

# Investment Options In A Difficult Economy: Fiduciary Considerations for Plan Sponsors

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# AGENDA

- ◆ Sponsor Fiduciary Issues as it Relates to Investment Choices
- ◆ Selection and Monitoring of QDIA's, including Target Date Funds
- ◆ Current Discussion about Annuitization of 401(k) Accounts at Retirement
- ◆ New Investment Vehicles being Introduced for De-accumulation Phase



# **Sponsor Fiduciary Issues as it Relates to Investment Choices**

# No Change in Key Fiduciary Responsibilities

- ◆ Prepare written Investment Policy Statement (IPS)
- ◆ Document Investment Decisions
- ◆ Use “Prudent Experts” to make investment decisions
- ◆ Diversify assets with respect to specific risk/return objectives
- ◆ Monitor activities of money managers and service providers
- ◆ Monitor and Control Expenses
- ◆ Avoid Conflicts of Interest

# Heightened Focus on Investment Options

- ◆ Are options suitable?
- ◆ Are there adequate choices?
- ◆ Do funds measure up?
- ◆ Are expenses reasonable?

# Are Options Suitable?

- ◆ Is there room for specialty funds?
  - Precious metals/commodities
  - Bear market funds
  - Market neutral
  
- ◆ Need to consider investment expertise of average participant
  
- ◆ Need to consider overall number of alternatives

# Are There Adequate Choices?


- ◆ Broad coverage of capital markets
  - Domestic and international equity
  - Fixed income
  - Capital preservation
  
- ◆ Passive and actively managed options
  
- ◆ Single solution options
  - Lifestyle or target date

# Do Funds Measure Up?

- ◆ Performance
  - Versus peer group & benchmarks
  - Cumulative & moving time periods
- ◆ Risk profile
  - Alpha, Sharpe Ratio, Standard Deviation
- ◆ Style Consistency
- ◆ General characteristics
  - Size, number of holdings, diversification
  - Manager tenure
  - Expense ratio

# Are Expenses Reasonable?

- ◆ Need to consider
  - All plan costs
  - Plan parameters
  - All plan services provided
  - How well services are provided
  - Assets, participants, average account balance
  
- ◆ Separate investment management & administration
  - Understand revenue sharing arrangements
  - Understand who is getting paid and how much
  
- ◆ Consider cost sharing between sponsor and participant



# **Selection and Monitoring of QDIA's, including Target Date Funds**

# QDIA Alternatives Permitted

## ◆ Target Date QDIA

- Investment fund product or model portfolio
- Based on participant's age, target date, or life expectancy
- Diversified to minimize risk of large losses
- Providing varying degrees of long-term capital appreciation and capital preservation through mix of equity and fixed income exposures
- Asset allocations change over time, becoming more conservative with increasing age
- Example: life cycle or targeted-retirement-date funds

# QDIA Alternatives Permitted (cont.)

- ◆ Demographically-Averaged Investment
  - Diversified to minimize the risk of large losses
  - Providing long-term appreciation and capital preservation through a mix of equity and fixed income exposures
  - Consistent with a target level of risk appropriate for participants of the plan as a whole
  - Example: balanced fund

# QDIA Alternatives Permitted (cont.)

## ◆ Investment Management Service

- A fiduciary allocates assets of a participant's account based on individual's age, target retirement date, or life expectancy
- Changes asset allocation and associated risk levels over time, becoming more conservative with increasing age
- Example: managed account

# Causes of Current Inquiries into Target Date Funds (TDF)

- ◆ 2008 recession investment return experience
- ◆ Possible misunderstandings of plan sponsors about risks
- ◆ Significant differences in amounts of risk in various TDF products
- ◆ Inconsistencies in risk within the products
- ◆ Perceived lack of participant understanding

June 18, 2009

## DOL and SEC Joint Hearing

- ◆ On issues relating to investments in target date funds and similar investment options by 401(k) plan
  - General belief that target date funds are extremely beneficial investment option for the majority of plan participants
  - Common concerns:
    - ◆ Widely divergent allocations to equities and fixed-income investments
    - ◆ Whether strict limits should be imposed on equity and fixed-income allocations within target date funds

June 18, 2009

## DOL and SEC Joint Hearing (cont.)

- Majority of panelists against mandated one-size fits all or “range” requirement for target date funds
- Customization and choice may ultimately be good for the participant
- Should target date fund glide paths continue to change “to” the target date or “through” the target date
- Need for glide path disclosure
- DOL should consider reviewing QDIA language regarding whether a higher standard should be established for fiduciaries when selecting a particular QDI

October 8, 2009

## U.S. Senate Special Committee on Aging

Phyllis Borzi, Asst Sec of Labor:

- ◆ Target-date funds have been under scrutiny this past year for exposing investors and plan participants to the market downturn
- ◆ Many funds with the same target retirement date have investments that differ significantly
- ◆ Such differences in target date funds, and associated differences in recent investment performance, have prompted questions about whether plan fiduciaries and workers have an adequate understanding of target date funds, and their benefits, risks, and costs
- ◆ The QDIA regulation does not contain any requirements regarding the composition of target date funds

October 8, 2009

## U.S. Senate Special Committee on Aging

- ◆ Preamble to the final regulation says fiduciary continues the obligation to prudently evaluate, select, and monitor any investment option, regardless of whether the plan includes an automatic enrollment feature or whether the fiduciary seeks to comply with the QDIA regulation
- ◆ Under ERISA, plan fiduciaries are not liable for plan losses merely because an investment lost money but because they acted imprudently in selecting and monitoring the investment
- ◆ Accordingly, when investigators review the selection of investments, they will generally focus on the procedures used by a plan fiduciary, rather than the ultimate performance of the asset

# 2010 Morningstar Market Survey

- ◆ “Open architecture” series, which feature managers who are independent of the funds’ advisor, have offered no performance advantage during the period under study
- ◆ Current version of target-date funds is not deeply flawed; rather is a framework as being a useful, logical starting point for a default investment
- ◆ Overall, the target-date business remains very concentrated by mutual fund standards, with the three largest target-date families accounting for more than 75% of industry assets

## 2010 Morningstar Market Survey (cont.)

- ◆ Shortcomings with 2010 funds shouldn't obscure the bigger success story at hand with target-date fund
  - Other than the 2010 target-date category, Morningstar's investor-return data indicates that target-date shareholders' returns have exceeded the funds' actual total returns over the past three years, in some cases quite substantially
  - That bucks the prevailing trend of the fund industry, in which investors tend to pull their money at market lows and chase investments close to their peaks

# Understanding The Various Offerings

- ◆ What are the investment objectives?
- ◆ What is the “glide path”?
- ◆ How are the funds that make up the TDF selected?
  - Among best in class?
  - Among the vendor’s proprietary funds?
  - Who is monitoring the funds that make up the TDF?
  - What are the criteria for changing a fund, if ever?

# TDF Fiduciary Decision Checklist

- ◆ Demographic factors of the plan
  - Pattern of retirees taking their money or leaving it invested in the plan
  - Relevance of the pattern, since TDF's are very new
  - How investment knowledgeable or sophisticated are plan participants
  - How well has risk been explained to participants
- ◆ Glide path choice
  - To NRA
  - Through NRA

# TDF Fiduciary Decision Checklist (cont.)

- ◆ Acceptable level of glide path risk
  - Until NRA
  - After NRA
- ◆ Quality of TDF product
  - Expenses
  - Performance of each TDF
  - Performance of underlying funds in each TDF
- ◆ Universe of products available

# Some Musings

- ◆ Would a fund that goes to cash at the NRA continue to qualify as a QDIA because it is no longer allocated among cash, bonds, and equity?
- ◆ Is it reasonable to assume that the average participant will not take a lump sum at NRD?
- ◆ If the better assumption is that participants will take lump sum at NRD, wouldn't it be appropriate to allocate the fund to all cash in last 5 years?
- ◆ Is this much to do about nothing?
  - The market values have returned
  - Participants stayed with the funds
  - Plan sponsors stayed with the funds



# **Current Discussion about Annuitization of 401(k) Accounts at Retirement**

# Recession of 2008

- ◆ Volatility of investments in DC accounts
- ◆ Studies of sufficiency of DC account accumulations to fulfill retirement income needs
- ◆ The Retirement Security Project

# The Retirement Security Project

- ◆ J. Mark Iwry (Brookings Institution) one of the authors
- ◆ Test drive a lifetime retirement income product
- ◆ Overcome existing biases Reframe public's view of retirement income products
- ◆ Improve retirees' ability to evaluate their retirement distribution option
- ◆ Default retirement distributions into a 2-year trial retirement income option, unless retiree elects out
- ◆ At the end of 2 years, default is a permanent retirement income option, unless retiree elects out

# 2009 Obama Administration Suggestion

- ◆ Mandatory automatic enrollment in individual retirement accounts
  - Announced by J. Mark Iwry, Deputy Assistant Secretary for Retirement and Health Policy at the Department of the Treasury
  - Mandatory for employers if they don't offer a retirement plan to their workers
  - Could be automatically invested in low-risk Target Date Funds, or
  - In newly created Treasury-issued retirement bonds (R Bonds) to eliminate the volatility issue
    - ◆ Could be the "training wheels" to allow workers' small accounts to grow to be large enough to attract the financial industry
    - ◆ Once accounts become of size, could graduate into long-term type investments, such as Target Date or Life Cycle funds

# February 2010

## Departments of Labor and Treasury RFI

- ◆ Input due by May 3, 2010
- ◆ Questions asked:
  - Advantages and disadvantages of distributing benefits as a lifetime stream of income both for workers and employers, and why lump sum distributions are chosen more often than a lifetime income option
  - Type of information participants need to make informed decisions in selecting the form of retirement income
  - Disclosure of participants' retirement income in the form of account balances as well as in the form of lifetime streams of payment
  - Developments in the marketplace that relate to annuities and other lifetime income options

# February 2010

## Departments of Labor and Treasury RFI (cont.)

Phyllis C. Borzi, assistant secretary for the DOL's Employee Benefits Security Administration:

- ◆ The RFI initiative is particularly important given the shift from defined benefit plans that offer employees lifetime annuities to 401(k) and other defined contribution plans that typically distribute retirement savings in a lump sum payment
- ◆ Large swings in the stock market also may have forced policymakers to rethink how the nation saves for retirement

# What is the likely result?

- ◆ It is unlikely that:
  - There will be mandatory requirements for plans to limit distribution options to annuities or similar guaranteed products
  - Plan sponsors will accept actuarial liability of guaranteeing lifetime incomes
  - 401(k) plans will accept actuarial liability, at the risk of reducing other participant accounts
- ◆ Possible for a significant percentage of a lump sum distribution defaulted to annuity type investment unless participant and spouse waive it (similar to spousal protection rules)

## What is the likely result? (cont.)

- ◆ Annuitization can be accomplished through a mutual fund as well as through an insurance product and/or a hybrid product
- ◆ Mandated IRA accounts, or some similar type account, is likely to occur eventually. Something needs to be done for workers who are not covered by an employer retirement plan

# The Challenge

How can we make DC plan benefits look and act like DB plan benefits?



# **New Investment Vehicles being Introduced for De-accumulation Phase**

# New Investment Products for Asset De-accumulation

- ◆ Annuity purchase programs
- ◆ Periodic income products
- ◆ Guaranteed income products

# Annuity Purchase Program

- ◆ Provider arranges for quotation service with several insurance carriers
- ◆ Typically at preferred rates
- ◆ Participant requests quotes and decides whether or not to proceed
- ◆ Advantages:
  - Gtd income for life
  - Maximizes monthly payouts
- ◆ Disadvantages:
  - Lose control of assets
  - No flexibility once started

# Periodic Income Plans

- ◆ Fidelity Income Replacement Funds (2016-2042 in two year increments)
- ◆ Vanguard Managed Payout Funds (three options various risk levels)
- ◆ Putnam Absolute Return Funds (4 options with target 100 to 700 basis points real return)
- ◆ Advantages:
  - Participant retains full control of assets
  - Lump sum withdrawals available
- ◆ Disadvantages:
  - No guarantee that income will continue for life

# Guaranteed Income Products

- ◆ Prudential IncomeFlex
- ◆ John Hancock Gtd Income for Life
- ◆ Mutual of Omaha Lifetime Gtd Income
- ◆ Features:
  - Participant controls timing of investment (usually over a period of years prior to retirement)
  - Guarantee may increase based on market performance but will not decrease
  - Flexibility to take lump sum distributions (will impact ongoing guaranteed income)
  - Market value of residual assets payable to beneficiary
  - Risk charge in addition to investment management fee