INSTITUTIONALIZING DC PLANS
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LEARNING FROM EACH OTHER:
UNDERSTANDING GLOBAL RETIREMENT PLANS’ BEST PRACTICES

Retirement saving in the United States has changed dramatically since the Internal Revenue Service adopted regulations ushering in defined contribution vehicles such as 401(k) plans. But we still have a lot of work ahead. By adopting the best features from other leading nations, we can move closer to a structure where U.S. workers put aside enough to fund their golden years.

A number of shortfalls in the American retirement structure need addressing. These are especially evident when you compare the U.S. system to other countries’ retirement programs. The U.S. retirement system could vastly improve retirement outcomes for millions of contributors if we implemented a few key changes.

1.  Make retirement saving or auto enrollment compulsory for U.S. workers.
2.  Embed an annuitization process as a mandatory feature of these plans.
3.  Work toward simplification of regulations governing retirement savings plans so employers more easily understand them and are less concerned about potential litigation that may arise from forcing participants to save and invest.
4.  Implement federally sponsored educational efforts so that current and future workers understand retirement savings, investment and distribution choices.
5.  Severely limit pre-retirement withdrawals and loans to staunch the “leaks” we typically see in retirement savings accounts that can significantly erode their ending values.

STILL NOT SAVING ENOUGH

The three-legged stool that underpins the U.S. worker’s retirement savings doesn’t provide the same level of support, financially or education-wise, as the multi-legged models other countries employ. With the continued decline of defined benefit (DB) plans, Americans typically rely on employer-based defined contribution (DC) programs such as 401(k) plans, as well as Social Security and their own personal savings.

Of those people with some retirement savings, the median amount saved is $104,000 for households age 55 – 64 and $148,000 for those ages 65 – 74. That’s equivalent to an inflation-protected lifetime annuity of just $310 and $649 per month, respectively.
Astonishingly few U.S. workers nearing retirement have saved enough (or any) money for their retirement years. In fact, about half of U.S. households aged 55 and older have no retirement savings at all, according to the U.S. Government Accountability Office Retirement Security report issued in May 2015. And that figure includes any 401(k) or IRA savings. Of those people with some retirement savings, the median amount saved is $104,000 for households age 55 – 64 and $148,000 for those ages 65 – 74. That’s equivalent to an inflation-protected lifetime annuity of just $310 and $649 per month, respectively. It’s not much money to supplement Social Security – assuming the program survives the next decades – and any personal savings, which often include home equity.

That means too many U.S. workers are relying almost exclusively on the government to provide funds during retirement rather than saving on their own. Many others must continue working part-time after their “official” retirement just to get by. The reasons for this are legion, but foremost among them is the fact that the United States does not require its workers to save for retirement. In a heterogeneous, melting-pot culture where self-reliance and bold decision-making are held up as virtues, we do not hold our retirement funding structure up to that same social scrutiny. Many workers can and would save, if only we required it.

HOW OTHERS DO IT

That situation contrasts markedly in other developed countries with well-regarded retirement structures. One huge difference is that the United States does not make contributions to pension savings plans mandatory. Nor do we require workers to understand the financial investment they are making in their own futures.

In Denmark, for example, employees contribute one-third and employers contribute two-thirds to the mandatory DC program, which incentivizes annuities by removing the limit on contributions paid into it. The Danish program provides greater protection against fraud, mismanagement or provider insolvency of members’ accrued benefits, and it uses investment professionals to handle the DC funds’ asset allocation. Norway has offered a national public insurance program since 1997 and implemented an updated pension plan in 2011. It includes a mandatory occupational pension arranged by employers for employees. And in the Netherlands, there are a number of “hybrid” DB-DC plans where the employee also contributes to the DB-type employer-sponsored program.

In Hong Kong, the government set up a mandatory savings scheme in 2000 under which workers and employers each contribute 5% of their salaries. Now, some 85% of employees are covered by a pension plan, far above the roughly 30% of workers who had voluntary coverage before the government stepped in. Hong Kong also is implementing a default fund option for investments if the participant fails to choose a specific fund for his contribution. The default option has a cap on the fee charges as well as an investment strategy that is to be standardized across all MPF schemes. And although Hong Kong doesn’t encourage individual savings by offering a tax advantage, it differs culturally in that there is much more family support for retired workers than in the United States.
Beginning in the mid-1960’s, Canada has operated a federal pension plan, the Canada Pension Plan (CPP), funded by employee and employer contributions. The CPP forms one of the two major components of Canada’s public retirement income system, the other component being the Old Age Security (OAS). Canada’s retirement system is further supported by private pensions (defined benefit or defined contribution plans), either employer-sponsored or from tax-deferred individual savings (known in Canada as a Registered Retirement Savings Plan). To provide additional retirement income, Canada culturally has always encouraged individuals to take personal responsibility for saving enough to retire. That voluntary approach, however, is slowly changing as provincial governments realize that the current retirement savings program may not be sufficient to support its growing and aging population. While some provinces (Ontario and British Columbia in particular) explored the setting up of supplementary provincial pension plans, an enhanced federal program through the CPP has been proposed that will see increases to benefits and contributions to help close the gap.

Among the most forward-looking and aggressive government retirement schemes is in Australia, where the government requires employer minimum superannuation guarantee contributions of 9.5% into a superannuation fund. That money is invested in the employer’s fund or the employee’s fund of choice. One key difference between the Australian and U.S. systems is that contributions to Australian superannuation funds are taxed at entry and are tax-free when transferred out of superannuation into retirement accounts. However, the recent 2016–17 Federal Budget introduced a AUD 1.6 million cap on the amount that can be transferred tax-free at retirement.

**UNIVERSAL CONCERNS**

Other retirement funding issues cross all geographic borders. Foremost among them are concerns about increasing amounts of regulations and paperwork around pension plans and schemes. The lack of clarity about the rules governing the plans, as well as opacity around the rule-making process,hamstrings those who must abide by the rules. As some pension sponsors note, it’s hard to play by the rules if you don’t understand them!

Also universal among complaints is the recognition of a dearth of solid education aimed at making employees and students – the future workers – savvier financial consumers. Although some nations, including Australia, are addressing this with government-sponsored efforts, others have little in the way of national programs.

In the United States, we face a woeful lack of education to help workers understand and evaluate their retirement income on an annual basis. And too much of the material that does exist comes from financial companies with a vested interest (i.e., commissions) in guiding those monies into their own branded funds and investments when white-labeled funds might perform better.

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1 The Canada Pension Plan is for all provinces in Canada except Quebec, which has the Quebec Pension Plan.
We also foster the impression that 401(k) plans are the worker’s total end-all, be-all savings, so many do not squirrel away much money in addition to those DC contributions. And given the annual contribution caps in place, a 401(k) plan alone likely will not provide enough income in retirement for many employees. So there must be other money set aside for retirement.

The focus should be not only on calculating likely budgets during retirement but also on figuring how much money a worker will have each month or year during retirement. Instead of honing in on the total nest egg he or she has accumulated, we should look at annuitizing that amount to compare to the worker’s expected monthly retirement budget.

One way to better acclimate future workers into this holistic mindset would have the U.S. Department of Education implement widespread educational programs starting in elementary school. These could indoctrinate young students into the habit of thinking about saving for retirement as a natural part of the transition process when they graduate from an academic setting into the working world. And they would help erase the fear factor that can grow up around the math needed to figure out future finances.

Another key change that U.S. plans should make would be to severely curtail the ability of U.S. 401(k) plans contributors to take money out entirely or take loans before age 59-1/2. Many employees like the idea of a flexible retirement account that they can access if they deem it necessary. But this practice causes “leaky” plans, where it’s estimated that some 40% of money contributed flows out long before the employee retires.

This contrasts starkly with policies in Australia, Germany, Hong Kong, the United Kingdom and Canada, all of which limit withdrawals to hardships. But the catch is that some U.S. employers and plan sponsors fear the accusations and potential litigation from employees if you take away their ability to access their own money.

MORE WORK AHEAD

Many of the countries with the strongest retirement systems also have much less federal debt to service and much higher taxes overall that fund their healthcare and pension programs. It’s clear that the United States would be hard-pressed politically and socially to suddenly raise taxes to the levels seen in France or Denmark in efforts to strengthen our social safety nets.

But we can take other smaller steps – closing some of the loopholes that allow for early withdrawals, making some level of pension contributions mandatory and stepping up our educational efforts. All these are less angst-causing moves that are doable across a broader swath of the current work force. And all are clearly aimed at making the financial possibility of a less-stressful retirement achievable for more American workers.
As defined contribution plans increasingly replace defined benefit plans as the primary vehicle for employee retirement savings, responsibility for retirement readiness has shifted from employer to employee. Participants shoulder responsibility for investment decisions and associated market risk. The average worker, who is not an investment professional, is expected to understand not only what to do with his or her retirement assets, but also what not to do.

The industry has taken steps to ensure these plans are on course to provide meaningful income streams for employees. For example, automatic enrollment has significantly increased plan participation. Additionally, automatic escalation provides a method for passively increasing the savings to meaningful amounts as employees progress toward retirement. Ultimately though, investment discretion is left firmly in the participant’s hands. The industry is rife with stories of participants making the wrong investment decisions at the wrong times (for example, pulling out of equity after a market drop, only returning after the market has recovered). In an effort to ensure proper investment of retirement assets, is it time to take a stronger stance over how participants act?

To help participants better manage the long-term nature of retirement assets, target date funds (TDFs) were created. They offer a set mix of asset classes with a predetermined maturity date. Allocations in the fund automatically rebalance to more-conservative investments as the employee nears retirement. Participants select the fund and leave the rest to a predetermined glidepath. However, even these funds leave room for participant discretion. Participants can elect to invest in as many TDFs as their employer provides, and movement in and out of the funds is not restricted. This can create opportunities for less-than-ideal decisions, including market timing issues.

In an effort to ensure proper investment of retirement assets, is it time to take a stronger stance?

TOM LAUER
Senior Vice President and Defined Contribution Asset Servicing Consultant at Northern Trust.
Take, for example, a large corporation’s participant-directed activity during a significant market dip in 2016. For the first time since 2008, participant-directed transfers reflected a net negative position for their aggregated TDFs. Participant activity in other plans showed similar patterns. The movements out of the funds appeared to correspond to downturns in the equity markets. TDFs, with the inclusion of professional asset management, are intended to deter such participant-directed activity. Indeed, part of the design and advantage of these funds is to relieve participants of that management burden. However, with nothing restricting movements out of the TDFs, a large number of participants reacted to the market downturn and transferred their money out in favor of fixed income funds.

Though TDFs are intended to help participants manage long term investing, is this happening? In reviewing transfer activity for a $2 billion corporate DC plan, the following was observed:

- Of the plan’s 18,500 employees, only 27% had a balance in at least one TDF.
- Of the approximately 5,000 participants invested in a TDF, nearly 95% invested in only one TDF. However, of the remaining 5%, nearly half invest in three or more vintage options, including a dozen participants who invest in 12 different vintages.
- Of those 5,000 participants, 70% used at least one other fund in the menu.
- Despite 27% of the participants having some money in the TDF suite, only 5% of the plan’s assets were invested in those funds.

Some participants invest in multiple TDFs in an effort to further customize to their own target retirement date. However, in doing this, participants have unnecessarily diversified their assets. A TDF, by definition, is designed for a group of participants based on an approximate retirement date. It is already diversified, so investing in multiple TDFs is not necessary.
We believe it is time to restrict the use of TDFs in an effort to force participants to use them as intended. Here are some suggestions to consider:

**Plans should only offer vintages with 5 year increments.**

Also, participants should be restricted to invest in only one TDF. This is not suggesting they can only invest in a single plan option, but rather they can only use one TDF. For example, 50% to a 2025 Fund and 50% to the other non-TDF options is allowable, while 30% to the 2025 Fund, 20% to the 2030 Fund, and 50% to the non-TDF options is not.

**Use non-TDF options to “customize” allocations.**

If plan participants want to "customize" their allocations, they could achieve that goal by using non-TDF options. This would give participants an easier-to-calculate method than trying to meld different glidepaths.

**Transfers in and out of the TDFs should be partially restricted.**

By electing to invest in a TDF, a participant signs on to professional money management that has a defined investment strategy over a determined length of time. For example, a certain TDF may have a greater allocation to non-U.S. assets in an effort to increase diversification. Such a strategy may underperform in a strong U.S. equity market such as 2011 – 2014, but the horizon should be longer. Participants therefore should not move in and out in an effort to better the short term result.

**All participants who do not make an election should be automatically enrolled in TDFs.**

In addition, any participant who did not make an election in the past should retroactively be enrolled in a TDF. Participants can opt out if they desire, but the goal is to capture those who have never elected or are uncomfortable doing so. Though it may be operationally challenging to transfer funds out of stable value funds or culturally challenging to transfer out of company stock options, this is in the best interest of the participants. Both stable value funds and company stock are the options that tend to be the most misused investments and those most frequently in need of realignment.

**Re-enrollment should become a periodic event that occurs every 5 years.**

This re-enrollment process would serve as verification that participants are aware and approve of their investment choices.

Defined contribution investment shouldn’t be viewed as a way to get rich, but rather as a way to provide enough income to maintain a lifestyle.
These changes would move TDFs in the direction to more closely mirror defined benefit plan management: having a long term eye to the future with a goal of providing a meaningful income stream at retirement. That doesn't necessarily translate into accumulating as much money as possible, but rather accumulating enough money. Defined contribution investment shouldn't be viewed as a way to get rich, but rather as a way to provide enough income to maintain a lifestyle. The dollars in these plans should be viewed as money participants must have at retirement, and should not be risked in efforts to accumulate more. This is where professional oversight is needed as participants may not understand that having either too much or too little risk can be harmful. Well-run target date funds combined with proper participant usage would best serve DC plan participants in the quest for a meaningful retirement income stream.
Hubert Danso: How can alternative investments fit into defined contribution plans?

Larry Powell: At Utah, we spent a fair amount of time looking into integrating alternatives into our DC options. We actually had a small allocation to liquid alternatives in one of more of our balanced options within our Defined Contribution (DC) plan.

I spent several weeks in Australia, and, as many of you know, their entire superannuation scheme platform/programs are structured as DC plans and most have illiquid alternatives in them.

There was one group I met while in Australia with quite a bit of infrastructure in their DC plan. I really liked the structure of this particular plan and the limited number of options available to their participants. Their structure was really simple, they gave their participants three options as follows: cash, multi-asset diversified or go somewhere else.

The problem many of the supers had in Australia during the great financial crisis is many of their participants pulled out of risky assets and into cash, leaving the long-term investors with all the illiquid assets.

In the end, everything worked out fine after the markets stabilized.

After I returned from Australia, we discussed in great lengths the differences between how the pensions are run in the U.S. vs Australia.

When it comes to resources expended to run the superannuation schemes, the Aussies allocate significantly less human capital to run most of these plans than they do here in the U.S., and the amount pales in comparison to that of their Canadian counterparts.

At the same time, in terms of structure, the Aussie plans that are almost 100% DC are way ahead of the curve compared to U.S. pension funds. U.S. pensions are moving in the same direction, but we are a long way from 100% DC. In summary, in some ways the Aussies are way ahead of us and in others way behind.

Ron Virtue: Alternatives are best used as part of a bundled solution where they are in a balanced or life cycle type of fund or could be incorporated into a custom target date solution.

Northern Trust collaborated with Clear Path Analysis to sponsor a series of articles about the institutionalization of defined contribution plans.

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These investments can be difficult to understand for participants, and education is still needed even if they are part of another investment. But it does create difficulty if people are choosing to move in and out of these investments on a daily basis because the real purpose of them is not as a stand-alone option but is in the correlation benefits that we see blending all of these different asset classes together.

We see the same benefits from many traditional strategies as well. So, this could go for some alternatives as well as traditional strategies that are best used, like emerging market equities, in a bundled solution.

Even on the traditional side, we believe that some asset classes and choices are best bundled with others in a life cycle type of fund.

**Jas Chumber**: We have over 80 funded pension plans in 45 countries so we see this challenge in many markets.

Our largest DC plan is in the U.S and is fairly sophisticated, but we don't use many illiquid assets and are mainly liquid.

I am more focused on some of the European and Asian plans that we have. We prefer members to have limited but good quality choices with the default investment option, either through a target date or life cycle fund. In some markets we bundle or construct the funds ourselves.

We can take a number of the pieces and blend them together in a multi-asset fund. Some of our multi-asset funds do have illiquid assets like emerging market debt, high yield and emerging market equity.

We haven't gone as far as to use private equity and this is where the big challenges would come. I do see challenges on use of some illiquid assets with fee caps on DC becoming prevalent in some of the European markets, particularly when these asset classes tend to be relatively expensive. In the UK there is a charge cap on DC retirement assets including member administrations of 0.75%. The risk is these charge caps will be lowered, preventing investment in illiquid assets.

A lot of the DC plans in Europe tend to be smaller than in the U.S. as the U.S. mainly started this DC journey in 1974 following ERISA. Small DC plans are unable to benefit from economies of scale as much, and so it is a challenge when it comes to cost and the ability to access illiquid asset classes in a cost-efficient way.

**Hubert**: How are these investments structured differently for the DC market, as opposed to the way that they are structured for DB plans?

**Ron**: It can make sense to have a slightly different structure of the same investment type whether it is in DB or DC.

In a DC plan structure, we could see a benefit from having a liquid portion in combination with an illiquid portfolio. For example, real estate could have a small component of public real estate combined with a larger component of private real estate, and the public component would provide that daily access to liquidity.

Or you could use a public vehicle that accesses the same alternative risk premia. One example could be to compare a global asset allocation fund to a global
CAN ADDING ALTERNATIVE ASSETS IMPROVE THE PERFORMANCE OF DC PLANS?

macro hedge fund. And those might at times give you similar results in terms of risk and return, but they are accessing different vehicles for their traits.

Another issue would be to look for non-performance fee vehicles in the DC market, as the performance fee vehicle could be easier to implement in the DB plan.

**Jas:** They have to be structured in a multi-asset fund as I don’t feel that giving direct access to these illiquid assets to members would make sense.

We haven’t looked at this in detail but this is something that we are thinking about and are carrying out research.

**Hubert:** What is inspiring you to do the research in this area?

**Jas:** It is about the potential illiquidity premium that could be captured. Some of the DC plan assets could be more sticky than DB because, as in my experience, I see in Europe little trading between accounts by the majority of members and expect assets not to be consolidated for a very long time and in many cases left until retirement.

The reason we are analyzing illiquid assets is that some research suggests DB investment returns tend to be on average 1% per annum higher than DC, partly due to the illiquidity premium.

It is about trying to capture that liquidity premium that looks interesting.

**Larry:** There is no doubt that you couldn’t have private equity or infrastructure as a distinct option in a DC plan. The only viable way DC participants can participate in alternatives is through some kind of life cycle, target date or balanced portfolio.

The scheme in Australia I mentioned before offers what is essentially a balanced or DB option. They are trying to replicate what we are doing on the DB side, which is managing one giant pool of capital allocated across multiple asset classes including but not limited to global equities, fixed income, hedge funds, private equity, and real estate assets and offer that as an option.

**Hubert:** What do you feel the benefits are?

**Larry:** I don’t believe one could have a DC option with alternatives with daily liquidity, it would have to be quarterly or annually.

A lot of people suggest using 40 Act funds for hedge fund exposure in a DC construct as a viable option. However, I totally disagree as these funds are very different than what you get when investing in a limited partnership.

Hedge fund managers generate huge revenues from managing their private partnerships wherein they levy management as well as incentive fees. It would be financial suicide for them to offer the same strategy in their 40 Act funds where they can’t levy incentive fees. If they were actually running the same strategy in both structures, all their investors would pull their money from the higher fee option (unregistered) and reinvest in the lower fee option (40 Act).
CAN ADDING ALTERNATIVE ASSETS IMPROVE THE PERFORMANCE OF DC PLANS?

Hubert: Is having a NAV at the end of each trading day critical for DC investor participation, or could they feel comfortable with a totally illiquid investment locking up their capital for long periods of time?

Jas: Unfortunately, a lot of the platform providers in Europe would only put funds on their platforms if it has a daily NAV. Sometimes we have to play the game which is being dictated, which may or may not be the right thing for members.

There are other funds where we strike the NAV twice a month so there are possibilities there. However, given that platforms, particularly from a UK perspective, typically want daily dealing funds, this is the market norm.

A lot of investors are used to daily NAVs and trading on a daily basis and this may now be imbedded as market practice and expected. To take that away may result in some pushback from members.

I don't personally feel it is critical to have a daily NAV, but given the way platforms are set up in the UK and Europe, this leads in practice to a daily NAV type of arrangement.

Larry: There is no simple answer to this question. It is really dependent on where you are in the world, and the regulatory requirements of a particular country, etc. Some jurisdictions and structures demand daily liquidity.

The solution is you have an option that is dedicated to be a DB-like alternative and the investor elects to be part of this. In return, they may not have daily liquidity. Even if they did have a daily NAV, it wouldn't mean they could mark to market illiquid assets on a daily basis as it doesn't work and it's meaningless.

At Utah, we had nearly 50% of our assets in alternatives and we had issues on a quarterly and monthly basis trying to come up with a really accurate NAV of our total portfolio because of the illiquid pieces, particularly real estate, which was significantly difficult to value.

At Utah, which I am sure is no different than other state plans, as a general rule, 20% of the participants were creating 80% of the activity in our DC plan. Some of the bigger members with larger interests in the DC plan were making lots of trades.

Hubert: Can you think of a time when it would make sense? Which countries would be more favorable to it?

Larry: The only country I know of that is 100% DC is Australia.

At Utah, we spent 99% of our time on the DB as it is where the bulk of our assets were.

Hubert: Ron what are your thoughts?

Larry: I do understand that in the DC environment, particularly for record keeping purposes, that an NAV needs to be struck on a daily basis, but part of that is just process and it does not mean that the entire NAV or allocation needs to have a different NAV on a daily basis.
You can have up to a certain percentage in a balanced fund with an NAV that changes on a less regular basis like bi-weekly, monthly or quarterly. As long as it is not a huge percentage, it is still fine if you have it written in your documents the right way. This percent will be valued on a less frequent basis, and we will just use the most recent value.

The time frame is long for most DB and DC investors, so there shouldn’t be a big difference. If you think of the liability analysis that is performed by actuaries on DC investors, is it really different just because of a DC structure? The liability is effectively the same.

We have a short-term mindset when we are participating in a DC plan just because we feel like we are controlling the assets and should be actively involved, making trades and moves. But if we are in a lifecycle or bundled fund, then we are in the same place as if we are invested in a pool together on another type of DB plan. Except it is not the plan sponsor’s obligation to provide a certain balance at the end.

**Hubert:** Are alternative funds the answer to getting DC plans to perform more so like DB plans?

**Larry:** Yes; DB plans are so much different in the way they are structured in general compared to DC plans and the big difference is the DB plan’s asset allocation to alternatives.

**Ron:** I don’t know if there is a single answer, but if you want to improve investment outcomes, you would rather have more access to different types of investments.

If a DB plan administrator is able to invest in a wider group of investment types including alternatives and illiquid and has chosen to do this, there must be a good reason.

On the flip side, this means that we are restricting the universe too much if we are taking investments out of our choices in DC plans.

If we look at the muted returns that most experts are expecting for the next several years in traditional asset classes, where are people going to see those returns from? It doesn’t look very good if DB plans have a much better return than DC plans as it looks like the DC plan participants wouldn’t be in a very good situation. So they could benefit from having access to the alternatives as part of their investment even if they aren’t the core choices.

**Jas:** From a governance perspective, there is probably a higher level of due diligence that needs to take place on alternative assets.

On DB funds the risk is taken by the employer but on DC it is by the member so there is a higher level of due diligence required and many governance groups may shy away from illiquid assets because of the higher governance required. In practice, DC having more assets, particularly in areas like hedge funds, could be a practical challenge.

Unfortunately, a lot of the platform providers in Europe would only put funds on their platforms if it has a daily NAV.
CAN ADDING ALTERNATIVE ASSETS IMPROVE THE PERFORMANCE OF DC PLANS?

DC governance is still in development in Europe, where funds are generally much smaller and governance around some DC funds is not as well established as that of the large U.S. and Australian DC plans.

In markets, particularly in Europe where there are charge caps, investing in alternatives is a real challenge and in some cases may be a show stopper if there is a certain charge cap that you need to be below. Typically, a lot of the DC plans would like to be below the minimum by a reasonable margin, particularly if they hold out their DC solution to be low cost relative to the market to attract members.

Hubert: Do you have any final thoughts on this topic?

Larry: I believe, given the proper mindset, there would be a huge market for a DC option with alternatives.

At the end of the day, it would probably be the more sophisticated investors buying into it. As Ron mentioned, a lot of education needs to be conducted by the DC sponsor to get investors comfortable with the risks and the returns of alternatives.

The risks aren’t just the market going down and things going sour. As we have seen from several institutions here in the U.S. who have DB-like options in their DC plans, the risk of having too heavy of an allocation to alternatives in a rising equity market, from an opportunity cost perspective, is huge.

There are quite a few factors to consider, but it is a viable option and in the U.S. we are moving towards a DC environment. The tide is definitely moving in this direction and we need to be prepared for the inevitable.

Ron: As a plan sponsor who has included alternatives in their DC plan, we believe that it is in the spirit of the Employee Retirement Income Security Act (ERISA) as a prudent fiduciary to look at different levers that we can use to improve outcomes for our participants and alternatives are part of the whole solution.

Jas: It is all about the member outcomes and alternatives may have a role to play but there are challenges predominantly to do with governance and costs. If these can be overcome then alternatives can have a future.

Hubert: Thank you all for sharing your views on this topic.
WHY ARE DEFINED BENEFIT FUNDS OUTPERFORMING DEFINED CONTRIBUTION FUNDS OVER TIME?

David Grana: Over the last 15 years, Defined Benefit (DB) plans have outperformed Defined Contribution (DC) plans at least 75% of the time and by at least 39 basis points and on average, by 70 basis points. Why is that?

Tony Tomich: A DB plan has many structural features that aren’t available in DC plans. One is that you have access to lower cost vehicles in a pension plan, such as separate accounts. These are fundamentally cheaper than mutual funds, which are the prevalent vehicle in a DC plan.

Mutual funds are much more expensive; you have to close them daily and work on marketing and regulatory work that you don’t have with a separate account.

When you see the migration of many bigger plans in the DC space to open architecture, one of the motivations is to move away from mutual funds because they are relatively expensive and if you are a big plan, you don’t have to use them.

Another issue is scale within the different pension plans and asset classes. With scale, you usually have lower fees.

In a pension, you have professional/institutional management, and the importance of that can’t be overstated. When you have professional management of assets, you have a very thoughtful and diligent risk budgeting, strategic asset allocation that is identified and defined.

You also have disciplined re-balancing to stay in line with that strategic asset allocation and so this ultimately leads to better outcomes.

On the other side of this, when you are dealing with retail investors, they can display behavior that is very different. Sometimes they can chase returns at the top or can be fearful at the bottom of markets and so retail investing behaviors are very different to institutional behaviors.
WHY ARE DEFINED BENEFIT (“DB”) FUNDS OUTPERFORMING DEFINED CONTRIBUTION (“DC”) OVER TIME?

David: Would you say education has a lot to do with this?

Tony: I don’t know if I would pin education as you can have very well educated, smart people who behave in sub-optimal ways in times of market volatility.

It is more about whether one is more seasoned and experienced rather than educated. If you have a seasoned, institutional investor, this person might behave differently than someone who might be very intelligent but who doesn’t have the experience or expertise.

One of the main benefits of institutional investors is their patience; they understand that market volatility is a part of how the markets and the global economies work.

They know that in the long term, sticking to their strategic asset allocation is what creates optimal risk-adjusted returns.

In DB plans, investors have access to asset classes that they don’t in a DC plan. You can look to collect different risk premia or illiquidity premia that just isn’t appropriate for some stand-alone DC fund options.

David: An employee working 60 hours a week may find it difficult to keep a close watch on their DC plan and re-balance according to their proposed strategy. Is there anything automatic in the market that investors can rely on to solve this issue?

Tony: Target date funds do this, and that is why you have seen such a growth in this product. It does rebalance for you on a periodic basis; it sets a glide path and changes risk and asset allocation as time goes by.

It is also professionally re-balanced and that is why you have seen them grow so quickly, because they do it for a retail investor.

There are other services out there, like managed accounts, which will help someone create a strategic asset allocation (SAA) and maintain it to rebalance, but these cost money and may be confusing for some investors.

When we converted to open architecture, we had a number of focus groups and asked people simple questions: did they know we had a 401(k), did they know what a stock or bond was, etc. The overall theme that came out from this was that people were confused and needed help.

This is why we have a belief that structures are very important and you have to put them in place to help use momentum in a good way instead of letting it work in a bad way.
WHY ARE DEFINED BENEFIT ("DB") FUNDS OUTPERFORMING DEFINED CONTRIBUTION ("DC") OVER TIME?

The momentum of a DC plan is a very strong factor, as once people enroll they tend to not touch it. This is why having them consider a target date fund, or something that has a structure that allows for diversification, is really important.

This is one of the reasons we simplified our plan. We got rid of the myriad mutual funds that were very confusing.

David: How did you determine that these options were the right ones?

Tony: Before we converted, we had three tiers. And if you look at most DC plans out there, they tend to have three tiers. Tier one is a suite of target date funds where you can pick whatever date you anticipate you are going to retire. Tier two is all of the mutual funds or asset blocks; some have 20, others have 100, and it just depends on the plan. Tier three is the brokerage window.

We conducted focus groups and looked at guiding principles about how we thought about the conversion.

One element was that we wanted to ensure that cost-efficiency was the most important factor that guided what we did. We know that 20 basis points expense over a lifetime savings is six to seven years of income and is really important.

Another factor that was important was the ease of use, as we wanted people to be able to understand it and not be intimidated by it.

We focused on giving people two decisions to make and this was how we simplified things: one was active versus passive and the second was stocks versus bonds.

Back in the 80’s, the style box came into the scene where you had large cap growth and small cap value, etc., which was a great way to create a lot of different products to get into the markets by the asset management companies. You see, most DC plans have 20 to 300 of these different mutual funds that fit into that style box and all around it, but people often don’t know how to optimize this. As a result, you see a lot of sub optimal behavior when you look at what your participants are doing.

They have what is called one over N. This is where they have 25 options and don’t know which one to choose, so they put a 25th into each option and, as most of the funds are equity, become overweighted to equity risk. Or they end up picking one or two, causing them to become over-concentrated, which can be inappropriate based on their age.

We know that 20 basis points expense over a lifetime savings is six to seven years of income and is really important.
We wanted to give our people just two decisions: passive or active and stocks or bonds. Our plan now has four tiers. Tier one has our target date funds in it. Tier two is passive, and you can choose a stock fund and a bond fund. Tier three is active and here they have three choices: stock, bond or stable value. And the 4th tier is the brokerage window.

We simplified to an extreme degree and with these choices they become like pensions and are white labelled parent-child fund structures. We manage the parent-child structure ourselves like pensions. With the active stock fund, if you look underneath, the parent is Farmers Active Stock Fund and then underneath you have all of these children-like options: small cap, international, EM and U.S. large cap, etc.

We manage the SAA ourselves. We rebalance on a regular basis based on business rules we established. We also use separate account and co-mingled trust accounts that are more cost-efficient than mutual funds. And because of our size, we were able to do this.

David: Have you done an analysis on what the cost structure was prior to the open architecture system versus what it is like now and how much it has been reduced?

Tony: Absolutely. It is much more cost-efficient and our participants have many more diversified choices to pick from. Whereas before, they could have picked just one mutual fund and ridden the rollercoaster, now they can pick the active stock fund and are globally and sector diversified.

They are more cost-efficient and have structures that give them the best chance for a positive retirement outcome.

David: Do you see one of the options being more popular versus the other in the selection from the employees?

Tony: This comes back to momentum and how your mapping or transition strategies work. Once people make a choice, they tend to stick with it.

David: Have you done a comparison of DB versus DC to see how they perform?

Tony: You can’t compare the two, as they have very different goals. We do have a quarterly investment committee meeting where the performance of both plans are presented to our governance, investment and pension committees. In the pension, we have a structure that has an Asset Liability Matching (ALM) concept. In the pension, you have a liability that exists that is long duration that you have to try and match and also there is a growth component where you want to grow the asset as well.
WHY ARE DEFINED BENEFIT (“DB”) FUNDS OUTPERFORMING DEFINED CONTRIBUTION (“DC”) OVER TIME?

You are addressing different risks in the pension than you are in the DC plan. You can compare single mandates (i.e., how does the equity sleeve in the pension look versus the stock fund), but even that is not really a fair comparison as the stock fund in the 401(k) is globally diversified as well as diversified from a sector standpoint.

David: You mentioned that one of the advantages of a DB plan is the ability to invest in illiquid vehicles or alternative investments. Do you foresee that DC plans will start to introduce more illiquid types of investments? Do you feel that they should?

Tony: I attend many conferences and adding alternatives to the DC world is a theme that is frequently talked about.

The challenge is that alternatives are not liquid and they don’t get valued on a daily basis like a public security does in the fixed income or equity markets. At nearly every DC conference, typically one of the asset managers will be real estate orientated and will talk about how they are trying to get real estate into DC options.

This is all about liquidity because you have to have daily liquidity in any kind of DC plan because you have activity all of the time. Every two weeks you have payroll contributions coming in, you have loans that people take and there are many moving parts.

If you don’t have assets that have daily liquidity or a liquidity sleeve, they just don’t work. You also have to be able to strike a daily Net Asset Value, or “NAV,” for DC plans so that when people go to the websites of their plan record keepers, they can see the value of their DC plan on a daily basis.

Also, if they want to get in and out of it you have to strike a price to trade them in or out of the funds.

Alternatives like real estate, hedge funds or similar just don’t lend themselves to the requirement of daily liquidity. This doesn’t mean that these people haven’t tried to get into the DC space as this is where all the growth is going to be over the next 10 years. The alternative managers are working very hard to get into the DC space.

The issue is that there are just many structural challenges here.

If you don’t have assets that have daily liquidity or a liquidity sleeve, they just don’t work.
David: Are there issues with employees cashing out of their DC plan if they are invested in an alternative fund?

Tony: This speaks again about daily liquidity. Hopefully, within a plan the fund is big enough that you can deal with that daily transactional volume that you have. If I leave my job and want to convert my 401(k) over to a new plan or a rollover, the liquidity of the fund has to be able to deal with that daily transaction and it could be me or 100 of my coworkers who leave on a particular day, depending on the size of the plan and company.

For real estate, whether you have a structure of 75% direct real estate and a 25% liquidity sleeve, a money market or something else, I am sure people will figure this out.

It is just hard because real estate is only appraised once a quarter or every six months, and the inherent lack of daily NAV and liquidity is challenging.

David: Is it safe to say that DB plans were better able to respond to the financial crisis of 2008 because they were able to shift their allocation much quicker than DC plans?

Tony: I would challenge the assertion you just made as it goes back to that retail behavior.

When the crisis hit, many people turned unrealized losses into realized losses by moving their holdings, while many institutional investors just stayed patient.

The truth is, you might have been better off to have just done nothing and turned off the TV. The markets are back even farther than they were during the crisis.

A big part of dealing with volatile markets is that, often, it is better to do nothing, to be patient and not hit the panic button. If you look at any chart from the early 2000’s, you did see a big dip but then it came right back and you are now further ahead than you were before the crisis.

In times of market volatility, this retail behavior and reaction to the news and to other people’s concerns may lead to poor performance. Retirement savings and investing is about the long term and that has to be your mindset.

David: So was it this retail behavior that saved investors from losing a bit of their capital?

Tony: The retail behavior actually hurt those people as had they just done nothing they would have gone down but come back up.

The other consideration is that if you are in your 20’s and 30’s you can go up and down and it doesn’t hurt you long term. However when you have people who are close to retirement, a big dip like this can really hurt because the timing of volatility is really important in retirement.
WHY ARE DEFINED BENEFIT (“DB”) FUNDS OUTPERFORMING DEFINED CONTRIBUTION (“DC”) OVER TIME?

This speaks to how you have to de-risk as you get closer to retirement. For example, if you are close to retirement but you have a huge allocation to equity, that is probably not the appropriate risk allocation given the potential for short-term volatility when you need to start converting your savings to retirement income.

That is why target date funds and other professionally managed funds de-risk and take equity risk off the table and put you into other areas like fixed income vehicles as you get closer to retirement.

David: So, patience, simple choices, and rebalancing according to your level of risk are all factors that will allow you to be able to have a decent pot for your retirement?

Tony: These are our guiding principles: efficiency, ease of use and structures that give folks the best chance of good retirement outcomes.

David: With all this being said, do we now have a formula that can get us pretty close to DB type returns or do we still have a way to go?

Tony: I am not sure that DC will ever get you the type of returns of a DB plan because they are managing to different objectives and are able to take different types of risks.

Not that Farmers Insurance does this, but as a DB manager I could take much more risk and get into different vehicles in order to get paid more. That plan could theoretically do things that might mean taking on more risk or be really different than what a DC manager could and should do because that DB plan might have access to different asset classes and patient capital.

As a pension manager, if I do something that backfires, the company has to then make more contributions to the pensions, whereas if I am a manager of a 401(k) plan, I am touching other people’s money so the fiduciary duty here is a bit different.

You have to behave a little differently in a DC plan as you are a fiduciary for other people’s funds.

David: Thank you very much for sharing your views on this topic.