What will DC plans look like in 2025?

Ten considerations

In a post-defined benefit (DB) world, defined contribution (DC) plans – historically only used to supplement a monthly pension – have largely failed to prepare U.S. workers for retirement. This leaves those who rely on Social Security as their primary benefit and only source of guaranteed income vulnerable and may also adversely impact employers. Delayed retirement creates workforce management issues because employees facing financial stress often come to the workplace in poor health, may be disengaged and are blocking younger workers from advancing. In BlackRock's 2019 DC Pulse Survey[1], 93% of plan sponsors agree that they should be responsible for the retirement preparedness of their employees, which may be an indication that employers are beginning to understand their exposure to this issue.

Russell Investments believes that, by 2025, more employers will adopt some of the characteristics of the most successful pension plans to help put them on a path to create a fully funded retirement income stream for participants. This paper explores that concept by discussing changes we hope will soon become mainstream. To set expectations, we have assigned probabilities that such changes will be incorporated by 2025, where 1=low probability and 5=high probability. Our focus is on the benefits of updating investment governance structures, the need to increase savings to better fund these future "liabilities," and the importance of utilizing more efficiently managed portfolios to increase the likelihood that employees will have successful retirement outcomes

Updating investment governance

DC plans are now the sole source of retirement income for millions of U.S. citizens; however, committees have been slow to adapt their governance. Still today, most are primarily focused on benchmark-relative performance, with little time devoted to overall strategy. Research by Ambachtsheer, Capelle and Scheibelhut[2] suggests that improving governance by enhancing discipline and consistency can increase performance by 1% to 2% per year. That should provide ample incentive for committees to consider the strategies below, and we believe these two updates to a plan's governance will be considered best practice by 2025.

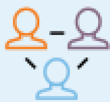
[1] Driving well-being through retirement preparedness, BlackRock, April 1, 2019. https://www.blackrock.com/us/individual/financial-professionals/defined-contribution/news-insight-analysis/driving-well-being-through-retirement-preparedness

[2] Ambachtsheer, K.; Capelle, R; Sheibelhut, T.; Willis Towers Watson, "What is delegated management?" 2019

1. Establish investment beliefs

Investment beliefs are a series of high-level principles, unique to each committee, that guide decision-making and supersede the personal views of individuals. They are considered a core factor in global best-practice models, fundamental to improved governance and are now utilized by many of the largest portfolios in the world. Establishing beliefs saves time and allows committees to focus more on strategies to improve retirement outcomes for participants. Because codified investment beliefs are foundational for improved governance, Russell Investments strongly believes they should become standard for all large DC plans. We also expect to see a more prominent focus on Environmental, Social and Governance (ESG) factors in investment beliefs and investment policy statements.

Probability 4/5



2. Delegation of investment decision making

Committees are often composed of senior level executives with competing priorities, who have limited capacity to spend added time focusing on the organization's retirement plans. The agendas for most meetings are allocated to discussing plan investments, even though returns generated by managers will not have the biggest impact on participant outcomes. To mitigate the workforce management risk and maximize the probability that participants won't need to delay retirement, committees should re-evaluate how they spend their time. DC committees would benefit by deciding to focus more time on strategy and outsource investment decisions to either an internal sub-committee (e.g., staff) or to an outsourced chief investment officer (OCIO). By 2025, Russell Investments believes that this will become the standard approach for oversight of DC plans.

Probability 3/5

Funding future DC "liabilities"

Unlike pension plans, most DC plans are primarily funded by participants, with only modest contributions coming from plan sponsors. Since investment performance is only a small part of what is necessary to achieve a successful retirement outcome, it is important that committees re-evaluate their funding policy. The objective should be to ensure that participants have sufficient assets to replace their income in retirement, which could be considered their future liability. By 2025, we believe that there will be broader utilization of multiple employer plans (MEPs), which will expand coverage and increase overall savings for our retirement system, and committees should have more tools and thus will spend more time on strategies designed to optimize total contributions.

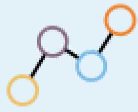
3. Expanded coverage through MEPs

It is broadly accepted that most employees are not on track to have sufficient savings at retirement, and the chances of a successful outcome are even more challenging for a large percentage of U.S. citizens. According to a 2018 study by the Empower Institute[3], approximately one-third of U.S. households are not eligible for a workplace retirement plan. Policymakers are keenly aware of this hole in our retirement system and are considering proposals to expand access to open MEPs. The Empower Institute study found that 66% of small business owners who don't currently offer a retirement plan are likely to consider an open MEP, and many with an existing plan would even consider switching.

With the passage of legislation supporting open MEPs, they are very likely to become a viable alternative for both small and large employers by 2025. In this scenario, the number of workers covered by a plan will increase dramatically, which will improve the overall funded status of the United States' retirement system.

Probability 5/5

[3] Empower Retirement Small Business Open Multiple Employer Plan research conducted Sept. 25-October 8, 2018 by Harris Insights and Analytics; 304 small business decision makers completed an online survey. Businesses were for-profit with 5-250 employees and in business for more than one year.

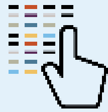


4. Lifetime income disclosures

Regardless of the stage of life, saving for retirement can be challenging for many employees. Although the nature of the expense can differ for early-, mid- and late-career employees, there is constant competition for a share of the paycheck throughout a working life. Even for those intent on starting early, the decision is further complicated by not knowing how much to save each year, or the total assets needed to fully fund their retirement. This is akin to a corporation trying to fund a pension plan without a clear estimate of the future liability.

Legislation has passed that will require employee statements for private sector DC plans to include an estimate of projected monthly benefits. By providing this estimate, participants will then be able to use the tools provided by their plan's recordkeeper to more closely approximate the total assets needed at retirement, and adjust their funding level to reach that goal.

Probability 5/5



5. Turning behavioral headwinds into tailwinds

According to Shlomo Benartzi, Professor at UCLA Anderson School of Management, "Economists have uncovered predictable but irrational ways human beings make decisions – many of which are evident in our saving and investing behavior. Without programs to overcome these behavioral issues, many American workers will be unable to comfortably retire – and employers will suffer the consequences. Responsible corporate plan sponsors should consider the powerful and positive impacts of behavioral based programs that automate improved savings decisions."

Because plan participants look to their employers to tell them what to do through plan design, plan sponsors should be using participant inertia to their advantage. According to the Profit Sharing Council of America's (PSCA) 2018 Survey[4], 61.2% of all plans use auto enrollment, but only 7.6% of those plans re-enroll employees that have opted out. The most common starting point for deferrals is 3%, and only 29.2% of plans automatically escalate the rate of savings. This results in an average deferral rate for plans with auto enrollment (6.7%) being lower than plans with traditional enrollment (7.2%).

Optimizing the use of automatic features is one of the strategies plan sponsors may utilize to improve their overall funded status, but some approaches may require additional financial commitments at a time when budgets are already stretched. However, much like how organizations periodically review the funding policies for their pension plans, it is critical that employers understand the impact their decisions have on funding DC benefits. Russell Investments believes that by 2025, there will be increased emphasis on aligning plans with organizational priorities, and sponsors will focus on strategies to ensure that participants are on track to reach their retirement goals.

Probability 4/5

6. Utilization of retirement readiness studies

Success in a plan's efforts to help participants reach retirement was historically measured by participation rates exceeding industry peers, and deferral percentages being above national averages. Unfortunately, these statistics offer little in the way of insight into determining retirement adequacy for plan participants.

Most DC industry surveys indicate that one of the top priorities for sponsors of large DC plans is to improve the overall retirement readiness of their workforce. The rationale is that employees who aren't prepared for retirement will be forced to work longer, which can adversely affect employers' finances and operational flexibility. One study estimates that the cost to the employer for a one-year delay in retirement is $50,000 for an individual, or between $30 million and $50 million per year for an employer with 50,000 employees.[5]

Similar to the approach of evaluating a pension plan's funded ratio, plan sponsors should periodically conduct a retirement readiness study to better understand the equivalent collective "funded status" of the participants in their DC plan. It is particularly important to establish this baseline prior to implementing investment or plan design changes, including those designed to turn headwinds into tailwinds, to enable the employer to measure the impact of its decisions. Russell Investments believes these will be considered best practices by 2025.

Probability 5/5

[4] 61st Annual Survey, PSCA's Annual Survey of Profit Sharing and 401(k) Plans reflecting 2017 plan experience of 605 401(k) and/or Profit Sharing plans. Published December 2018

[5] Prudential, "Why employers should care about the cost of delayed retirements," 2017

Designing menus and constructing portfolios to improve participant outcomes

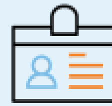
Investment menus for many DC plans historically have included a long list of options that are tied to style and capitalization boxes. Employers who still view DC plans as supplemental often emphasize choice over the quality or clarity of investments. However, as fewer employees are covered by a pension benefit, it becomes even more important to have a clear and well-designed DC menu. Defined benefit plan fiduciaries have long understood that creating portfolios with the appropriate balance between return seeking and hedging strategies most often leads to success, particularly at the end of the glidepath. We believe that DC committees should consider incorporating similar strategies to improve the efficiency of their plan's investment options.

7. Alternative or diversifying strategies

Transferring investment risk from the plan sponsor to the participant is an important driver in the shift from DB to DC plans as the primary retirement vehicle. Unfortunately, this creates significant challenges for most participants who are now forced to make complex investment decisions to ensure a successful retirement outcome.

Committees should focus on simplifying investment decisions for participants by streamlining the investment menu and imbedding complexity into the portfolios. Using the fundamentals of portfolio construction such as diversification of return drivers and managing downside risk, committees can construct portfolios that improve efficiency and mitigate negative surprises. Similar to the approach used by large, well-run pension plan portfolios, incorporating alternative strategies such as real estate, hedge funds and private equity can add this type of diversification. This may be accomplished today in a white-label structure for the core investment menu or in custom target date funds (TDFs). While it may take legislative relief or a prolonged bear market, more committees will be considering strategies long considered best practices for large portfolios.

Probability 2/5



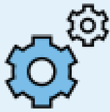
8. Personalized default options

TDFs are utilized as the Qualified Default Investment Alternative (QDIA) by more than 76% of the respondents to the PSCA 2018 Annual Survey[5]. TDFs are constructed using fundamental investment principles and portfolio construction best practices with a goal of mitigating different risks over an investor's life cycle. However, off-the-shelf TDFs are based on an average participant, rather than on specific investor characteristics, and they are only attempting to simplify investment decisions, rather than providing advice on funding and investing strategies.

Managed accounts are a service for plan participants that recommend a savings level along with a personalized asset allocation using the core fund line-up. They utilize readily available participant data to tailor the asset allocation to each participant's individual circumstances by including outside assets, risk preferences and retirement spending needs. Just as the funding and investing policies for pension plans can be unique to each sponsor, DC participants require this type of personalized advice in order to reach successful outcomes. According to the PSCA's 2018 survey[5], only 9.2% of plans use managed accounts as their QDIA, with cost and platform availability as two factors likely creating headwinds for higher utilization.

Most major recordkeepers only provide access to one or two managed account providers, one of which is often proprietary. Since committees are generally accustomed to evaluating several managers before making a decision, this is often too restrictive when choosing the plan's QDIA. Limited competition also weakens a plan's ability to negotiate fees, so the off-the-shelf pricing may be as much as 0.50%, in addition to fees paid to managers. Advances in retirement technology have paved the way for a new category of default solutions that are personalized to each participants' unique characteristics and preferences. These solutions are legally and operationally managed accounts, but they've been specifically designed to function as the plan's QDIA. Since recordkeepers now allow plans to use almost any manager in their investment menu, we are hopeful that they will also move to open architecture for managed account providers, paving the way for broader availability of these types of solutions. Assuming we see these positive changes, we believe that utilization of managed accounts as QDIAs will increase significantly by 2025, and annual cash flow could eventually surpass the level of assets directed at TDFs.

Probability 3/5

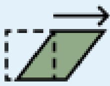


9. Efficient implementation

Implementation is broadly defined as trading strategies executed by a third-party manager to mitigate the costs and unintended risk exposures of moving between investment mandates. Any asset movement in a DC plan can have serious implications if risk and costs are not carefully managed with thoughtful implementation. In DC plans, implementation comes in many forms, including transitioning assets from one investment manager to another, centralized investment implementation of multi-manager portfolios (i.e., portfolio emulation) or an implementation account within a custom TDF to improve the trading efficiency of rebalance and roll-down.

By 2025, more DC plans will use implementation specialists because they represent a natural extension of the current focus on fees and costs. The pitfalls of relying on money managers to transition assets between mandates are becoming more apparent as DC plans move away from mutual funds to more institutional structures. Efficient investment implementation reduces turnover and trading costs, keeps participants fully invested in the capital markets and avoids blackout dates and performance holidays commonly associated with transitions in DC plans today.

Probability 3/5



10. Replacing monthly pension payments with income from a DC plan

The sole focus for DC plans has historically been on accumulating assets, with little thought to helping participants manage spending in retirement. Running out of money is one of the greatest financial fears for U.S. citizens, and this concern is likely one of the primary reasons that participants delay retirement. With Social Security as the only source of guaranteed income, trying to determine how to convert retirement savings into consistent income is critical, but it is also one of the most complex financial decisions we face.

As DC plans have become the primary source of retirement income, employers have begun to change the way they view the role of their plans. In their Lifetime 2012 Income Poll[6], MetLife reported that only 9% of employers agreed with the statement, “The primary focus of a DC plan is to serve as a source of retirement income.” However, by 2016[7], 85% of plan sponsors said income should be the core purpose of a DC plan and we believe this trend will continue.

While it’s encouraging that more employers are allowing periodic distributions, and providing tools and education to help participants, the inclusion of investment options specifically designed to manage decumulation is not widespread. BlackRock’s 2019 DC Pulse Survey revealed that only 7% of employers offer an investment option to address retirement spending needs.

Just as the needs of each participant are slightly different during accumulation, there is no single option that will be appropriate for all employees in retirement. To supplement income from Social Security, committees should consider the addition of a retirement tier, including both guaranteed and non-guaranteed options, designed to provide predictable income. This will provide employees with the confidence to avoid delaying retirement, and will allow employers to better deal with workforce management issues. Along with the recent passage of the SECURE Act, we believe this provides enough incentive for plan sponsors to introduce decumulation options, which will result in growing utilization of these strategies by 2025.

Probability 3/5

Conclusion

Although DC plans today appear to be significantly different than the first generation, the pace of meaningful change now seems painfully slow. Whether committees are paralyzed by litigation concerns or are awaiting legislative clarity, the adoption rate of most strategies that will positively impact participant outcomes continues to be low. For DC plans to succeed as our primary retirement vehicle, it is important that committees consider the strategies discussed in this paper and prioritize those that will be most impactful to their participants.

[6] MetLife, Retirement Income Practices Study, June 2012

[7] MetLife, 2016 Lifetime Income Poll, May 2016,

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