

DC Directions:

Russell's experience in Australia provides lessons for U.S. retirement plan sponsors

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Lessons for U.S. sponsors

- 1) Increase participation using non-compulsory nudge strategies
- 2) Don't set targets too low; understand the power of defaults
- 3) Consider implementing Australia's mix of assets, but not as a single static allocation
- 4) Take note of Australia's lack of annuity options; think about post-retirement decumulation strategies
- 5) Plug leakage from withdrawal privileges

As respective heads of Russell Investments' defined contribution (DC) practice groups in the United States and Australia, we enjoy the benefit of regular professional communication. We are able to leverage Russell's presence in markets including Australia, Canada, Continental Europe, Japan, the UK, and the U.S. Our professionals compare notes, discuss global strategies, and get firsthand insight into client experiences in many markets.

These top-down macro insights and bottom-up practical experiences provide our U.S. clients with a fuller perspective that can help them make better-informed, more forward-looking decisions about their specific programs.

Right now, the Australian DC system, known as superannuation—or super for short—is of great interest. Australia is about 10 years ahead of the U.S. in terms of moving down the DC path and has many interesting features. By comparing the U.S. system with its Australian counterpart, plan sponsors can see which features work best, and try to incorporate the best from both worlds in their plan design.

Australian system has many institutional “DB” features

Much of the difference between the two systems is the result of historical circumstances. In the U.S., DC plans originated as a minor add-on to defined benefit (DB) pension programs. By contrast, the Australian superannuation program was designed as a comprehensive system from the beginning. As a result, it developed with an institutional flavor. When we talk about the “DBization of DC plans” in the U.S., we can turn to the system in Australia to see a real-world example of what that might look like.

Compulsory contributions solve the participation problem but not necessarily adequacy

First, let's take a closer look at the distinguishing features of the Australian DC system. The key difference is the fact that the Australian superannuation system has been compulsory since 1992. All employers are required to make "super guarantee payments" for every employee. By contrast, under the voluntary DC system in the U.S., nearly 78 million working Americans don't have access to a retirement plan.¹ This number consists of people who work for small employers, the self-employed, uncovered populations of larger employers, and seasonal employees. In addition, even at companies that do offer a plan, participation rates persistently hover in the 75 to 80 percent range².

Of course breadth of coverage is a critical first step. But that doesn't guarantee employees will have an adequate income in retirement. Currently the minimum required deferral rate for Australian employers is 9 percent of pay—a level reached in 2002. Because the compulsory system has only been implemented over an 18-year period, the average account balance now stands at approximately \$100,000, which isn't enough to fund a multi-decade retirement. That's why, earlier in 2010, the government announced it wants to introduce new rules to progressively increase the deferral rate over the next eight years to 12 percent of pay.³

What's in a super? A look at the investment portfolio.

Because the superannuation system evolved as a core retirement benefit, the investment components of individuals' super portfolios tend to have an institutional flavor. There's a strong focus on active investment management, using diversified, multiple-manager investment strategies. Along with this focus on diversification within asset classes, there's a corresponding interest in a broad range of asset classes. In particular, alternative assets are widely used in DC plans in Australia; these include commercial real estate, infrastructure, hedge funds and private equity.

Another significant feature of the Australian system is that up to 80 percent of participants choose the default option offered by their employer plans. That's a pretty good choice, because the typical default option in Australia has, for a long time, been a moderately aggressive vehicle with about 70 percent invested in growth assets.⁴ Objectively, this growth-oriented default has served Australian investors better over the long term relative to U.S. investors. In the U.S., plans have historically been more risk adverse and relied on stable value funds as the default.

¹ Annual Report of the White House task force on the middle class, 2010

² Vanguard, "How America Saves," 2010

³ Association of Superannuation funds of Australia website, <http://www.superannuation.asn.au/mr100812/default.aspx>

⁴ Collie, Bob, Don Ezra, Matthew Smith, *The Retirement Plan Solution: The Reinvention of Defined Contribution*, p. 125, 2009

Australia avoids some of our major pitfalls

In hindsight it's easy to criticize the DC system in the U.S. for its piecemeal approach. However, when you consider how our system evolved, some of its prominent characteristics—and shortcomings—make a bit more sense. Our DC system started as a supplemental savings plan that was never designed or intended as a primary retirement vehicle. In fact, the DC system in the U.S. started in the 1970s as a mechanism for executives to defer bonuses. Even today some DC vehicles are still called savings plans.

This legacy has a lot of implications. With no intention to create a full-fledged investment program, employers either made their contributions in company stock or left employees to invest as they pleased using retail products. The result was poor diversification. Some participants left their assets in nearly risk-free defaults, such as money market funds or GICs (guaranteed investment contracts). These controlled volatility, but barely kept up with inflation. On the other end of the spectrum, participants could find themselves with a heavy concentration in a single stock, usually the company's, or the latest hot mutual fund.

Another implication is that U.S. plans were designed to allow more flexibility for participants—either when a participant left the employer for another job or needed the money through loans or through hardship withdrawals. This resulted in “leakage” that made it more difficult for participants to fund their retirements.

With its institutional heritage, the Australian superannuation system avoided these pitfalls. The Australians were ahead of us in understanding the importance of defaulting individuals to more diversified portfolios. And further, they made it extremely difficult for employees to borrow from their accounts. In Australia, hardship withdrawals are uncommon and strictly limited in scope.

AUSTRALIA'S DC SYSTEM HAS MANY ATTRACTIVE FEATURES		
Nation	U.S.	Australia
DC origin	Minor add-on to DB plans	Comprehensive system
Compulsory participation	No	Yes
Typical account balance	\$50,000	\$100,000
Historic default option	Stable value	70/30 growth/income; diversified asset classes
Borrowing from accounts	Common	Uncommon/restricted

Source: Russell Investments

Areas where the U.S. leads the way

Innovation is probably the chief strength of the U.S. system. Because U.S. DC programs are voluntary, employers can't match the participation rate in Australia. However, necessity has fostered innovation in the form of strategies to “nudge” more people into participating—and to participate at a higher level. These include new plan provisions such as automatic enrollment, auto escalation, and sophisticated “target date funds” as the default option.

Australia lacks these plan elements and, ironically, the reason is probably because there is a bit of overconfidence in the compulsory system. People tend to have a false

sense of security, assuming that their 9 percent compulsory contribution will be all they need to save enough for retirement. In fact, that contribution level is inadequate, which is why there are proposals to raise the rate to 12 percent. Even so, some voluntary nudge strategies might help Australians defer even more income.

Also, while the standard default allocation of 70/30 has served Australians well for a long time, it's also becoming obvious that that mix may not be appropriate for the entire population. The asset allocation for a 20-year-old should be different than the asset allocation for a 60-year-old. U.S.-style target date funds are designed to optimize the level of risk the portfolio takes throughout the participant's lifetime.

Finally, it's a peculiarity of the Australian market that virtually all payouts, even in defined benefit plans, are in the form of a lump sum benefit. Some of this relates to provisions in the taxation system, which are no longer in effect. But the lump sum mindset seems to be locked in.

Now, as Australia's own large baby boom generation approaches retirement, more and more people are facing longevity risk—and there is no deep traditional annuity market similar to that in the U.S. While the U.S. has a long way to go yet in incorporating these options in DC plans, Australia could benefit from having more annuity products with wholesale, institutional pricing as we have in the U.S.

Lessons for U.S. plan sponsors

By combining the best elements of both the U.S. and the Australian systems, we can suggest the following five lessons for plan sponsors:

1. INCREASE PARTICIPATION USING NON-COMPULSORY NUDGE STRATEGIES

Under U.S. law, there's nothing a plan sponsor can do to compel employees to participate in the retirement plan. Thus, it's unlikely we'll ever match the 100 percent participation rate that they have in Australia. The U.S. system is voluntary, so our primary tool is to incorporate plan design features that encourage better participation. These strategies start with setting defaults that require new employees to opt out of the DC plan if they don't want to participate, instead of asking them if they'd like to opt in.

2. DON'T SET TARGETS TOO LOW; UNDERSTAND THE POWER OF DEFAULTS

While Australia's compulsory system assures breadth of coverage, we've already noted that most people still aren't contributing enough to ensure a comfortable retirement. In Australia, we're seeing some of our larger clients opting for what we call soft compulsion. It's similar to auto enrollment: Every time a new employee is hired, the company directs 3 percent of their pay into their DC account, which is in addition to the 9 percent compulsory employer contribution. The employee can elect to opt out.

In the U.S., we recommend auto-enrollment and also advise sponsors not to be squeamish about setting a relatively high default for percentage of salary to be deferred. Studies show that employees tend to have a pretty high threshold for tolerating higher default contribution rates before opt-out rates start to increase. Similarly, automatic escalation of the default contribution rate is also effective in increasing employee commitments to their retirement plan.

In our experience, we know that plans have often kept default contribution rates low—3 percent is a common number.⁵ Without auto escalation, plan sponsors notice that a lot of participants tend to be clustered at the 3 percent level, even three or four years later.⁶ Psychologically, participants tend to view the default as an implicit recommendation, and this imparts a false sense of security, as we've seen in Australia.

3. COPY AUSTRALIA'S MIX OF ASSETS, BUT NOT AS A SINGLE STATIC ALLOCATION

Historically, Australia has certainly had a better approach to asset allocation than we've had in the U.S., with a focus on well-diversified portfolios that include best-of-breed managers and asset classes beyond the standard stocks and bonds.

That said, the 70/30 mix is not appropriate for everyone, particularly people approaching or already in retirement. Target date funds in particular do a better job in matching asset allocation needs with the needs of different participant demographics.

4. TAKE NOTE OF AUSTRALIA'S LACK OF ANNUITY OPTIONS; THINK ABOUT POST-RETIREMENT DECUMULATION STRATEGIES

The ability to better manage longevity and purchasing power risks will be critical for retirees to attain better retirement security. Lump sum payments from a retirement plan are difficult to invest and easy to squander. As a result, some form of annuity or other well designed post retirement solution can provide that key element of stability, which is so important during the decumulation phase of the investment lifecycle.

5. PLUG LEAKAGE FROM WITHDRAWAL PRIVILEGES

We noted above that there are few if any withdrawal privileges in an Australian Superannuation plan. Once the money's in, it stays in, where it can enjoy the important benefit of tax-sheltered long-term compound growth.

Unfortunately, "leakage," which is the temporary or permanent withdrawal of retirement assets through loans, hardship withdrawals and distributions for job changers, is a major issue in the U.S. In most cases, they will be hit with taxes and penalties, diminishing the amount that is available to fund their retirement.

Leakage is an artifact of our voluntary system. The withdrawal privileges are a tool that employers have used to encourage more people to participate. But with the advent of the Pension Protection Act (PPA) and auto-enrollment, it's possible that some of these features are not as necessary. One practical way we are engaging plan sponsors in this area is to utilize education to discourage the usage of loans.

⁵ Vanguard, "How America Saves, 2010"

⁶ Defined Contribution Institutional Investment Association, "Raising the Bar: Pumping Up Retirement Savings", 2010

Talking to the government

In both Australia and the U.S., we've seen that government action is capable of having a dramatic impact on the status of retirement security. The changes contained in the PPA have already made a significant difference.

That's why we make it a point to stay in touch with government initiatives. Two key areas of focus in Washington are target date funds and retirement income. In the last year, hearings were held on both of these topics and Russell was invited to testify as an interested subject matter expert.

Another important issue that we follow in our government relations efforts is the coverage question: How do you design an investment vehicle for working Americans who aren't covered by a DC plan? Some sort of "auto IRA" bill is currently receiving a lot of attention. In these conversations, we're glad to have the experience of our Australian colleagues to draw upon.

Conclusion

The challenge of retirement security is enormous as countries around the world face aging populations. Significant challenges include participation, adequate contributions, appropriate investments and decumulation strategies. We have seen examples of successes and failures as we look at systems in different countries. For example, the Australian system has many attractive features but also has room for improvement. Sponsors will benefit from global insights and perspectives as we work to build a better system.

For more information:

Call Russell at **800-426-8506** or
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Target date funds are not intended to be a complete solution to investors retirement income needs. Investors must weigh many factors when considering to invest in these funds, including how much an investor will need, how long will the investor need it for, what other sources the investor will have and, if the investor is purchasing shares in an IRA account, whether the fund's target distributions will meet IRS minimum distribution requirements once age 70 1/2 is reached.

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