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Secure Choice: The Next Chapter in the U.S. Defined Contribution Story

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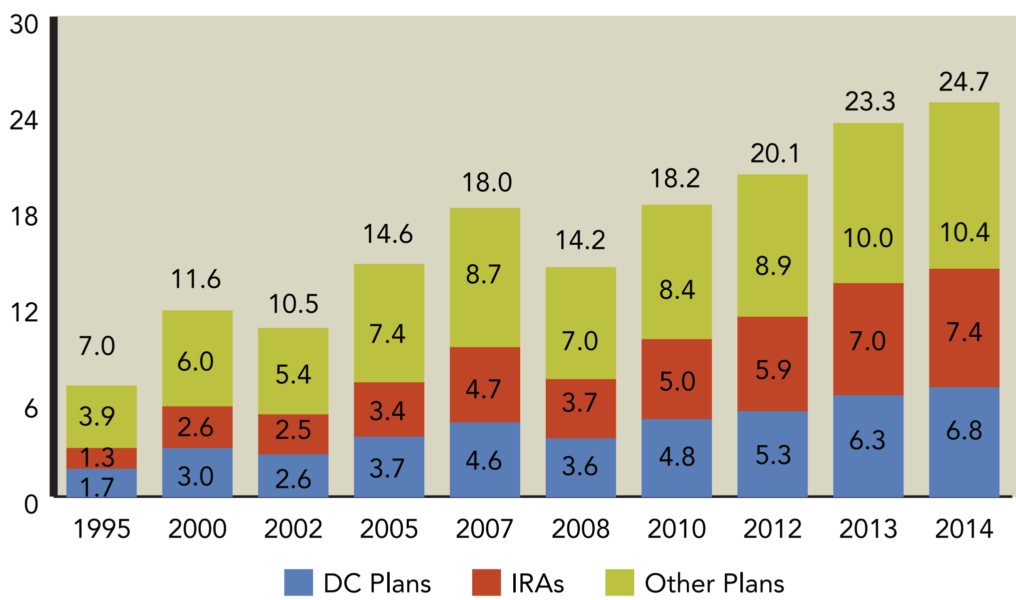
In the Marquette paper, Defined Contribution Plans: A Look at the Past, Present & Future, we highlighted the following key trends in the U.S. defined contribution market:

- The percentage of U.S. workers that are covered by a traditional defined benefit (DB) pension has declined in recent decades while over the same period, defined contribution (DC) plans have become the most commonly used employer-sponsored retirement savings vehicle.
- The continued evolution of best practices around the design, monitoring, and accessibility of defined contribution plans.
- Increased direction for plan sponsors from regulatory organizations such as the Department of Labor (DOL).

Exhibit 1: The Growing Popularity of DC and other Self-Directed Plans ($ Billions)



Source: Investment Company Institute - 2015 Investment Company Fact Book

In the same paper, we also encouraged plan sponsors and consultants to further leverage the best-practice foundations set forth by the Pension Protection Act (PPA) and mainstream acceptance of behavioral finance. In building on these strong foundations, we actively encouraged DC plan sponsors to consider and adopt our robust governance and monitoring framework.[1] Under this framework, plan sponsors will ensure that the depth and quality of their defined contribution investment lineups are equally important as maximizing participant engagement, plan design, and diligent oversight of all third-party vendors responsible for providing services to DC plans.

In this latest Marquette Defined Contribution paper, we build on the similar themes of governance and evolving best practices by emphasizing that positive challenges lie ahead for trusted stewards of defined contribution plan assets; particularly, as defined contribution assets continue to grow, new types of DC plans emerge, best practices evolve, and an increasingly diverse population is gaining access to defined contribution plans. Consequently, those of us that are entrusted as fiduciaries have a great opportunity to place segments of our country's workforce on a steadier path towards retirement readiness.

What is Secure Choice?

Secure Choice Programs or Plans ("SCP") are one of the newer developments in the DC world and capture many of the positive challenges currently faced by fiduciaries. Recent legislation has established defined contribution Secure Choice Programs in states such as California, Illinois, Massachusetts, Washington State and Oregon. Additionally, some 20 other states including Connecticut, Minnesota, New York, Utah and Vermont are exploring the adoption of Secure Choice legislation.[2] While differences will exist between the different SCPs that are birthed across our nation, it is our belief that most if not all Secure Choice Plans will share at least three common traits:

Trait #1 – They are Public-Private Partnerships that will provide millions of American workers access to a retirement savings plan

It is estimated that some 70 million U.S. workers do not have direct access to a retirement savings account.[3] Expanding further, these numbers mean that approximately 50 percent of private sector workers —particularly those who are lower-income or employed by small firms—lack coverage from a workplace retirement savings program primarily because they do not have access to one.[4]

By definition, Secure Choice Programs are publicly administered retirement systems that have been created to provide a retirement savings plan for private-sector workers who would otherwise not have access to an employer-sponsored retirement savings plan.

Trait #2 – They are multi-employer plans

SCPs are multi-employer DC plans that are likely to have a board of trustees consisting of state, private employer, and private employee representatives.

[1] As examples, please refer to the summer 2015 edition of Defined Contribution Insights published by the Plan Sponsor Council of America (PSCA) and the July 2015 edition of Benefits Magazine published by the International Foundation of Employee Benefit Plans (IFEB) – both publications feature Marquette's views on establishing a governance and monitoring framework.

[2] Sources: Pensions and Investments, Georgetown University and the Pension Rights Center (PRC)

[3] Brookings Institution

[4] U.S. Government Accountability Office (U.S. GAO)

Trait #3 – Clear lines of governance

From a governance standpoint, we would expect that the executive director and/or the Chief Investment Officer (CIO) of a Secure Choice Program would report directly to a board of trustees. Any investment and/or administrative staff that would work directly for the Secure Choice Program would report to the CIO. Ultimately, the board and staff would have a fiduciary duty to the Secure Choice Trust.

Exhibit 2: Illustrative Governance Structure for Secure Choice Plans

Source: Marquette

Inheriting an evolving best practice rule book: challenges and opportunities

As Secure Choice Programs represent one of the latest chapters in the U.S defined contribution story, fiduciaries of SCPs should genuinely feel that they are in a good starting position for these new programs as they can leverage the many common-sense DC-focused best practices that have been promoted by the PPA of 2006[5] and the mainstream acceptance of behavioral finance.[6] These best practices have evolved from years of trial and error as well as observations of clearly irrational behavior from a material number of DC plan participants over the decades. So, unlike DC fiduciaries of the 1970s or the 1980s and 1990s, today's stewards of Secure Choice assets have been bequeathed a common sense rule book to build upon. This rule book includes PPA-influenced best practices such as automatic enrollment, automatic escalation[7] and age-appropriate target date funds as the default investment option for participants.

Exhibit 3: Auto-features are widely viewed to be positive in DC Plans as they are an effective means of increasing participation rates.

Percentage of Plans with Automatic Enrollment by Plan Size

Number of Participants	1-49	50-199	200-999	1,000-4,999	5,000+	All Plans
Percentage of Plans	18.9%	45.2%	53.6%	63.8%	66.7%	50.2%

Source: PSCA 57th Annual Survey

Adoption of Automatic Escalation

Plans that use automatic enrollment	65.2% automatically increase default rates (auto-escalate)
Plans that do not use automatic enrollment	24.6% automatically increase default rates (auto-escalate)

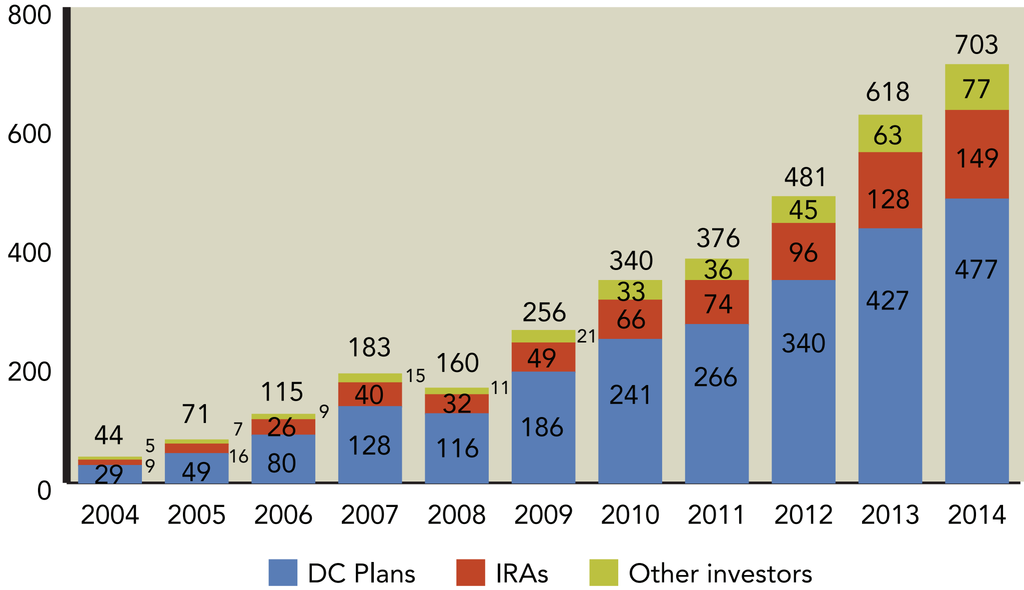
Source: PSCA 57th Annual Survey

[5] As an example, please refer to the introductory section of the Defined Contribution Institutional Investment Association (DCIIA) 2014 Plan Sponsor Survey (published June 2015) that highlights the transformative nature of PPA.

[6] Bestsellers such as Nudge: Improving Decisions About Health, Wealth, and Happiness by Richard H. Thaler and Cass R. Sunstein and Time Magazine's article on "Fuel Your 401(k) with the Secrets of Behavioral Finance" by J.D. Roth are just a few examples of how behavioral finance concepts have become a part of mainstream discussion and how behavioral finance is no longer perceived within the mainstream as a purely academic discipline.

[7] Institutions such as the PSCA, DCIIA and the EBRI have highlighted how the addition of auto-features can have a material positive impact for many DC participants (including those that fall in a low-income category). Prior to the PPA, many employers were reluctant to "auto-enroll" plan participants because they feared that they would be opening themselves to legal liability under a variety of different scenarios.

Exhibit 4: The Rapid Growth of Target Date Mutual Funds ($ Billions)[8]



Source: Investment Company Institute - 2015 Investment Company Fact Book

In addition to the PPA, recent initiatives from the Department of Labor include the participant fee disclosure regulation of 2010 - 2012. This regulation requires plan administrators to provide participants with specific information related to fees and costs associated with plan investment options. As a result, the DOL has motioned a process that provides DC participants access to a useful layer of information to help them make more informed decisions about the long-term management of their plans.

Mainstream acceptance of behavioral finance has also aided DC program management and how investment options are presented to plan participants. When voluntary DC plans were first established through the Revenue Act of 1978[9], it was a widespread—but inaccurate—belief that individuals eligible to invest in DC plans would make sound financial decisions which would be implemented in a rational manner over their working lives—hence the "do it yourself" nature of the DC plan. As noted during Marquette's webinar Defined Contribution Plan Stewardship: History & Opportunities, decades later, it was clear that this optimistic yet unrealistic view of individual investor behavior ignored a key finding of behavioral finance, namely that due to a number of different psychological and environmental reasons, many individuals will make poor investment choices which can lead to inappropriate portfolio diversification and in turn insufficient growth of assets. To remedy the behavioral deficiencies to which the typical DC investor may be prone, Exhibit 5 highlights how today's common best practices such as tiered investment structures and targeted communications can be helpful.

[8] While they come in many different flavors, Target Date Funds continue to be popular as they present a conceptually simple way to access a professionally managed, diversified portfolio that uses an automatic asset allocation glidepath. Adding the $700 billion held in target date mutual funds to the estimated $300 billion that is held in non- 40 Act commingled accounts, it is estimated that Target Date Fund assets are in excess of $1 billion (Morningstar and Barons).

[9] The Revenue Act of 1978 established qualified deferred compensation plans (Code Section 401(k) plans), which allowed for pre-tax employee deferrals. Under the act, employees are permitted to withdraw their contributions from such plans after age 59 & ½, or upon separation from service (currently "severance from employment"), or because of hardship or disability (Source: Georgetown University Law Center).

Exhibit 5: Examples of how the DOL and behavioral finance have shaped DC best practices

Investment	
Best Practice	**Benefit to Participant**
Tiered Structure	Aligns particular types of investments with the investing appetite and inclinations of different plan participants
Plan Design	
Best Practice	**Benefit to Participant**
Automatic-enrollment	Helps participants to be involved in the savings process as soon as they are eligible
Automatic-escalation	Increasing the default rate over different intervals is a prudent way to improve the probability of generating a higher retirement balance
Qualified Default Investment Alternatives (QDIA)	Has enabled automatically enrolled participants to access "one-stop-shop" options such as Target Date Funds
Administrative	
Best Practice	**Benefit to Participant**
Fee transparency	Participants are in a stronger position to make informed choices around investmement options and are given the tools to understand how fees impact returns over the long-term and short-term
Targeted Communication	As an example, targeted communications to participants can highlight whether their portfolios are concentrated in one type of option and then highlight the potential benefits of adopting a more diversified portfolio

In spite of the positive developments that we have just highlighted, the inherited rule book that was described at the beginning of this section does remain a work in progress and much ground still needs to be covered to place a material number of the U.S. workforce on a better path to retirement readiness. As it specifically relates to Secure Choice Plans—programs that could potentially impact at least 70 million workers—fiduciaries of such programs are in a strong position to advance ongoing discussions and spur continued action in many key areas.

Opportunity Knocks, Let's Answer the Call

In order to place a material percentage of the U.S. workforce on a better path to retirement readiness, there are three priority areas that we would encourage Secure Choice fiduciaries to focus on over the near-term, either following or in tandem with the adoption of a streamlined investment lineup and implementation of a detailed governance and monitoring framework. These three areas are:

- Fee negotiation (investment and administrative)
- Monitoring savings and allocation trends based on race, ethnicity and gender
- The feasibility of guaranteed income solutions for Secure Choice participants

Fee reduction

With respect to fees, many strides have been made in the defined contribution world. As an example: in 2000, DC plan participants incurred an average expense ratio of 0.77 percent for equity funds; by 2014, the average expense ratio had fallen to 0.54 percent, a 30 percent decline.[10] Also, with respect to administrative or per head fees paid by DC participants, it is generally accepted that recent developments such the DOL's fee disclosure requirements have added downward pressure to recordkeeper fees in the past few years.[11]

While fees in the DC world are headed in the right direction, we cannot ignore that there is room for additional reductions. To reinforce this view, we refer to a recent study from the Boston College Center for Retirement Research, which highlights that during 1990-2012, DB plans outperformed DC plans by 0.7 percent, with the most likely contributor behind this deviation in performance being the higher fees paid by DC plans[12] versus DB plans.

With regard to how Secure Choice fiduciaries can keep fees competitive for their programs, practical steps such as reviewing the mix of active and passive options in a line-up could prove to be worthwhile. From a plan governance standpoint, it is prudent to offer a low-cost suite of passive products as well as best in class actively managed core investment strategies to participants. To illustrate this point, Exhibit 6 highlights how median costs can vary considerably between active and passive options in the same asset class.

Lastly, because Secure Choice Programs are publicly administered, a willingness from fiduciaries to explore fee aggregation initiatives with other public entities within the same state could be another productive avenue to explore as a means of negotiating the most favorable fee structure for the SCPs' investments and other services.[13]

Exhibit 6: Looking at Fees through the Lenses of Active and Passive Management (for $100M mandate)

Asset Class	Passive				Active	
	Commingled Funds		Mutual Funds			
	Annual Fee	Basis Points	Annual Fee	Basis Points	Annual Fee	Basis Points
U.S. Large Cap Core	$50,000	5.00	$127,500	13.00	$500,000	50.00
U.S. Mid Cap Core	$60,000	6.00	$230,000	23.00	$637,500	64.00
Non-U.S. Large Cap Core	$112,500	11.00	$210,000	21.00	$588,750	59.00

Source: eVestment. Estimated Median Annual Fee based on $100M mandate

Race, ethnicity and gender

The need to focus on yesterday's "elephants in the room"—race, ethnicity and gender—can also be a high priority item on the modern fiduciary's "to-do" list. At the end of the day, fiduciaries are obliged to place all of their plan participants on a steadier path to retirement readiness. Unfortunately, several studies from both public and private sources highlight an alarming story when we look at how ill-prepared certain segments of our population are for retirement.[14] Furthermore, we live in a diverse country meaning that certain states currently implementing Secure Choice Programs as well as those that plan to roll out SCPs in the near future will more than likely contain sub-sets of their workforce that are diverse by gender and/or ethnicity.

[10] Source: The Economics of Providing 401(k) plans: Services, Fees, and Expenses, 2014 by the Investment Company Institute (ICI)

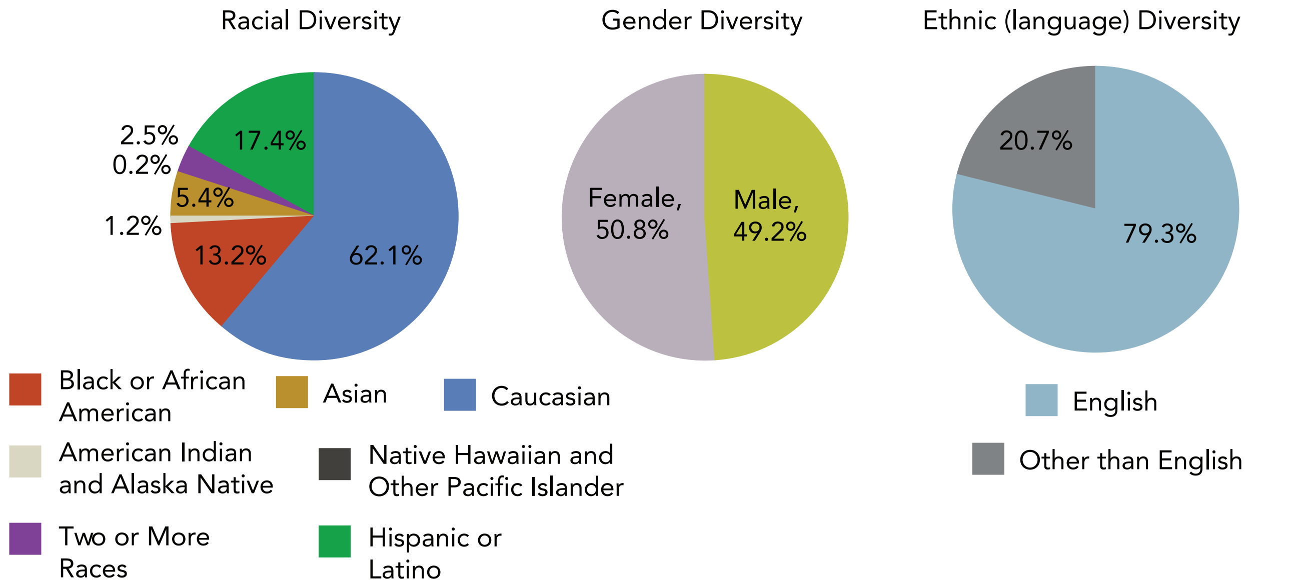
[11] As examples, please refer to the Workforce.com special report: Fewer in the 401(k) Field (Patty Kujawa, November 7, 2014) and the Pensions and Investments article Fee-disclosure rule spurring searches for DC record keepers (Robert Steyer April 29, 2013)

[12] Please refer to the paper Investment Returns: Defined Benefit vs. Defined Contribution Plans by Alicia H. Munnell, Jean-Pierre Aubry and Caroline V. Crawford. Their analysis compares returns by plan type from 1990-2012 using data from the U.S. Department of Labor's Form 5500. Their report shows that during this period, defined benefit plans outperformed 401(k) plans by an average of 0.7 percent per year, even after controlling for plan size and asset allocation.

[13] Source: The Economics of Providing 401(k) plans: Services, Fees, and Expenses, 2014 by the Investment Company Institute (ICI)

[14] As examples, please refer to the ERISA Advisory Council report on Disparities for Women and Minorities in Retirement Savings (2010); the New Republic's The Alarming Retirement Crisis Facing Minorities in America (Danny Vinik, February 2015); Reuter's Why Minorities are Losing the Retirement Race (Mark Miller, December 2013) and the ING Retirement Research Institute's 2012 study, Retirement Revealed.

Exhibit 7: U.S. Diversity – "E pluribus unum"



Source: www.census.gov

As we live in an age where information is readily available at the push of a button, fiduciaries can work closely with their recordkeepers to establish whether based on gender, race or ethnicity, different savings behaviors are prevalent within pockets of their SCPs' participant populations. And, the same way that DB plans are known for conducting asset allocation studies to determine if they are strategically on the right path, we believe that it is beneficial for fiduciaries of Secure Choice programs to establish a best practice of reviewing participant behaviors in detail at a minimum of once every 2-3 years as well as after targeted communication campaigns or changes to the fund line-up.

By consciously monitoring participant behavior over periodic intervals, SCP fiduciaries can establish an effective process to gauge whether discernible trends (both good and bad) exist within sub-sets of their Secure Choice participant populations. Related to this, fiduciaries of Secure Choice Plans can feel confident that established methods like automatic escalation, re-enrollment, targeted communications and one on one professional advice for participants have proven to be effective in reinforcing and influencing positive savings behaviors of DC plan participants.[15]

Feasibility of guaranteed income products

In theory, guaranteed income or annuity-like options such as a Guaranteed Lifetime Withdrawal Benefit (GLWB) are methods for DC plan participants to exchange the present value of their DC assets for a stream of predictable and guaranteed future payments at retirement. There are practical reasons why guaranteed income options could be appealing for DC plan participants, including the predictability and security that comes with a regular income stream during retirement, as well as the shift of market risk (volatility) from plan participants to annuity providers (insurance companies)—the latter example would be particularly beneficial to participants during extreme down markets.

[15] Please refer to the following sources for additional information: The Impact of Automatic Features in Defined Contribution Plans by Shai Akabas and Brian Collins of the Bipartisan Policy Center (BPC) - September 2014, Vanguard's How America Saves 2015, the DOL's Successful Plan Communications for Various Population Segments.

When DC plans were initially rolled out to the U.S workforce in the late 1970s and early 1980s, they were originally presented as a means of augmenting a fixed DB pension benefit. As traditional DB pension plans have continued to be phased out of today's modern retirement story, DC plans have evolved from a supplementary retirement vehicle to the main source of retirement income for our country's workforce. Consequently, the dominance of DC plans has led to a number of independent research papers as well as studies from asset managers and insurance companies that highlight a phenomenon called longevity risk—when a DC plan participant outlives the assets in his or her portfolio. Recent research has highlighted how this type of risk can be better managed for plan participants through the use of guaranteed income options.[16]

In addition to managing longevity risk, guaranteed income products can also buffer plan participants from significant bouts of volatility in down markets and during crucial points in their respective accumulation and distribution cycles. The Global Financial Crisis of 2008 (GFC) was a painful reminder that DC plan benefits for those at or near retirement were neither fixed nor guaranteed. For instance, DC assets declined by roughly 22% from $4.6 trillion at the end of 2007 to $3.6 trillion at the end of 2008[17] while plan participants aged 55-64 saw their average account balances decrease by over 20.2% over the same period.[18]

Not surprisingly, the widespread loss of material wealth for those at or nearing retirement during the GFC was a catalyst for broad discussions around the feasibility of incorporating guaranteed income options within defined contribution lineups. For instance, the existence of guaranteed income options in a defined contribution lineup would mean that during an extreme bear market, DC participants that were at or near retirement could actually rely on a set income stream that would not fluctuate based on the performance of the stock market.[19]

While there has been a significant amount of dialogue around the use of guaranteed income options in DC plans, the reality is that only a handful[20] of defined contribution plans currently offer some type of guaranteed income option within their product lineups. Some of the commonly cited reasons behind the slow adoption of guaranteed income options include plan sponsors' concerns around their operational complexity, cost, lack of portability, and the perceived lack of clear guidance from regulatory organizations like the DOL.

In light of these concerns, we recommend that Secure Choice fiduciaries continue to educate themselves on the different types of guaranteed income options currently available in the market place. After all, guaranteed income options—like every other type of investment product—can come in many shapes and flavors. Through the education process, SCP fiduciaries will be in a stronger position to establish which of the aforementioned concerns around adding a guaranteed income option to a lineup are more nuanced in nature (for example their complexity and limited transferability) versus those concerns that are relatively easier to address (for instance the misperception that there is a lack of clear direction from regulatory organizations).

In order to address some of the concerns that plan sponsors have around the additional operational complexity of guaranteed income products, SCP fiduciaries could initiate discussions with some of the DC plans that have successfully incorporated retirement income options in their programs. One potential benefit of this approach would be the leveraging of the intellectual capital and research that were used by these innovative plans, meaning that SCP fiduciaries would not necessarily have to recreate the learning curve on the potential use and implementation of guaranteed income options.

[16] As an example of the recent research on longevity risk, please refer to the 2015 paper entitled The Transition from Defined Benefit to Defined Contribution Pensions: Does It Influence Elderly Poverty? (Natalia Orlova, Matthew Rutledge and April Wu). One of the main conclusions of their research is that households with liquid assets (like DC plans) that do not receive annuity payments were more likely to dip below 150% or 200% of the poverty line.

[17] Please refer to exhibit 1 in this newsletter.

[18] Change in Average Account Balances From January 1, 2008 – January 20, 2009 Among 401(k) Participants with Account Balances as of Dec. 31, 2007, The Employee Benefit Research Institute (EBRI), February 2009

[19] The guaranteed income stream would be a function of the financial strength and claims-paying ability of the insurance company/companies that sponsor the guaranteed income options in the DC plan.

[20] 8.5%, per PSCA

Similarly, fiduciaries of Secure Choice Plans could also walk through implementation case studies with the asset managers and insurance companies that currently manage guaranteed solutions in the DC marketplace. By interacting with these product providers, fiduciaries could obtain a sense of the potential hard dollar costs associated with the different retirement income options and also review how early adopters of these solutions were able to address any operational and transferability hurdles.

Finally, with respect to overcoming concerns such as the perceived lack of direction from regulatory organizations on the implementation and monitoring of guaranteed income products, education sessions could highlight to SCP fiduciaries that the DOL's Annuity Selection Safe Harbor Regulation for DC Plans (2015) and the Treasury Department's guidance on QLACs—qualifying longevity annuity contracts (2014) are recent examples of practical guidance provided to DC plan sponsors.

Conclusion: Answering the Call to Provide Security and Choice

The latest incarnation of the U.S. DC plan is the Secure Choice program, a state administered defined contribution plan that will be offered to private sector employees that lack access to an employer sponsored retirement plan. While SCPs are a relatively new concept in America, the challenges that Secure Choice Plan participants and fiduciaries face are far from new. In fact, relative to DC trustees and service providers from a few decades ago, fiduciaries of Secure Choice plans are in a somewhat enviable position as they can "hit the ground running" by leveraging years of innovation in areas such as plan design, investment monitoring and behavioral finance. Additionally, the roll-out of Secure Choice Programs in various states coincides with the creation of forward-looking DC-focused policies in previously untested areas; the Safe Harbor implications of guaranteed income options to DC plan participants is a prime example. Going forward, the success of SCPs should be measured by additional progress and innovation in the following areas:

- Fee reductions;
- Addressing the disturbing savings trends characteristic of certain segments of our working population, and;
- The feasibility of offering guaranteed income options to plan participants.

Given the sheer number of our country's workforce that could eventually have access to a Secure Choice Program, fiduciaries should look to embrace what we will call the "dawn of the Secure Choice Plan" and the positive challenges that lay in wait to positively influence the latest chapter of the U.S retirement story. After all, fiduciaries of these public-private partnerships are morally obliged to help prepare participants for a retirement befitting their years of service and dedication to the workplace.

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