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Defined Contribution Plans

DC Dialogue
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Not-for-Profits Get Retirement-Ready

This issue features an interview with **Paul Staples**, Director of Defined Contribution Services at Summit Strategies Group

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In this PIMCO *DC Dialogue*, we speak with Paul Staples about the defined contribution (DC) plan evolution within not-for-profit organizations. Paul shares that this market is following in the footsteps of corporate plans, including a focus on retirement readiness as the primary plan objective. He shares how plans are gaining greater control by streamlining providers and plan types. They are simplifying their core investment lineups and increasingly are offering white label multi-manager and custom target-date strategies. In closing, Paul mentions improving plan governance, and he suggests that plan committees consider creating a three-year agenda.

DC Dialogue: Can you tell us how not-for-profit DC design is evolving and how not-for-profit plans differ from other markets?

Paul Staples: Not-for-profit plans are becoming more like the corporate 401(k) structures. There is increasing focus on retirement readiness. With that objective in mind, plans are seeking greater control, simplifying their investment designs, and improving governance.

DCD: Can you tell us more about their focus on retirement readiness?

Staples: We are seeing a big shift toward helping participants meet their retirement objectives. Not-for-profit employers often take on this objective with the same care and attention they apply to their organization's objectives. For instance, a hospital may think of participants in the same way that it thinks of its patients. A religious organization may think of participants in the same way that it thinks of its congregation. They want their participants to succeed.

Besides helping their workers with retirement, many of these organizations also help their workers with broader financial planning such as debt management, college savings and other life needs. They take a holistic approach to financial education and want their population to be financially secure.

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While there may be an altruistic motivation behind making sure participants are retirement-ready, there is often a financial necessity as well. In particular, health care and manufacturing organizations need to effectively manage employee turnover, given rising labor costs and the physical demands of the work. Focusing on retirement readiness leads to natural turnover in the labor force. This benefits employers and employees alike.

DCD: How are not-for-profits measuring retirement readiness?

Staples: Plan sponsors look at whether their participants have the assets they need to sustain their lifestyle, or standard of living. Increasingly, plan sponsors are applying a defined benefit (DB) framework to their DC plan. We often hear, "I know my DB plan funded ratio, but I don't have a similar concept to evaluate the success or failure of my DC plan." A similar approach can be taken for a DC plan. We can define the liability – that is, how much their participants need as a percentage of projected final pay to maintain their lifestyle. Then we can model the future account value using assumed salary increases, contribution rates, asset returns, mortality date and other variables.

This modeling allows the plan sponsor to measure the probability of participants having sufficient assets to replace, for instance, 50% of final pay, and it shows whether the plan has a funding gap. This is the success metric for DC plans: Will participants have the assets to maintain their lifestyle, or will they be forced to make very difficult choices in retirement?

With this information, a plan sponsor may modify the enrollment protocol or change the match formula to help drive better results. For example, they may auto-enroll (if the plan allows it) at a higher contribution rate (e.g., 5% instead of 3%), change the match to encourage a higher contribution rate (e.g., 50 cents on every dollar up to 8% of pay instead of a 100% match on 4% of pay), or consider a plan re-enrollment into the default option to correct participant asset allocation errors, such as excessive cash balances when that option previously served as the plan's default option before the Pension Protection Act made target-date funds the default standard. By making these changes, the plan sponsor may realize significant improvements in the plan's funding gap and retirement readiness score.

DCD: Is the DB liability-funding framework applied at the participant level?

Staples: We don't see many third-party administrators (TPAs) using the funded ratio at the participant level. Rather, they'll show a gap analysis to participants. For example, if a participant needs $1,500 a month to maintain their lifestyle throughout retirement, the TPA's website may show the participant that, based on their contribution rate and other variables, they are likely to have only $1,000 a month and, therefore, have a gap of $500 a month. The participant can then correct this gap by increasing their contribution rate, changing their asset allocation, moving their retirement age, or taking some other step.

The best tools we have seen offer multiple sliders – which allow the participant to view the effect of changing the contribution rate, asset allocation and retirement age – and then provide a button that basically says, "Make this happen." It's that easy to model and execute the changes.

Generally, most folks have undersaved for retirement because they are late savers or undersavers. In white collar-oriented plans, many participants have experienced rapid salary increases and have not ramped up their DC contributions accordingly. We also see asset allocations that are too conservative – for instance, with young workers investing all of their assets in a money market fund. By showing participants a projection of their future retirement income, they are encouraged to make adjustments before it's too late.

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We have seen employers help participants by offering group education programs and peer ambassador programs. The ambassadors help new hires understand the DC plans and show them the online retirement readiness tools.

We have also seen employers bring in retired workers to talk with groups. They may say, "Chuck retired five years ago and is here to share his experiences. He'll talk about what he might have done differently as he prepared for retirement." These peer-based programs work particularly well in manufacturing facilities or other work environments where a large group may look up to certain people for guidance.

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DCD: In what ways are plans gaining more control?

Staples: Plans are increasing control by consolidating multiple TPAs to a single provider. In the health care market, the move to consolidate to a single TPA occurred a decade ago. The government market has also largely abandoned the multi-vendor model. They realize there are greater economies of scale by consolidating both the assets and services with one vendor.

DCD: What types of DC plans are being offered by not-for-profit organizations?

Staples: In the not-for-profit market, 403(b) plans have been around the longest and hold the largest share of assets. Yet, we believe that will change. In the last few years, we have not seen the startup of any 403(b) plans. Plan sponsors prefer more flexible plan structures, in particular the 401(k) plan. The larger the plan and the more states the plan sponsor operates in, the more likely the plan sponsor will offer a 401(k) plan.

We also continue to see the use of 457 and 401(a) plans. In fact, it's not uncommon to see employers offer all four plan types: 403(b), 401(k), 457 and 401(a).

DCD: Can you explain why so many plan types are used by some employers?

Staples: As mentioned, the 403(b) has been around the longest and captures participant contributions. The 401(a) is set up to capture the employer matching contribution. The 457 deferred compensation plan is typically added as a top hat or executive compensation plan to help retain senior talent. Then, 401(k)s are introduced, particularly in the $500 million+ market, often with the intent of eventually replacing the 403(b). Unfortunately, plan sponsors generally cannot simply map 403(b) plan assets to a 401(k), so the 403(b) ends up frozen – assets remain in the plan but it no longer accepts contributions.

DCD: What is driving large plan sponsors to offer a 401(k) plan?

Staples: Fees and investment flexibility are the primary drivers behind 401(k) plan usage. Unlike the vast majority of 403(b) plans, the 401(k) allows the plan to invest in unregistered investment vehicles such as separately managed accounts and commingled investment trusts (CITs). These structures usually have lower fees than mutual funds. They also open the door to structuring unitized multi-manager white label and custom target-date strategies.

There are exceptions to the 403(b) registered investment rules. For instance, church plans are permitted to invest in unregistered investment vehicles. That's a small slice of the not-for-profit market. Church plans have no need to move to a 401(k) structure. They are not subject to the governance requirements of ERISA, yet they enjoy the same investment flexibility. Basically, they have the best of both worlds.

DCD: How are the investment menus changing in not-for-profit plans?

Staples: Most of the investment trends we see in the corporate market are also occurring in the not-for-profit market, but with a multi-year lag. For instance, plan sponsors are simplifying their menus. They are introducing target-date fund and core investment tiers. We also see more use of custom target-date and white label funds, even in the 403(b) plans.

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While the 403(b) plans generally cannot unitize – that is, use a funded trust with a single net asset value (NAV) – to create white label and custom target-date funds, they can offer a "model portfolio" approach. Like the unitized trust, model portfolios can be designed and managed by a fiduciary. We typically see plan sponsors hire a consultant as a 3(21) fiduciary, which allows the plan sponsor to maintain discretion by reviewing and approving recommended asset allocation changes. Other plans may fully delegate to a 3(38) fiduciary if they are comfortable in fully assigning the asset allocation decisions to a third party.

Unlike a unitized approach, model portfolios show participants the breakout of the asset allocation on their statements. For instance, instead of seeing a daily single NAV for the 2030 target-date strategy, they are shown the allocation weights to each of the underlying investments – for example, 10% in the bond fund, 20% in the real asset fund, 30% in large cap equities, and so on. Now, some providers may require the participant to invest "all or nothing" in the model portfolio – that is, 100% of his or her account. We also see this type of requirement with managed accounts. Of course, that's a restriction that you don't see with mutual funds or unitized custom strategies.

Requiring participants to allocate 100% of their account balance to the managed account service or model portfolio ensures that the asset allocation remains appropriate and is not distorted by ancillary allocations that can materially alter the intended risk/return profile. However, this requirement also diminishes participant control, which may be desired by participants who want the ease of the model portfolio and the ability to allocate to certain core options they believe enhance their overall allocation.

Custom and white label strategies allow their participants to benefit from the plan sponsor's investment manager selection and oversight.

DCD: Why are not-for-profit plans using custom and white label approaches?

Staples: Custom and white label strategies allow plans to invest in asset class specialists instead of defaulting to a single manager for all asset classes. They also allow the sponsor to use the plan's existing core options, which have been fully vetted and deemed appropriate for participant investment, as building blocks. Most large plan sponsors take time to review and select managers for both a DB and DC plan. Many ask, "Why would we use a different approach in our DC plan than we have in our DB plan?" Custom and white label strategies allow their participants to benefit from the plan sponsor's investment manager selection and oversight.

DCD: How are plans approaching capital preservation offerings?

Staples: With the upcoming money market reforms, we're spending a lot of time in this area. We believe offering a fully liquid vehicle is important regardless of the return. While stable value can be attractive, since the 2008 financial crisis, we have seen some clients shed the guaranteed or stable value products and offer a money market fund instead. Some plan sponsors worry about wrap provider or other potential risks. They also worry about participants' (even the youngest) perceptions of the safety of and excessive allocations to what is communicated as the "stable" fund.

Plans are focused on offering liquidity, in particular to satisfy retiree installment or partial withdrawals. Unfortunately, in this rate environment, that means settling for close to a zero return from money market funds. We anticipate that the money market reforms will drive more plans away from prime money market funds to government money market funds. Plans will choose liquidity over the marginal incremental return and potential lockups or liquidity restrictions that may be imposed on prime money markets.

DCD: Are you seeing changes to the fixed income offerings?

Staples: Most plans still offer a core or core plus mandate. To meet retiree demand for more fixed income options, many plans have added more opportunistic and total return-seeking bond funds, such as multi-sector or income-focused funds that include allocations to more sectors such as currency and international bonds.

For plans that add foreign bonds, we encourage sponsors to determine their comfort level with the potential impact an appreciating U.S. dollar will have on returns. For many U.S. investors, the negative impact of currency conversion in 2014 offset the returns on foreign cash bonds. To properly "match" the currency of participant liabilities and investments, many sponsors are considering a fully hedged implementation or the exclusion of foreign bonds entirely.

We also see more interest in unconstrained bond funds, which we generally support. Our concern with unconstrained strategies is participant communication. We're not sure that participants understand or really appreciate the dynamic portfolio asset allocation of an unconstrained fund. What the participant invests in on day one may be very different a week or six months out. So as not to be surprised, participants need education to understand how the fund may change. They also need to understand that unconstrained bond funds are not necessarily absolute return funds and there is no guarantee of a positive rate of return.

We're also seeing greater interest in short-term bond funds, which may be fueled in part by more plans using a money market as the capital preservation option. A short-term fund allows more opportunity for return, but with low relative volatility. We're also seeing more absolute return-focused products.

DCD: What types of absolute return funds are plans adding?

Staples: Funds often focus on outpacing inflation – for instance, beating CPI by 5% over time. Plans may offer an absolute return fund in the inflation-hedging category. Or they may find one that simply includes real assets such as Treasury Inflation-Protected Securities (TIPS), commodities and real estate. What's important is offering a portfolio that is correlated to CPI, which is what plan sponsors are most concerned about. They want participants' account values to keep up with the cost of living, especially so that retirees can maintain spending habits.

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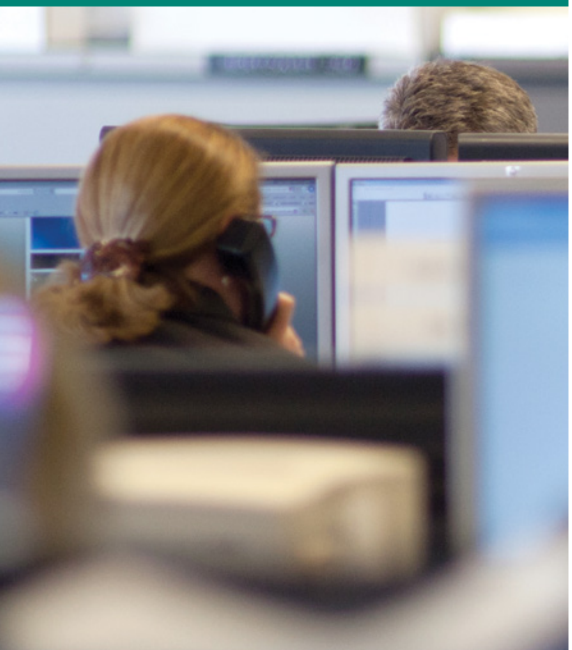

Plan sponsors generally are interested in keeping retiree assets in their plans. We believe retirees are most likely to leave for non-investment reasons.

DCD: What are you seeing in the equity lineup?

Staples: Many plans are shrinking the number of U.S. equity funds at the recommendation of consultants and in recognition that more highly correlated funds do not enhance diversification. Instead, they are expanding the number of international equity funds in response to the global equity opportunity set. This often includes international small cap, an asset class widely used by defined benefit plans.

DCD: Are plans adding investment options or insurance products aimed at retirement income?

Staples: We have had more questions about annuities recently. This interest is fueled by the change in the qualified longevity annuity contract (QLAC) rules that pave the way for offering in-plan deferred annuities. But we're not seeing early adopters of these products, and we doubt that the first movers will come from the not-for-profit market. That market will wait and watch what the corporate plans do before it adds insurance products to its plans.

Plan sponsors generally are interested in keeping retiree assets in their plans. We believe retirees are most likely to leave for non-investment reasons. Anecdotally, retirees often are looking for handholding and advice that the advisor market offers. This may include holistic financial planning, including estate planning as part of the retirement income management. They want an expert to meet with them in person once a quarter to tell them what they can afford to spend and invest their assets accordingly. That level of one-on-one advice is not present in many DC plans. While 403(b) plan providers often provide on-site representatives, they do not provide one-on-one financial advice. Holistic financial advice is a critical element of the service model needed for retirees.

DCD: You mentioned that plans are improving their governance. Can you tell us more about that?

Staples: There is greater alignment between the investment policy statement (IPS) and the actual practices used to select and monitor funds. Due to increased scrutiny by the DOL and a desire to be less subjective in their fiduciary decisions, sponsors want the IPS to drive the investment selection criteria and removal process. They want a clear and concise governance document. If they are ever questioned as to why a fund was added or terminated, plan sponsors want to point to the document that dictated the decision-making process.

Plan sponsors want a well-articulated investment review process. This should also cover how they select and monitor managed accounts when this service is offered.

We anticipate that in the near future, plan sponsors and consultants will spend considerable time evaluating and determining the plan's managed account provider. Many of these services were proposed by the plan's recordkeeper and may not have been subject to the same due diligence process followed for other plan options. Plan sponsors are asking, "How do we know if our managed account provider is doing a good job? How do we define and measure success?" Managed accounts have been sort of a black box, but plan sponsors must look at them and determine whether they are appropriate for participants. We expect the DOL to offer guidance on evaluating and selecting managed account providers, given their increased usage in the marketplace and in concert with the pending fiduciary rule.

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DCD: Are you seeing more plan sponsors interested in outsourcing their investment oversight?

Staples: The majority of RFPs we receive include one or two questions on outsourced CIO services – that is, 3(38) services. They may ask, "If we chose to move in this direction, can you offer OCIO services?" Plans with less than $50 million in assets may be more likely to move to a delegated approach. These small plans often lack the in-house expertise they need to manage their DC plan. Yet, they likely would retain certain oversight, such as selecting the recordkeeper. We have not seen a plan fully outsource all decisions.

I encourage plan sponsors to create a three-year agenda for overseeing their DC plan. Whether you are a not-for-profit or a for-profit entity, you need a long-horizon focus.

DCD: Do you have any final suggestions for plan sponsors?

Staples: I encourage plan sponsors to create a three-year agenda for overseeing their DC plan. As a committee, they may step back and ask what they would like to address over the coming years and then work through the list in a systematic way.

Managing a DC plan is a lot like managing any other operation. Whether you are a not-for-profit or a for-profit entity, you need a long-horizon focus. Plans should ask, "What are we trying to do here? What's our plan's objective? What plan enhancements will help move participants toward achieving that objective?"

DCD: Thank you for your insights and suggestions.

Staples: Thank you for asking me.

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- Investment professionals on staff exceed 700
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Our PIMCO DC Practice is dedicated to promoting effective DC plan design and innovative retirement solutions. We are among the largest managers of assets in defined contribution plans, offering investment management for stable value, fixed-income, inflation protection, equity and asset allocation strategies such as target-date solutions. We also provide analytic modeling, plus can help plan sponsors identify DC consultant resources. Our team is pleased to support our clients and the broader retirement community by sharing ideas and developments for DC plans in the hopes of fostering a more secure financial future for workers. If you have any questions about the PIMCO DC Practice, please contact your PIMCO representative or email us at pimcodcpractice@pimco.com.

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