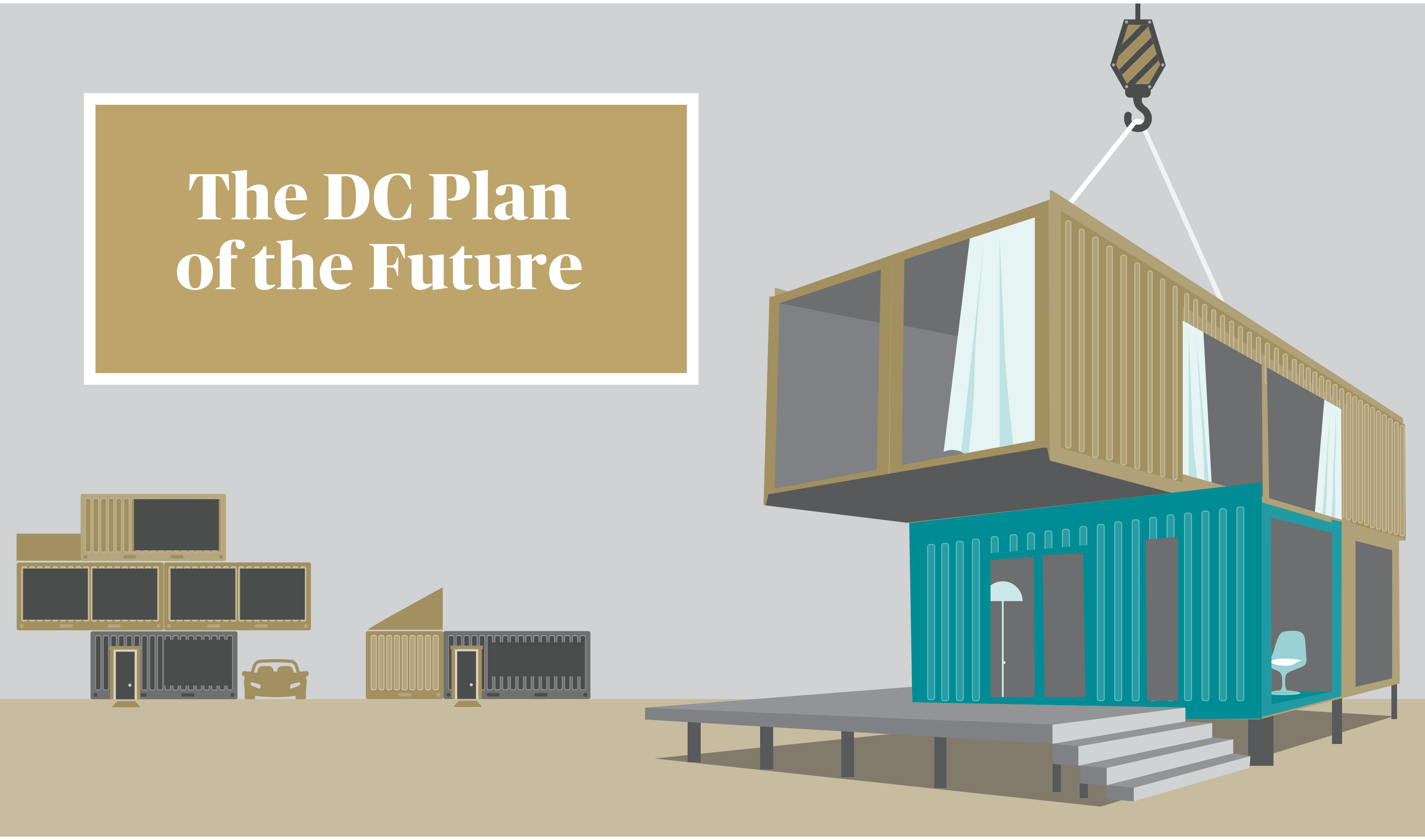
The DC Plan of the Future



DB PRINCIPLES FOR THE DC GENERATION

BNY MELLON

CONTENTS

As Defined Benefit (DB) plans continue to be frozen or terminated, a greater number of American workers will rely on Defined Contribution (DC) plans to provide for their retirement. Estimates of the US retirement market indicate that with a projected market value of over $8.5 trillion in 2018, DC plans will be larger than their DB equivalent by $1.3 trillion.[1] However, even with the growing number of workers covered through such plans, there is mounting evidence suggesting that DC plan participants are not on track to sufficiently fund their goals.[2]

With retirement planning becoming a greater concern for baby boomers, generation X and even millennials, awareness of their particular concerns and what to do about them is an important consideration for plan sponsors.

Historical approaches to DC plans have generated decidedly mixed results, including an over-reliance on retail investment solutions, inability to integrate automation and education, and inefficiently priced products and services. As we look to the future, it is incumbent upon plan sponsors to gauge the impact of these macro industry trends on the operations of their individual retirement plans.

To provide context to this issue, BNY Mellon sponsored research that involved in-depth interviews with some of the leading DC plan sponsors in the US. The interviews gathered insight as to how these organizations are responding to the evolutionary sea-change underway, and what best practices were being utilized to increase the efficiency of their plans. Although observations were made on a broad range of topics, a number of common themes or best practices emerged from the interviews:

- Leveraging institutional investment strategies, or the “institutionalization” of DC
- Ensuring that education and automation work together
- Pursuing greater transparency in the pricing model

This paper explores each of these topics in-depth.

THE "INSTITUTIONALIZATION" OF DC PLANS

Since the introduction of the first private pension plan by American Express in 1875, pensions have evolved into a highly sophisticated institutional industry. With the need to meet pension obligations, DB plans and their sponsors have looked at many different ways to achieve these objectives, leveraging broad asset allocation, investment structures and other techniques. While acknowledging that maintaining DB plans was either too expensive or too burdensome, many of the interviewed sponsors wanted to be able to replicate some of the efficiencies they had utilized in running DB plans. Comparing the DB experience to the more typical approach on the DC side, a number of shortcomings are often identified with DC plans:

– Higher costs

– Limited access to alternative investments, limiting their ability to increase returns and reduce risk through diversification

– Uncertain final benefit with participants bearing investment risk

Many of the DC plan sponsors we interviewed wanted to replicate some of the efficiencies they had utilized in running DB plans.

Sponsors have sought to address the limitations of DC plans by borrowing best practices from the DB arena. While stopping short of a full-scale return to the pension model, the so-called "institutionalization" of DC plans relies on the following approaches:

– Increased use of low-fee, institutional vehicles

– Greater use of alternative strategies

– Generating an income stream during retirement

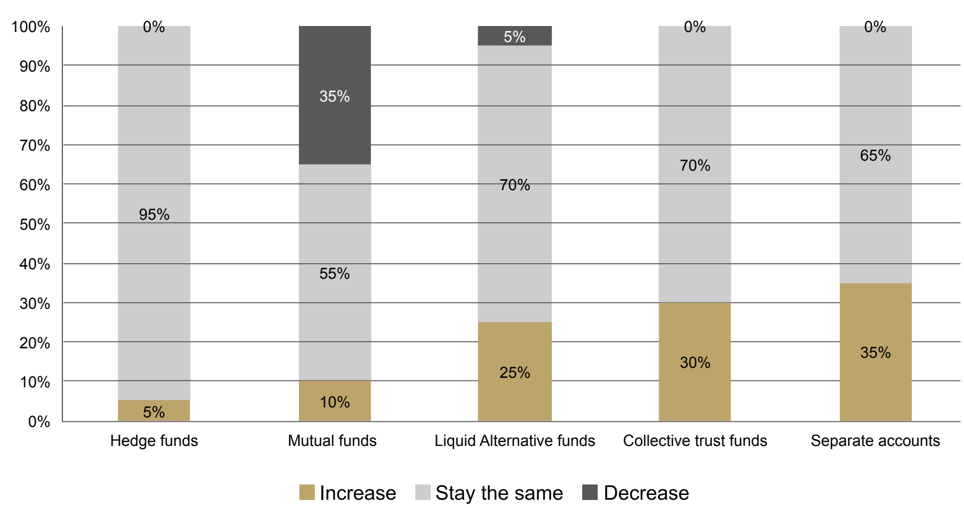
The benefits of each of these approaches are explained in greater detail below.

INSTITUTIONAL VEHICLES: LOWER COST, GREATER CONTROL

When seeking to make their DC plans more DB-like, the use of institutional vehicles provides sponsors with low-hanging fruit. Mega-market sponsors[3] in our survey expect a 65% increase in their use of alternatives to mutual fund vehicles, such as separately managed accounts (SMAs) or collective trusts (CTFs). This does not include other sponsors in our sample who are already using these vehicles.

Costs or fee advantages are a clear benefit of SMA's and CTF's over the mutual fund approach. Since these vehicles are not subject to oversight from the US

Exhibit 1: Expected change in investment vehicle use by 2020.



Securities and Exchange Commission (SEC)[4] they do not incur some of the expenses associated with compliance and regulatory reporting.[5] In addition, there is also no need to support the marketing and distribution of the fund into the retail space (e.g. producing prospectuses and retail call centers). Further, retirement participants are more typically "buy and hold" type investors reducing portfolio trading costs. This can all result in both lower initial and ongoing operational costs.

CIT AVERAGE EXPENSE RATIOS Excluding LifeCycle Strategies		**WEIGHTED AVERAGE MF IN DC EXPENSE RATIOS** Excluding LifeCycle Strategies	
Active	0.37	Active	0.72
Passive	0.14	Passive	0.19
Average	0.32	Weighted Average	0.45
Source: Strategic Insight, an Asset International company [6]			

The shift to separate accounts and collective trusts offers additional benefits beyond lower fees. Separate accounts allow for greater flexibility and control; mandates can be customized to sponsors' specific objectives and risk tolerance. In addition, sponsors are insulated from the "hot money" that often flows in and out of mutual funds that fall in or out of favor. While CTFs are by definition collective vehicles, they can be created specifically for large institutional investors. Sponsors also like the flexibility CTFs offer in terms of pooling together assets across multiple plans, often a common goal of large organizations with a history of M&A activity.

Alongside the rise in use of CTFs and SMAs, sponsors are reducing their reliance on mutual funds.

Alongside the rise in use of CTFs and SMAs, sponsors are reducing their reliance on mutual funds. With billions or even tens of billions in assets, sponsors of mega plans have both the need and the ability to demand bespoke solutions. Whereas having mutual funds with strong brands may have been more important in the past, a number of sponsors we spoke with are assembling white-labeled (also referred to as plain label or private label) options in an effort to simplify their investment offering and reduce fees. White-labeling refers to the process of combining various investment managers, asset classes or investment styles, which is then given a descriptive name to describe the investment strategy (i.e. US Small Cap Equity, US Mid Cap Growth). In some instances, plan sponsors include their defined benefit managers in their white labeled offering. Sponsors see this as offering the best of both worlds: improving underlying diversification while minimizing participant confusion by limiting the number of investment options. Investment menu simplification is being increasingly prioritized by plan sponsors. As one plan sponsor commented, the white labeling approach was viewed as beneficial when engaging plan participants that are "unengaged and overwhelmed". Additionally, there is a growing consensus that less is more and that having smaller line ups can increase both rates of participation and deferral rates – both critical in helping to achieve desired retirement outcomes. When establishing and rolling out a white label fund, it is imperative that there is ongoing communication between the plan's custodian, record keeper, trustees, consultants and investment managers. With this in mind, leveraging service providers with an expertise in the creation and ongoing support of white label funds becomes a critical factor in the process.

ALTERNATIVE INVESTMENTS: THE 2% SOLUTION?

In addition to lower cost vehicles, DC sponsors are also looking to increase their use of alternative strategies. Large plan sponsors witness firsthand what studies have shown: namely that their DB plan investments typically outperform their DC offerings, sometimes by as much as two percentage points per year.[7,8] Providing access to asset classes that participants did not previously have should allow them to get closer to the level of returns for DB plans and also embrace other characteristics of alternative investments such as downside or inflation protection.

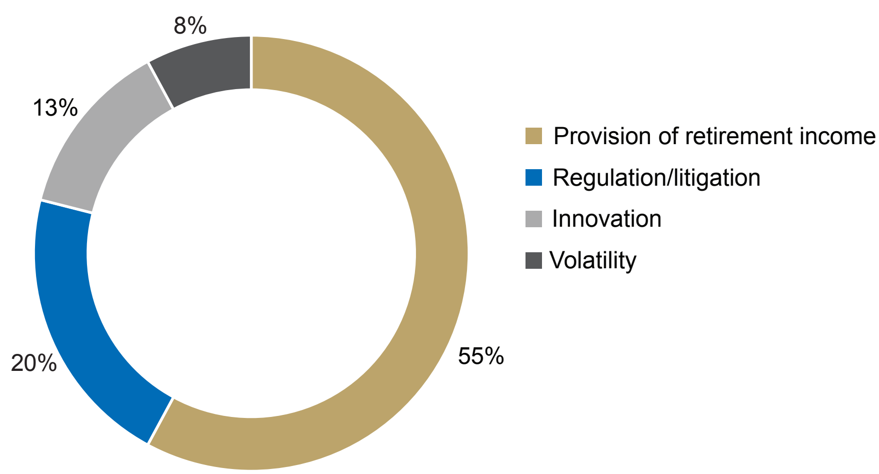
Sponsors we spoke with are looking to include alternatives within multi-asset portfolios, such as a target date fund (TDF).

As seen in the Exhibit 1, 30% of sponsors surveyed plan to add hedge funds in some form (either limited partnerships, or in mutual fund / liquid alternatives format), while a number have already added them, or other alternatives strategies and vehicles such as commodities and even private equity. Others would like to further diversify, but have concerns about offering less liquid strategies in a daily valuation environment.

Many sponsors have overcome the operational challenges and are delivering a true institutional investment platform. One approach is to use more liquid strategies, sometimes in the form of '40-Act registered mutual funds which strike Net Asset Values (NAVs) and meet redemptions on a daily basis. Increasingly, such products are offered not just by retail fund companies, but also by true alternative managers with an institutional pedigree. Such vehicles also typically avoid features of a more traditional hedge fund structure such as incentive fees, redemption notice periods, limited transparency and eligibility constraints.

In some cases, sponsors will utilize the limited partnership structure typical of the hedge fund space, provided that the underlying investment strategy is not overly concentrated or heavily weighted towards thinly-traded securities. Even less liquid strategies can be offered by unitizing the offering and including a liquidity buffer to meet redemptions. More commonly; sponsors we spoke with are looking to include alternatives within multi-asset portfolios, such as a target date fund (TDF). Doing so allows improved liquidity, while allowing participants to realize the benefits of diversification. This is consistent with recently published research from the Defined Contribution Institutional Investment Association (DCIIA) who outline their support for consideration of alternatives in DC plans.[9] Some sponsors remain wary of alternative strategies as a standalone option, since the educational stakes are higher: fiduciary concerns may arise if participants mistakenly believe that alternative strategies can't lose money. Use of alternative vehicles, even within multi-asset portfolios may come further under the microscope with recent litigation against a large corporate plan sponsor over alleged breach of fiduciary responsibility following their use of private equity and hedge funds within the DC plan.[10] However, it is clear based on the interviews that we completed and other market sources that alternatives have a role to play in the DC plan of the future.

Exhibit 2: Greatest Driver of Change by 2020



INCOME FOR LIFE

Taking an institutional approach to investing may improve results, but any serious discussion of "institutionalization" must consider lifetime income. When asked to identify the greatest driver of DC change over the next 5 years, 55% of sponsors cited the need to address longevity risk by generating retirement income.

In the same way that people know the monthly payments of their pension (DB) and social security, the same thing can be done with DC plans.

Whereas actuarial formulas provide clarity for DB participants, it is hard to get DC participants fully engaged when there is uncertainty not only about the amount of asset accumulation (a function of market performance, contribution rate, etc.) from retirement savings but also how that will translate into retirement income. Given that a clear priority for employees is having sufficient income in retirement, this is a critical challenge with knowledge needed both in terms of the most effective way to save and how to effectively draw down on the retirement nest egg.

In the same way that people know the monthly payments of their pension (DB) and social security, the same thing can be done with DC plans. Improved reporting and retirement income calculators are more prevalent to help educate the workforce. Moving beyond this to implementing a retirement income strategy is an area where forward thinking DC plan sponsors are being responsive. Sponsors are engaging with consultants, insurers, and other providers to formulate an approach for providing participants with sufficient retirement income.

There have been some obstacles to making lifetime income a reality in DC plans. During the financial crisis, some products were pulled off the market and perhaps more significantly, the viability of several insurance companies was called into question. Given the fiduciary responsibility that plan sponsors have in selecting annuity providers to be included, liability also remains a very real concern. The absence of a safe harbor has been a roadblock for what many increasingly recognize as a necessary course to chart to provide for lifetime income.

To date, several plans that we spoke to have made lifetime income a reality by working with insurance providers to wrap annuities into custom target date funds. Using multiple insurance providers helps diversify away firm-specific risk and lowers fees through competition. While most of the focus to date has centered on embedding guarantees into TDFs, other sponsors are looking to provide a similar benefit for participants allocating on their own.

EDUCATION AND AUTOMATION WORKING TOGETHER

While auto-enrollment has increased plan participation rates, many participants are not on track to meet their goals.

Given the emphasis that DC plans place on the individual - the majority of who have little or no investment knowledge - how best to engage the workforce to plan for retirement has long been a focus for HR and other professionals at plan sponsors. The passage of the Pension Protection Act (PPA) in 2006 allowed sponsors to rely more heavily on automation to increase plan participation and to simplify investing. While automation has proven to be a scalable solution for engaging most participants, it has not ensured adequate savings rates, it does not address participants' unique circumstances, and it fails to provide a post-retirement roadmap. To address these limitations, sponsors are combining automation with focused education.

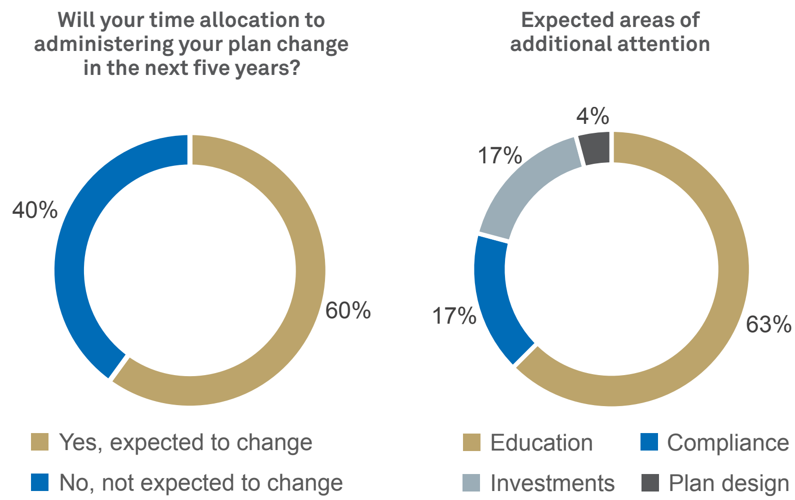
To boost general savings rates, sponsors and their providers are educating participants on growing their nest egg, rather than using it as a slush fund.

THE NEED FOR INCREASED SAVINGS

In the wake of the PPA, many sponsors shifted their approach from general education efforts to an approach heavily reliant on automation. Auto-enrollment was introduced, allowing the sponsor to automatically enroll employees in the DC plan, and increase deferral rates over time (a technique referred to as “auto-escalation”).

While auto-enrollment has increased participation rates, many participants are not on track to meet their goals. Automatic enrollment is often implemented with new employees only, stopping short of full-scale re-enrollment of all employees,

Exhibit 3: Expected Changes to Sponsors’ Areas of Focus



which some sponsors view as opening them up to increased liability. More importantly, default rates under auto-enrollment tend to correspond with the company match threshold—often between 3% to 6%—despite the fact that many experts recommend a target of 10% or higher. Particularly for lower-compensated employees, education is needed to boost savings rates well above the typical default rates. Consistent with this need, when asked how their time allocation will change, 63% of sponsors say that they expect to spend more time on participant education.

To boost general savings rates, sponsors and their providers are educating participants on growing their nest egg, rather than using it as a slush fund. For many employees there is still a disconnect between their projected retirement savings, income and needs and behaviors such as taking loans or reducing contributions that only compound the issue.

Part of this approach dispels the notion that participants can reach their goals solely on the strength of top-performing investments. Returns are important, but successful campaigns stress the need for disciplined approach, with savings as the main engine of growth. Detailed modeling and deeper analysis of the true cost of loans are but two ways sponsors are exploring to better educate their participants, and to prevent them from making poor decisions.

MEETING DEMOGRAPHIC CHALLENGES

Education remains relevant given the wide disparity in participant demographics. Even at similar income levels, participants of varying ages and tenure face different risks. Millennials have time on their side, and go into retirement planning with their eyes wide-open: they have never had a pension, and assume that the Social Security system will go bankrupt long before they retire. The bigger challenge lies with those between the ages of 50 to 60, many of whom grew up thinking that both the DB plan and Social Security would take care of them. For this age group, there are a lot of questions such as what to do with the money, how to access it, and what the fees are.

Most millennials have never had a pension and they assume that the Social Security system will go bankrupt long before they retire.

Working longer is not an ideal solution albeit one that many in the workforce currently consider part of their retirement strategy. The 2015 EBRI Retirement Confidence Survey highlights that in 1991 11% of workers expected to retire after 65, but that had increased to 36% by 2015.[11]

Of note, 10% of workers don't plan to retire at all. The challenges are especially noteworthy for manufacturing firms or other occupations dependent on physical labor, where having employees work into their 70s increases the risk of accidents or health issues that impair job performance. Using detailed data analysis, sponsors are working with their providers to identify participants headed for this scenario before it actually happens, so as to stave off this predicament.

RETIREMENT: A NEW BEGINNING

Sponsors also cite the need for education targeting retiring employees. Particularly for participants in mega-market plans with significant buying power, rolling out of the plan at retirement often means shifting into higher-priced products that will eat into participants' retirement income. The very institutional vehicles (CTFs and SMAs) sponsors are using to reduce costs in DC plans are likely to be replaced with higher cost mutual funds.

Often, the TDFs or stand-alone investment options in the DC plan will not be available in a retail setting. Even broad retail platforms may have limits as to the quality and type of managers offered, with no equivalent for the stable value option or the alternative investments offered in the DC plan. The need to revisit their asset allocation and develop a de-accumulation strategy may necessitate the hiring of an advisor, which will incur additional fees.

Targeted communications to participants nearing retirement can highlight the fact that staying in the plan is a compelling option. Sponsors with plans where the majority of assets concentrated among a narrow group of participants nearing retirement have the added motivation of considering the potential impact that large rollovers would have on the plan. Defections by boomers with high account balances could significantly decrease plan assets, leading to decreased economies of scale and higher fees for remaining participants.

UNBUNDLING AND TRANSPARENCY: SHINING A LIGHT ON FEES

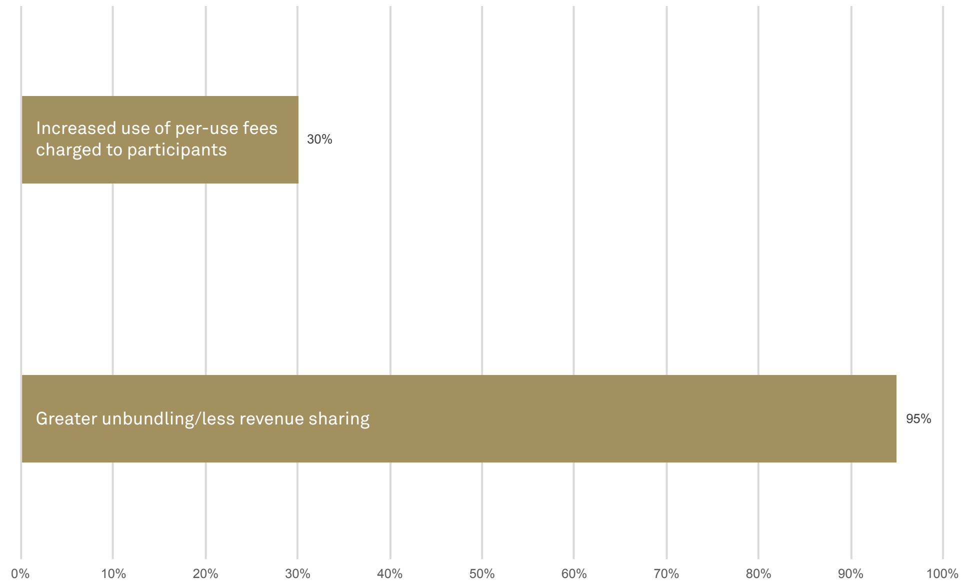
Although they have come a long way from being wholly reliant on proprietary fund lineups, DC pricing models continue to evolve. Bundled pricing arrangements – whereby investment manager, record keeping and potentially other administrative fees are all included together - can potentially offer limited transparency, inflate costs, and introduce conflicts of interest. Sponsors are increasingly looking to overcome these challenges through unbundled pricing models and adopting buying behaviors just as they would in the DB world.

The DC Plan of the future will have a more transparent fee structure, particularly on the investment side.

INCREASING TRANSPARENCY

While the DC industry grew up with all-inclusive fee structures, mega market sponsors have long had concerns regarding the fairness of these arrangements. From a corporate perspective, simple fee structures offer budgetary predictability, but it becomes impossible to compare underlying costs if those fees aren't itemized. Fees are also a key concern for individuals given that it's their retirement funds that are impacted by them. In the US, the Department of Labor implemented fee

Exhibit 4: What is the Pricing Model of the Future?



disclosure regulations in 2012 that help with some insight, but is no means the end of the road for transparency.

The DC Plan of the future will have a more transparent fee structure, particularly on the investment side. The vast majority (95%) of mega-market sponsors expect to see greater unbundling with less reliance on revenue sharing. Whether driven by regulators, lawsuits, or voluntary changes, sponsors anticipate a decreased reliance on marketing and distribution fees (e.g.12(b)-1 fees) and related payments. Fees will become more competitive once sponsors can see what they are paying for.

Even those sponsors still working under a bundled arrangement have hinted at potential changes. Those sponsors still reliant on revenue sharing and proprietary funds to reduce costs have put their providers on notice that if performance suffers, changes will be made.

Sponsors are concerned that the activities of certain participants are being subsidized by others.

REDUCING CONFLICTS OF INTEREST

Beyond their desire to negotiate fair fees at the plan level, sponsors are concerned that the activities of certain participants are being subsidized by others. When the cost of these services is not itemized, but rolled into the total cost of the plan, a conflict of interest is created. Accordingly, almost one-third (30%) of surveyed sponsors expect to see some increase in per-use service fees charged to the participant. For example, as plan sponsors look to allocate cost to the people that use the services, those taking loans or hardship withdrawals can expect to pay more. Qualified domestic relations order (QDRO) processing fees present another form of employee-specific fees that might be more appropriately paid for by the user, rather than the plan or participants in aggregate.

Implementing fee structures along these lines requires help from service providers such as recordkeepers and an in-house consensus on who pays for what. This analysis may be straightforward when user fees are already in place, but may require additional work if such charges were previously eschewed in favor of the “all-in” bundled fee arrangements common in the DC space. Sponsors may also need to look inward to determine their own level of paternalism, and whether their role is solely to provide for retirement, or help participants manage life-events.

LOWERING OVERALL COSTS

Sponsors see increased transparency not only as a goal in itself, but a means to an end. The majority of those surveyed believe that unbundling will continue to bring down fees: with clear segregation in investment costs and recordkeeping costs, sponsors will be able to comparison shop and negotiate a better deal with their providers. For those sponsors that have both DC and DB plans, the unbundling of fees may present opportunities for economies of scale and relationship pricing.

While lower fees afforded by transparency should have a positive effect on plan sponsors, the ripple effects for providers could prove challenging.

The majority of those surveyed believe that unbundling will continue to bring down fees with clear segregation in investment costs and recordkeeping costs.

KEEPING PACE WITH THE DC EVOLUTION

Defined Contribution plans have become a critical component for retirement provision across the US. They have made significant strides in terms of their evolution, but there remains work to be done if they are to improve retirement outcomes for the millions of Americans that they cover. The evolutionary journey itself also continues with a broader Financial Wellness philosophy becoming more common that includes budgeting, debt, home equity, health benefits and retirement in a holistic approach. It is incumbent on all plan sponsors to be able to gauge the impact of macro-industry trends on the operation of their plans.

Taking a page from several forward thinking organizations that were interviewed would suggest that, at a minimum, plan sponsors should evaluate the potential impact of the three initiatives discussed in this paper. In order to stay ahead of the curve, the exhibit below provides sponsors with a roadmap for suggested actions.

Exhibit 5: Empowering the DC Evolution

Key Trend to Monitor	Suggested Action
The “institutionalization” of DC	Evaluate existing mutual fund products against lower-cost vehicles (SMAs, CTFs, Institutional class mutual funds) Incorporate best practices of bellwether plans with respect to alternative strategies Work with insurers and other service providers to assist in developing a retirement income strategy
Education and Automation Working Together	Identify potential gaps in the automation strategy (e.g., near-retirement & low-salaried employees Work with recordkeepers and consultants to determine how other sponsors have implemented successful targeted campaigns Augment traditional methods (seminars, boilerplate documents) with technology (video, apps) to reach the unengaged
Greater Transparency into the Pricing Model	Push for full disclosure on underlying costs; dig deeper on anything offered “for free” Revisit non-core services to determine which are truly “must-haves” Align fees with those receiving the benefits, so as to minimize participant cross-subsidization and avoid conflicts of interest

METHODOLOGY

The DC Plan of the Future reflects the insights of 20 plan sponsors from Fortune 500 corporations, including leaders and innovators in technology, manufacturing, healthcare, and other sectors. These interviewees represent organizations with billions or even tens of billions in defined contribution (DC) assets; many have even larger defined benefit (DB) plans. As such, their complexity and buying power provides the need and the wherewithal to fuel innovation, cost savings, and better ensure favorable retirement outcomes.

While these interviews with DC leaders covered a wide-range of topics, including investments, regulation, and innovation, this paper focuses on the following three key areas:

– The institutionalization of DC plans

– Education and automation working together

– Unbundling: towards greater cost transparency

Rather than taking a theoretical approach to how the marketplace might change over the longer term, viewing these topics through the lens of the next few years enables focus on realistic changes already visible on the horizon.

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[2]Source - Employee Benefit Research Institute Retirement Confidence Survey www.ebri.org/surveys/rcs/2015 – 2015 RCI noted that 28% of respondents that had some kind of retirement plan were either not too confident or not confident at all that they would have enough money live comfortably through retirement

[3]Defined as plan sponsors with at least $1bn in Defined Contribution assets

[4]Mutual Funds are registered with the SEC and subject to the provisions of the Investment Company Act of 1940

[5]CTFs are regulated by the Office of the Comptroller of Currency (OCC) while still offering the benefits of lower costs and fee advantages over Mutual Funds

[6]CIT Expense Ratios reflects three custodians: Wells Fargo, BPAS, and Reliance Trust, across 407 share classes. CIT information not weighted due to data limitations. MF in DC based on 5500 filings, most recent year being 2013. Weighted to show actual plan sponsor/participant experience. Data excludes target date and target risk strategies. Source - Strategic Insight, an Asset International company

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