

Is It Time to Reboot Your Defined-Contribution Plan?

Companies may want to consider sweeping existing 401(k) participant balances into new and better funds.

By Lori Lucas

It is the rare plan sponsor who believes that defined-contribution plan participants have done a good job of investing. Indeed, the statistics remain grim: According to Hewitt Associates, at the end of last year, nearly two of every five 401(k) participants had 20 percent or more of their money in employer stock. Younger employees tend to be overly concentrated in stable value. Participants have been known to diversify by investing equally (and naively) in all funds in the plan. Others simply chase investment performance to their own detriment.

Plan sponsors have recognized all of this and reacted by aggressively adding and promoting professionally managed asset allocation funds within their defined-contribution plans. The Callan DC Index finds that 89 percent of plans offer an asset allocation fund, with more than 60 percent of those being target-date funds. A good number of plan sponsors have gone even further and defaulted new participant money into such funds through automatic enrollment.

Plan sponsors typically do so with the understanding that participant assets are likely to remain in these funds

because of inertia and other factors. In fact, many would consider this a desirable outcome—or at least preferable to the outcome of participants making poor investment choices on their own.

A logical next step for plan sponsors is to re-enroll existing participant balances into these asset allocation funds. After all, if such funds are a reasonable approach for new participants, wouldn't they also be suitable for existing balances? Yet in a recent survey, Callan found that only 5 percent of plan sponsors planned to engage in a re-enrollment of their plan in 2008.

Re-enrollment is essentially the same as "rebooting" the plan. It is a way of unwinding all of the poor investment decisions that plan participants have made in years past. It is also a way of seeing to it that existing participants more fully benefit from a plan that may look very different—and much more investor-friendly—from the plan in which they initially participated.

The virtues of a reboot range from potentially dramatically reducing exposure to company stock to increasing the economies of scale (and possibly reducing fees) in the plan's asset allocation funds.

There are several reasons why reboots are still rare. One concern frequently raised by plan sponsors is that rebooting involves unwinding the active investment choices that participants have made, as well as shifting defaulted monies.

This may be uncomfortable from a fiduciary perspective. Plan sponsors, of course, will have to rely on their own legal counsel for the ultimate answer regarding any possible fiduciary risk attached to re-enrollment. However, it is worth noting that the Pension Protection Act contains a number of provisions that provide ERISA Section 404(c) safe harbor protection for fund mapping and investment defaults.

The provisions provide guidelines on notification requirements, specify what constitutes a qualified default investment alternative, and provide a framework for appropriate fund-to-fund mapping. In other words, the Pension Protection Act appears in many ways to support re-enrollment.

And what about those active participant elections? Is it fair to change them? Studies have shown that even when defined-contribution plan participants make proactive choices, their investment preferences are weak at best.

Professors Shlomo Benartzi of

UCLA and Richard Thaler of the University of Chicago found in an experiment that participants unknowingly rated the average portfolio of their fellow employees equal to their own portfolio, and judged the median portfolio of their fellow employees to be significantly more attractive than their own.

Indeed, only 20 percent of the participants in the experiment preferred their own portfolio to the median portfolio. In other words, even participants who make active choices don't appear to do so with much conviction. Few participants tend to rate their own investment knowledge very highly, and many will admit that their investment choices were a guess. Often these choices were made at a time when the fund selection was vastly different from the way it is today. They were made, for example, before asset allocation funds were even available.

Why does this matter? A Hewitt Associates study found significant delays in the use of new funds by existing participants. According to the study, it took more than three years for more than half of existing participants to use newly added funds. It took less than three months for more than half of new hires to use the new funds.

Plan sponsors also worry about angry calls to their service center in response to shifting participant monies—especially in volatile market conditions. It is probably true that call volume will increase during a re-enrollment. However, consider the experience of one plan sponsor who recently re-enrolled participants from a balanced fund to a series of target-date funds. As a result of the change, the record keeper's service center did experience a 30 percent increase in calls compared with the same time period a year earlier.

Still, the plan sponsor reported that overall participant reaction was positive and supportive of the new program. Most important, the vast majority of participants allowed their assets to be defaulted into the target-date funds.

Plans that are the best candidates for some form of re-enrollment are those whose participants would not generally be characterized as investment savvy. In other words, re-enrollment is generally likely to be better suited to a retailer than to a financial services firm.

Plans that are engaging in a reshuffling of their fund lineup may also wish to take the opportunity to re-en-

roll or reboot, rather than to simply map assets from old to new funds. The rebooting solution may also make sense for plans with clear diversification issues, such as plans with an overweighting in company stock, stable-value funds or sector funds.

It wasn't so many years ago that features such as automatic enrollment, advice and target-date funds were considered aggressive and cutting edge. Plan sponsors harbored all the same worries about such features as they do today when it comes to re-enrollment and rebooting.

However, today nearly half of plans offer automatic enrollment, and more plans offer target-date funds than risk-based asset allocation funds. Rebooting is just another such tool for plan sponsors to consider in their ongoing effort to improve the potential outcomes for defined-contribution participants.

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