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# The Paternalization of Participant-Directed Plans

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The retirement plan industry has been refining and improving the defined contribution system over the last few decades, and many workers now have access to a variety of high-quality investments and in-depth investment education to assist them in planning for retirement, thanks to their employer-sponsored retirement plans. But even with these advantages, many participants are falling far short of their retirement goals. Studies of participant investment behavior indicate that much of the problem lies with the participants themselves.

In this paper, we'll examine the research covering participant investment behavior and how the industry and plan sponsors can address the issue so that the answer to the question, "Is the defined contribution system successful?" becomes an unqualified, resounding yes.

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"THE LIKELIHOOD OF INVESTMENT SUCCESS INCREASES AS THE PARTICIPANT'S INVOLVEMENT IN INVESTMENT DECISIONS DECREASES."

~ *CHANG, SIMON, ALLEN, 2005*

Is the defined contribution system successful? The best answer to this question may be a qualified yes. Most experts agree that the system is well-designed, with the proper incentives and structure in place to make it possible for American workers to achieve a secure retirement. However, workers are experiencing significant shortfalls in retirement savings. What is going wrong? Evidence is showing that the flaw in the system may point back to the participants and their investment choices. This is not to lay blame on these individuals, but to recognize that retirement plan participants may be finding themselves overwhelmed by the investment decision-making required of them.

The retirement plan industry has been refining and improving the defined contribution system over the last few decades, and many workers now have access to a variety of high-quality investments and in-depth investment education to assist them in planning for retirement, thanks to their employer-sponsored retirement plans. But even with these advantages, many participants are falling far short of their retirement goals. Studies of participant investment behavior indicate that the much of the problem lies with the participants themselves: "…evidence indicates that as a whole they are woefully unprepared to make their own investment decisions." *(Douthit)*

Some portion of the retirement savings shortfall can be attributed to participants simply not saving enough money. But a significant factor in chronic shortfalls is poor investment results, largely due to poor investment choices. The DALBAR Quantitative Analysis of Investor Behavior attributes a huge 45-55% of poor returns to psychological investor behavior. *(Dalbar, 2013)* The psychological investor behavior that contributes to poor investment outcomes refers to a variety of issues that are explored in some of the research to follow. Participants experience an initial struggle to develop an appropriate asset allocation, often fail to rebalance frequently enough, and make emotional decisions that try to time the market, all of which impact their investment results.

In this paper, we'll examine the research covering participant investment behavior and how the industry and plan sponsors can address the issue so that the answer to the question, "Is the defined contribution system successful?" becomes an unqualified, resounding yes.

## THE RESEARCH

A number of studies over the years have compared the investment returns of participant-directed accounts to the returns of index funds, market returns, committee- or trustee-directed defined benefit accounts, and asset allocation accounts like risk-based and target-date funds. Participant-directed accounts, in aggregate, consistently underperform over long periods of time in nearly every comparison. Furthermore, studies that take a close look into participants' asset allocation strategies reveal a lack of diversification that is likely to damage participants' long-term outcomes.

> **"Many plan fiduciaries, participants, and their advisors, as well as regulators, have come to a harsh realization: plan participants generally are not successful investors."**
>
> ***~ Chang, Simon, Allen, 2005***

One of the most thorough, oldest, and well-known studies was performed by the Center for Retirement Research in Boston College by Alicia Munnell, now a renowned behavioral finance researcher. This study, "Investment Returns: Defined Benefit vs. 401(k) Plans," compared 401(k) plan returns to pension returns over the period 1988-2004. The study set out to test the hypothesis that individuals are not very good at investing their money by comparing participant-directed funds with pensions funds managed by professionals. The result? "The bottom line is that over the period 1988-2004 defined benefit plans outperformed 401(k) plans by one percentage point. This outcome occurred despite the fact that 401(k) plans held a higher portion of their assets in equities during the bull market of the 1990s." *(Munnell et al, 2006)* One percent may not seem significant, but consider that, for example, $50,000 invested for 25 years will earn almost *$57,000 more* at a 7% rate of return than at a 6% rate of return.

The underperformance, however, was not the only issue the study uncovered. "The other is that despite a reasonable mix for 401(k) assets in the aggregate, nearly half of 401(k) participants are either nearly fully invested in stocks or hold no stocks at all. That is, nearly 50 percent of participants are not diversified in their retirement accounts." *(Munnell, 2006)*

Towers Watson has been studying and comparing defined benefit and defined contribution plan investment returns for more than ten years. Their conclusions are similar: "DB plans outperform DC plans by roughly an average of 1 percentage point per year." *(Towers Watson, 2009)* "DB plans have been earning higher returns than their DC counterparts since 1999." *(Towers Watson, 2011)* In the most recent study, Towers Watson discovered an anomaly to this pattern; DC plans outperformed DB plans during the bull market of 2009, their heavier weight to equities resulting in better performance. However, that same larger asset allocation to stocks hurt DC plan performance during bear markets. "During a bear market, DB plans outperformed their DC counterparts by roughly 2.5 percentage points." *(Towers Watson, 2011)* Because participants tend not to rebalance their portfolios, outperformance during up markets can turn against them on the other side of the market cycle. Other studies found a similar phenomenon; participant accounts fared slightly better during bull markets due to an overweight of stocks, but suffered more during bear markets for the same reason.

The DALBAR Quantitative Analysis of Investor Behavior (QAIB) makes a slightly different comparison, examining "average investors," the universe of all mutual fund investors, who represent participant-directed assets, versus "asset allocators," or those invested in an asset allocation fund such as a balanced fund, target-date, or risk-based fund. The "asset allocators" are divided into quartiles, based on four-year performance returns, to allow separate comparisons to different tiers of allocators.

The QAIB demonstrates a huge gap between average investors and asset allocators during down markets. For instance, "the analysis shows that in a down year (2008) where average equity investors lost 41.66%, the average asset allocation investor lost significantly less, 30.53%. This is an eleven point advantage for the asset allocation investor in the down market." *(Dalbar, 2013)* The return for the same period for the top quartile of allocators was -21.63%, a 20% advantage over average equity investors for the period. That the top tier of asset allocators had such an impact on return should serve as a reminder of the importance for plan sponsors to be diligent in their selection of asset allocation solutions. The QAIB, unlike Towers Watson, found that even in up markets, as characterized by 2012, average investor returns suffered relative to asset allocators; the average investor return in 2012 was 8.83%, compared with asset allocation returns ranging from 10.19% to 13.68% in the top quartile. *(Dalbar, 2013)*

Vanguard conducted research on performance during the five-year period from the end of 2007 to 2012, comparing defined contribution participants' investment returns to the professionally managed allocations of target-date funds. The study found that participant returns varied widely during the period, given participants' broad range of investment strategies. "Some participants may invest their entire portfolio in equities, while others invest exclusively in low-risk assets, such as money market or stable value funds.... As a result, participant total returns tend to be dispersed or distributed over a wide range." *(Lamancusa, et al, 2013)* Annualized investment returns for participants managing their own investments ranged from -1.7% to 6.3%, with the median being 2.3%.

During that same period, participants who were invested in a target-date fund experienced returns ranging from 1.7% to 3.7%. The narrower dispersion was also reflected in the volatility of portfolios; target-date investors experienced much less volatility (as measured by standard deviation) than do-it-yourself allocators. The study's authors note that "we believe that this reduction in dispersion of outcomes is attractive to plan fiduciaries, as it demonstrates both improved investment discipline and risk control in participant portfolios. This result also is gradually mitigating concerns about the quality of investment choices being made by inexperienced plan participants." *(Lamancusa, et al, 2013)* Higher volatility is generally punitive to wealth accumulation, as it can result in larger drops in value of an investor's portfolio.

Fidelity also recognized that participants who were investing on their own were struggling. "A recent Fidelity survey of 3,100 NetBenefits® participants found that 77% admitted to not having the time or investment knowledge to be confident in their investment decisions, yet many try to make their own investment choices." *(Fidelity, 2013)* Fidelity took a look at do-it-yourself participants' asset allocations with some surprising results. Thirty-three percent of participants held more than 90% of their assets in stocks, including 27 percent of baby

"IN SHORT, THE PRACTICE OF ALLOWING PARTICIPANT DIRECTION WITHIN A 401(K) PLAN IS GENERALLY NOT A GOOD ONE FOR HELPING PLAN PARTICIPANTS RETIRE COMFORTABLY."

*~ CHANG, SIMON, ALLEN, 2005*

boomers, despite being close to retirement. On the other end of the spectrum, 12 percent of participants were holding less than 10% of their assets in equities. Almost 90 percent of do-it-yourself participants had not made a change to their investment allocation in the past year, suggesting that they may not be adequately monitoring or properly rebalancing their accounts. *(Fidelity, 2013)*

The conclusion that people are beginning to draw from these studies is that participants in defined contribution plans may need more help making appropriate investment choices. Concerns about underperformance and poor diversification echo participants' own requests for more help and more advice. It may be time to consider returning to a more paternalistic approach to retirement savings.

"The rapid growth in professionally managed allocations — most notably, target-date funds, but also traditional balanced options and managed account advice services — is contributing to a reduction in extreme risk and return outcomes for participants. It is also gradually mitigating concerns about the quality of portfolio decision-making within DC plans. Plan sponsors should consider greater adoption of these strategies to encourage better risk control and investment discipline in DC participant portfolios."

*~Lamancusa, et al, 2013*

## Paternalizing plans

Imagine yourself as a new employee at your first enrollment meeting. An investment expert stands up in front of a PowerPoint™ presentation and describes the difference between stocks and bonds, then begins to talk about something called "asset allocation," a term you've never heard before. As you listen to phrases like "asset classes" and "equity funds," you begin to think about what you're going to have for dinner. It all sounds great, but when you're handed an enrollment form, you look at the list of 35 investment options and feel overwhelmed. You know that you are supposed to diversify, and you took a risk tolerance quiz in the enrollment meeting that identified you as a "moderate" investor. But you're not quite sure how to translate that into choices on the enrollment form. Ultimately, you choose three or four options and divide your contributions evenly among them. When you turn in the form, you are determined to remember to do something called "rebalancing," but the thought flees your mind within moments of returning to your busy desk.

This story may not be representative of all participants, but it encapsulates an experience common to many participants. Over the 1980s and 1990s, defined contribution plans became a primary savings vehicle for many Americans, taking the place of the traditional pension, or defined benefit, plan. With that shift, investment decision-making passed from expert hands into the hands of participants. Early defined contribution plans, intended as supplemental retirement savings, offered a small handful of investment options, making it fairly simple for plan participants to allocate their assets. But as defined contribution plans became a primary savings vehicle, the structures of many plans shifted to accommodate this new reality. In an effort to help participants be successful, many plan sponsors increased the number of investment options available with the hope that a robust plan would result in robust performance.

In essence, we shifted from a defined benefit mentality, in which retirement savings were fully managed for people, to early defined contribution plans, with a few simple options, to very complex plans demanding sophisticated investment acumen to navigate through decisions. For a time, then, education seemed to be the answer. Over the past two decades, participants have been inundated with investment education — in person, in print, and online. Great strides have been made to provide education that is accessible and friendly. However, investment education appears to have done little to improve participants' investment choices and thus investment returns. The direction in which the industry is turning now is toward the paternalization of retirement plans.

"Paternalization" is about benevolent guidance, such as a parent would provide to a child, not about dictating or eliminating choices. Paternalization means offering participants a path by which their retirement savings are managed by professionals, and by which all decisions can be taken care of for them, from enrollment to contribution rates to contribution increases to asset allocation. It is, in a way, a return to the defined benefit mentality, but this time allowing participants to opt out and make their own decisions should they choose to do so.

The increase in popularity of automatic enrollment and automatic contribution is an indication of a growing culture of paternalization in the defined contribution universe. Participants seem to be not only accepting the "do-it-for-me" paternalistic approach, but embracing it. Surveys repeatedly show that a majority of participants want help in retirement planning, and that a significant number are happy to turn over the responsibility to professionals.

How do we extend paternalization to investment choices? A number of options exist to relieve participants of investment decision-making and put asset allocation back into the hands of investment experts. Risk-based portfolios, target-date funds, balanced funds, and managed funds are all potential solutions that, as noted earlier, are likely to provide better, more consistent long-term returns with lower volatility, potentially improving ultimate participant outcomes in retirement.

## Investment solutions: A brief comparison

Professionally-managed, one-stop shopping investment solutions for participants have been evolving, and different forms offer different advantages and features (see Table 1 for a comparison overview). Common to most asset allocation options is that employers are able to designate them as qualified default investment alternatives (QDIAs), specifically provided for by ERISA Section 404(c) to alleviate plan fiduciaries from responsibility for participants' default investment in the options, assuming certain conditions are met. This allows asset allocation options to be used not only as options in a plan line-up, but as the default option for participants who do not make a proactive investment decision.

### Balanced Funds

Balanced funds are the simplest and most basic of asset allocation options; a balanced fund combines equity and fixed income instruments in a particular percentage mix. Most balanced funds are automatically rebalanced periodically to their target allocations. Balanced funds can satisfy QDIA requirements and provide participants

## Table 1 Comparing Asset Allocation Options

| | Simple investment portfolio decision | Professionally-managed asset allocation | Fulfills QDIA criteria | Targeted to participant risk profile | Targeted to participant time horizon | Managed glide path |
|---|---|---|---|---|---|---|
| **Balanced Funds** | ✔ | ✔ | ✔ | | | |
| **Risk-based Funds** | ✔ | ✔ | ✔ | ✔ | | |
| **Target-date Funds** | ✔ | ✔ | ✔ | | ✔ | ✔ |
| **Managed Accounts** | ✔ | ✔ | ✔ | ✔ | ✔ | ✔ |

with a diversified mix of investments; however, balanced funds are not specifically targeted to participants' risk tolerance or time horizon — they are usually delivered as "one-size-fits-all" options.

### Risk-based Funds

Risk-based portfolios are designed to meet specific risk and return objectives that generally do not change over time (e.g. conservative, moderate, and aggressive), and are invested broadly in various asset classes to provide diversification and maximize risk and return efficiency. Risk-based funds are typically rebalanced automatically to their target allocations. These portfolios allow participants to select an appropriate option based on their personal risk profile. However, because the funds maintain a static allocation, participants may need to review their risk tolerance profile periodically to ascertain whether they are invested in the most appropriate selection. When used as a default option, it is typically the "moderate" portfolio that becomes the default investment selection. Risk-based funds may be custom-built using the plan's underlying fund options to create the portfolios.

### Target-date Funds

Target-date retirement funds consist of a series of funds named for "target dates" that align with the date participants anticipate retiring. The funds' portfolios are managed to optimize risk and return over time by investing broadly in various asset classes to provide diversification, and adjusting the mix of assets as the target date approaches to become more conservative as the investor nears retirement. Target-date funds provide participants with an investment option that matches their time horizon but is not necessarily customized to their risk preferences.

"'Most participants recognize their lack of investing expertise,' says Bob Wuelfing, president of RG Wuelfing & Associates, a leading retirement industry research and consulting firm. 'When we survey participants about their needs in managing their defined contribution accounts, the most common response we get is 'Tell me what to do.' Many employees are insecure about the investing process, and prefer professional advice to going it alone,' Wuelfing says."

*~McLeod, 2008*

A number of providers offer suites of off-the-shelf target-date funds, or alternatively, plan sponsors can create custom target-date funds using the underlying investment options in the plan. In either case, it is important for plan fiduciaries to understand how the "glide path," or shift in investment allocation over time, is constructed and managed. In some target-date funds, the funds shift to mostly fixed income by the time the target date arrives, whereas others may continue to invest largely in equities under the assumption that investors will continue to be invested until long after their retirement date. Choosing the right target-date funds with appropriate glide paths will depend upon your participant population and objectives.

### Managed Accounts

Managed accounts offer participants an option whereby their personal information is used to construct an appropriate asset allocation. Factors that may contribute to the portfolio strategy development may include deferral rate, account balance, risk profile, age, expected date of retirement, and any additional retirement savings such as a spouse's account. Managed accounts will create a personalized asset allocation based on the inputs, usually using the plan's existing investment options. Rebalancing occurs automatically, and the asset mix may be adjusted as the individual factors change over time. A key fiduciary point of consideration is that participants in managed accounts may incur a significant management fee in addition to the expense ratios charged by the individual funds utilized.

## CHOOSING AN ASSET ALLOCATION OPTION

People don't like to ask for help, especially in our culture of fierce independence. The unfortunate result has been nearly a generation of workers experiencing unnecessary underperformance of their retirement savings investments and high anxiety about making retirement planning decisions. Are your retirement plan participants in need of investment assistance — and should your plan offer an asset allocation option to participants? If so, which option would best suit your employees, and provide the solution at a reasonable cost?

"PLAN SPONSORS CAN OFFER A POWERFUL COMBINATION OF EFFECTIVE ASSET ALLOCATION FOR THEIR PARTICIPANTS."

*~FIDELITY, 2013*

We recommend that you work with your advisor to examine the needs of your participant population and tailor a solution to your plan. You'll want to explore the advantages and disadvantages of different options as they relate to your organization and consider how to best fulfill your fiduciary responsibility. Begin by taking these fundamental steps:

- Review your plan to determine an appropriate level of paternalization.
- Make sure you have one or more asset allocation options in your plan.
- List asset allocation option(s) first among choices on enrollment forms.
- Select an appropriate default option for participants who do not make a proactive investment selection.
- Simplify your investment line-up to reduce the chance participants will make poor investment choices.

The information provided in this paper can provide a starting point for exploring whether paternalization is a path your plan should follow, and where it will lead.

## Endnotes:

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