k) plans without automatic enrollment are very low, in many cases under 50 percent. But if you switch to automatic enrollment, the percentage of individuals opting out, even in that young and low-income cohort, is quite small. You get the advantages of the increased participation rate, which should help increase overall balances in that group significantly.

VanDerhei also commented on how auto-enrollment may lead to higher retention of retiree assets:

There's no quantitative data thus far from which to draw conclusions because it's much too early. But I'm willing to predict that, as you find more of these 401(k) participants who are auto-enrolled, you also will find that more of them have never made any active investment decisions during the time they participated in a 401(k).

As a result, by the time these individuals reach retirement age, they may have very little desire to roll that money over to an IRA and then have to start actively managing it. Even if this IRA has the same funds available as in their former employer's DC plan, these individuals may be much more likely to keep their money with the 401(k) sponsor and continue to participate in a plan where they don't have to manage the asset allocation actively.

Beyond the U.S. borders, Australia and the UK have taken a more aggressive approach toward DC savings and asset retention. In Australia, employers are required to contribute 9.50 percent of pay, rising to 12 percent by 2025, to a tax-advantaged retirement plan (overwhelmingly a superannuation DC program). Between 2012 and 2017, the UK is phasing in a requirement for employers to auto-enroll participants at a rate that will increase to 8 percent of pay with at least 3 percent contributed by the employer (employees may still opt out). In contrast to the United States, once the money is in the Australian or UK programs, participants generally cannot withdraw funds until retirement age. Clearly, DC account values will build far more swiftly in the Australian and UK systems, given their higher contribution rates and their firmer control of leakage. In addition, the opting-out approach seems to function more effectively in the UK where many companies report that more than 85 percent of members defaulted into plans do not opt out.

IN CLOSING

In this chapter, we've set the stage for those that follow. We started with a review of the growing size and scope of DC plans in the United States and worldwide, and thus the growing importance of "getting DC right" as the future of an ever-increasing number of workers will depend on the income they receive in retirement from their DC plans. We introduced a number of core concepts that we'll further develop in the remainder of this volume, including the income replacement target for DC plans, and the question of

“what is a fiduciary?” We also outlined the importance of establishing an overall investment philosophy and governing structure for DC plans. Developing these guiding elements for a DC plan will help plan sponsors walk through the “how” and “why” they are implementing DC plans, and can help workers understand how and why they should participate to help meet their personal retirement goals.

This chapter also draws on some of the work that PIMCO has undertaken to develop principles for DC plan success, including how both the success and, crucially, the failure of a DC plan is to be evaluated and measured. We noted that for PIMCO, success is defined as “building and preserving purchasing power to meet retirement income needs for the majority of participants, regardless of the prevailing economic environment.” Folded into this definition of the objective for DC plans is the underlying idea that success must be measured by considering the outcomes for all participants, not just the average outcome for all. That is, the distribution of results is important—as the goal is to avoid failure for every participant, versus maximizing “winning” for some. With that objective in mind, we can ask: How might plans be designed to produce this outcome, and how does current plan design differ from the objective-aligned framework we’ve laid out in this chapter? With the continued global evolution toward a DC-based pension system and increasing reliance on these plans to meet retirement income needs, we’re now ready—in subsequent chapters—to consider the investment design for these critical plans. Before we start, however, we end this chapter with a set of questions for plan fiduciaries to consider as they reflect on the discussion we’ve undertaken so far.

QUESTIONS FOR PLAN FIDUCIARIES

1. What is the objective for the DC plan(s)? If there are multiple plans, does the objective vary by plan?
2. What is the income replacement objective for the plan?
3. Who is the plan fiduciary? Who are the stakeholders?
4. Do you need external experts—such as an investment consultant, glide path manager, ERISA counsel, or others—to help oversee the plan?
5. Are your plan documents current and accurate?
6. Do you have governing principles?
7. Have you considered how you will benchmark your plan investments?

