Changes in the Defined Contribution Arena and Opportunities for Investment Managers

Lori Lucas, CFA (left) and **Inga Sweet**

A CONVERSATION WITH LORI LUCAS

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Interviewed by Inga Sweet

The 2006 Pension Protection Act (PPA) contains provisions that will affect the entire retirement system including defined contribution, defined benefit, hybrid plans, and IRAs. Inga Sweet, a Senior Vice President and a member of Callan's Institutional Consulting Group, spoke to Senior Vice President and Defined Contribution Practice Leader Lori Lucas about changes in the DC arena and opportunities for investment managers.

SWEET: Lori, let's start with the 2006 Pension Protection Act. What are the most notable provisions?

LUCAS: The dominant theme we see in the Pension Protection Act with respect to defined contribution plans is that the PPA is seeking to create a more "fool proof" way for DC participants to accumulate retirement assets. The PPA essentially takes some of the features we typically see in defined benefit plans and creates that experience in DC plans so that people can be more successful with their savings and investments.

For example, about 30% of individuals who are eligible for 401(k) plans typically do not invest in them. That's a huge concern in an environment where the 401(k) plan is increasingly the primary—or only—employer-sponsored source of retirement income. Provisions that help people save in 401(k) plans, such as automatic enrollment, got a lot of support in the Pension Protection Act. For example, the PPA offers 404(c) protection for qualified default investment alternatives (QDIAs) that can be used with automatic enrollment. This makes it much easier for plan sponsors to offer automatic enrollment.

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What do you mean by a QDIA?

LUCAS: A QDIA is an investment that is used as a default for automatic enrollment that meets a specific list of criteria. The Department of Labor's draft guidelines for QDIAs say that such investments must be either a target-date fund, a balanced fund (target risk), or a managed account. If the default is one of these investments—and meets certain other criteria—then money in that investment has safe harbor protection, meaning plan sponsors are liable for choosing the investment, but they are not responsible for the participants' use of the investment. Such safe harbor protection is important to many plan sponsors. In the past, though, there has been no clear way to have 404(c) protection with defaulted monies. This new provision in the Pension Protection Act provides this safe harbor relief.

What has been used as an investment default historically, and where might that be shifting?

LUCAS: Traditionally, plan sponsors have often used capital preservation vehicles such as money market funds or stable value funds as defaults. This was considered a "safer" choice from a fiduciary perspective. However, the Pension Protection Act specifically states that not only capital preservation, but also capital appreciation are important features of a QDIA. The DOL went one step further in its guidelines by not including stable value or money market funds as QDIAs. Plan sponsors can still use them as defaults—they just won't have 404(c) protection.

What does this mean for stable value and money market options in the future?

LUCAS: We envision that if the draft DOL guidelines become permanent in their current form, we will likely see many plans shift their defaults from stable value and money market funds to the three qualified default investment alternatives. This will then result in a shift in plan assets from these capital preservation funds to target date funds, balanced funds, and managed accounts. Today if you look at the typical 401(k) plan, you will likely find a large amount of assets in stable value; going forward you'll likely see a large percent in QDIAs.

Related to that point, there has been an increase in target maturity products. How can providers differentiate their target maturity products?

LUCAS: Our research does find a large number of target maturity, or target date, mutual funds coming to market. We also see burgeoning interest in creating target maturity collective trusts. One differentiator is structure type. We observe everything from the typical mutual fund structure to looking at ways of creating custom target maturity portfolios out of the core investment funds in the 401(k) plan.

There is enormous differentiation among the glide paths that are being used in these funds. For example, we find that the terminal equity allocation among glide paths across major target date mutual fund providers varies from 17% to 44%. On the opposite end of the spectrum, the initial equity allocation varies from 81% to 93%.

Lori Lucas, CFA
SVP and
DC Practice Leader

We also find differences among the scope of the asset classes employed in the glide paths. There is greater use of everything from emerging markets, TIPS and REITs, to high yield investments. These types of investments are not often used as standalone options within defined contribution plans, which therefore provides opportunities for investment managers offering these strategies.

Can you expand on that last point?

LUCAS: For example, say an investment manager wishes to bring to market a target maturity fund containing REITs, but the investment manager doesn't have a REIT fund. That investment manager might use a sub-advisor, or in some other way, allow a non-proprietary REIT fund to be part of its target date funds.

Beyond that, there are opportunities for managers to be very creative in coming up with ways that would allow target maturity portfolios to benefit from the return and diversification benefits of the types of asset classes traditionally used within the defined benefit arena. For example, there are many studies that show how much worse the typical 401(k) participant does in investing versus a defined benefit plan. There are several reasons for this—poor asset allocation decisions, market timing, cash flows, as well as the fact that 401(k) participants don't have access to all the great diversification opportunities we often see in defined benefit plans because of the need for daily valuation and liquidity. However, within target maturity portfolios, there are opportunities to add these additional strategies for diversification. Direct real estate, hedge funds, commodities —these are all types of funds that would add a lot of value from a diversification standpoint within target maturity portfolios and offer opportunities for investment managers to fit into target maturity portfolios. Because these areas are so specialized, managers who do feature such investment expertise are in a good position to have their products added to externally operated target maturity portfolios.

What are some of the variables defined contribution plan sponsors focus on when selecting a target maturity vehicle?

LUCAS: We encourage plan sponsors to evaluate target maturity portfolios based on what they're trying to achieve from a retirement income adequacy perspective. So, looking at plan demographics and plan goals, what makes the most sense in terms of how aggressive the equity allocation is, what types of investments they are using, and the fees being assessed.

To what extent is Callan working with clients to create custom target maturity portfolios?

LUCAS: Callan works with clients to create both custom risk based portfolios and custom target maturity portfolios.

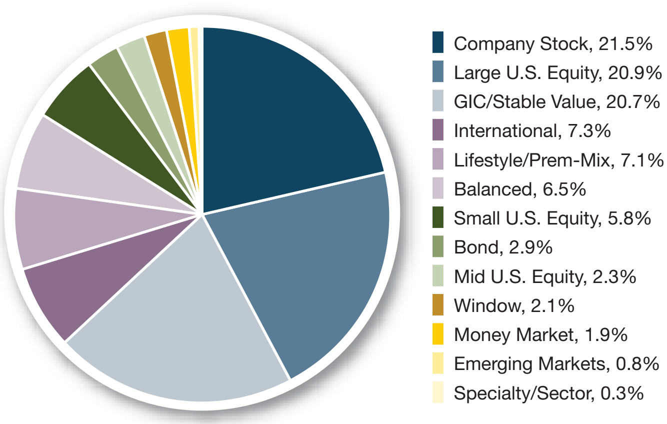
We see this as another great opportunity to help large plan sponsors, and for investment managers who are not in the business of providing record keeping services.

Inga Sweet
SVP, Institutional Consulting Group

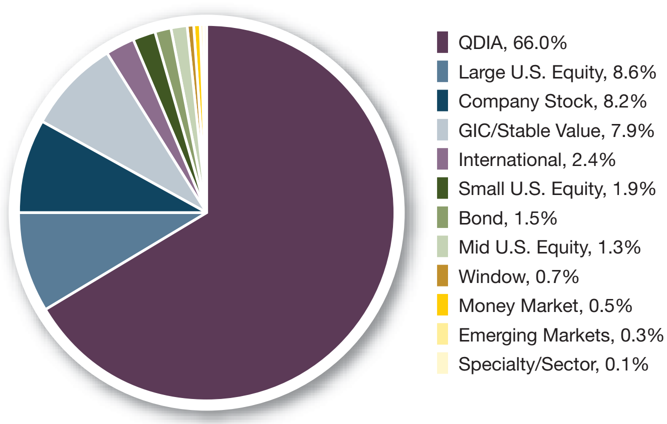
Large sponsors may wish to offer custom target maturity funds to control fees, accommodate the unique needs of the participant population, avoid draining monies from the core investment funds, monitor underlying managers effectively, and replace them individually if they do not fulfill expectations—without disrupting the entire structure.

For investment managers, the opportunity is to see their funds become part of the target maturity structure if they manage the core investment funds, and to provide non-core "sleeves" that will enhance the diversification of the custom target maturity portfolios. Again, we're talking about everything from emerging market funds to REITs,

401(k) Asset Allocation – October 2006



401(k) Asset Allocation – 2016?



Source: Hewitt Associates 401(k) Index™ and Callan Associates Inc. estimates.

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TIPS, and high yield bonds—as well as illiquid investments I mentioned earlier.

What should an investment management firm take away from these changes?

LUCAS: There are certainly a lot of opportunities right now for investment managers around QDIAs. In fact, QDIAs are potentially the most fruitful area of focus, especially for firms with alternative and specialist capabilities that don’t have a major presence in the 401(k) arena. Plan sponsors have very little appetite to expand their investment fund line up and add alternatives directly to it, or even necessarily to rearrange the core investment fund line up to include managers that they’re not familiar with and that are newer to the defined contribution arena.

Even if investment managers with alternative products are successful in getting their funds on a record keeping platform and having plan sponsors choose their funds—if it is an asset class such as emerging market equities, TIPS, or REITs—participants don’t tend to use those funds. Participants don’t understand them and instead tend to keep their monies in investments they’re familiar with, such as large U.S. equity or company stock. The opportunity for managers to not only get into the 401(k) plan but to collect assets is really through these QDIA vehicles, either by developing a target maturity portfolio of their own or by being part of a target maturity portfolio as a sub-advisor or alternative “sleeve.”

Beyond what we’ve discussed, where do you see opportunities for investment managers to participate in the defined contribution arena?

LUCAS: As unfortunate as the recent fee litigation has been, it certainly has caused more plan sponsors to focus on plan costs. Plan sponsors could benefit from more education on the types of vehicles that can help them reduce costs, such as separate accounts and commingled funds. They could also benefit from a better understanding of how to utilize managers in their DB plans to create more cost-effective investment options for plan participants. Plan sponsors may worry that such approaches will just raise costs from a custodial perspective or in some way create complexities or risks. To the extent that investment managers can mitigate and address these concerns, this provides another opportunity for investment managers who have a big presence in the DB arena to have an entrée into the DC world.

Thank you Lori.

Lori Lucas, CFA
Senior Vice President and Defined Contribution Practice Leader

Lori is responsible for setting the direction of Callan’s DC business, providing DC support both internally to Callan’s consultants and externally to Callan’s clients. She also develops research and insights into DC trends for the benefit of clients and the industry. Lori is a member of Callan’s Management Committee. Formerly, Lori was Director of Retirement Research at Hewitt Associates. Lori received a Bachelor of Arts from Indiana University and earned a Masters from the University of Illinois. Lori’s views have been featured in *The Wall Street Journal*, *Pensions & Investments*, *Plan Sponsor Magazine*, *USA Today*, Bloomberg, CNN, *The New York Times*, and *Newsweek*, among others.

Inga B. Sweet
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Inga is a member of Callan’s Institutional Consulting Group and a shareholder of the firm. Inga is responsible for published research that supports Callan’s broad consulting practices, including producing the Style, Trend, Analysis and Research (STAR) reports. Prior to joining the Institutional Consulting Group in 1998, Inga spent seven years within Callan’s International Consulting Services Group where she was responsible for research, analysis, and manager structure work in the international and global asset classes including developed and emerging market equities. Inga joined Callan Associates in 1991. She graduated from George Washington University with a B.A. in International Relations.

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