

# POINT OF VIEW

GLOBAL INVESTMENT SOLUTIONS FROM NORTHERN TRUST

Fall/Winter 2009

## CHANGES PENDING FOR MMFs

More transparency,  
risk management are  
primary goals



### DERIVATIVES-BASED INVESTMENT SOLUTIONS

Strategies offer potential to add return,  
manage risk

### THE NEXT PRIORITY FOR DC PLANS

U.S. researcher calls for retirement  
income focus



Northern Trust

# THE NEXT PRIORITY FOR DC PLANS

*U.S. researcher advocates shifting plan sponsor focus to asset distribution rather than wealth accumulation.*

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**W**ealth accumulation has been the focus of defined contribution (DC) plan sponsors and participants worldwide. But as more people reach retirement age, it's time to put more emphasis on asset distribution and retirement income. That's the view of one of the top researchers on retirement income in the United States, Jeffrey R. Brown, finance professor and director of the Center for Business and Public Policy in the College of Business at the University of Illinois at Urbana-Champaign.

Dr. Brown recently published a white paper on retirement income solutions in which he says annuities that provide guaranteed income for life ought to play a central role in the portfolio of most retirees. Susan C. Czochara, senior product manager in the DC Solutions Group at Northern Trust, spoke with Dr. Brown about his research, the current state of DC plans in the United States and how to make secure lifetime retirement income a priority.

**Susan Czochara:** *There has been a great deal of focus on asset accumulation within defined contribution plans, but there has not been a focus on the distribution of those assets. Why have policy makers and plan sponsors been slower to address this issue?*

**Jeffrey Brown:** Let's put this in historical context. The growth of 401(k) plans during the last two decades has, to a large

extent, been an accidental development. The 401(k) was never really designed to serve as a retirement security vehicle. Rather, the 401(k) is focused almost exclusively on wealth accumulation. So all the infrastructure that has grown up around the 401(k) system focuses on investment issues such as portfolio allocation. Even the way we communicate with employees about their 401(k) — by reporting account balances — focuses on the 401(k) as an investment vehicle.

It's only in the last few years — because of the baby boomers moving into retirement and the turbulent economic times — that the weaknesses of the 401(k) system as a source of retirement income have been exposed. And now participants, plan sponsors, policymakers and financial services providers have started focusing on the fact that accumulating wealth is only the first half of successful retirement planning. The second half requires that individuals have successful strategies for converting wealth into retirement income.

Plan sponsors have been caught between a rock and a hard place. We have a regulatory system that has historically discouraged plan sponsors from offering retirement income options within 401(k) plans. In the United States, for example, required minimum distribution rules set a minimum rate at which people must dispose of their assets. But we have no rules preventing them from squandering assets too quickly.

Up until fairly recently, U.S. regulations included the "safest annuity available" provision. That scared a lot of plan sponsors away from including income options in their plans. Essentially, plan sponsors who were successful at getting



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participants to take a lump sum at retirement were considered to have met their responsibilities and faced no more fiduciary risk. But if a plan sponsor wanted to provide participants with options for converting their account into guaranteed lifetime

**Susan Czochara:** *We have seen a lot of product development from investment and insurance providers. Some are trying to include an option within a plan and some are going with a roll-over solution. What are the advantages or disadvantages of each?*

**Jeffrey Brown:** The plan sponsor plays a more important role with in-plan annuities, and if there is one thing we've learned from all the behavioral research done during the past decade in the pension world, it is that the plan sponsor and plan design really matters. Employees take cues from how a plan sponsor designs and structures the options in the plan. For example, everybody knows automatic enrollment has had an enormous effect on participation. But we also have learned the menu of investment options can influence

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income, the plan sponsor was now subject to potential fiduciary risk through their choice of annuity provider. I think we have this backwards.

Fortunately, those rules have been relaxed. But the perception of fiduciary risk still serves as a disincentive for plan sponsors to provide an income option. Policy change will be required to change that environment.

**Susan Czochara:** *Although the policy isn't there yet to support a shift to provide retirement income, have you seen interest from plan sponsors?*

**Jeffrey Brown:** Plan sponsors are increasingly interested in providing guaranteed income options. But most plan sponsors do not want to be the first mover. They want proven, safe approaches that will work for their employees without exposing themselves to unnecessary risks. To move ahead, we'll need some action from Washington, D.C., just as we needed some encouragement to move to automatic enrollment in the accumulation phase of plans.

investment behavior in ways we might not expect. It may be that consumers view employers as implicitly endorsing certain options, or maybe it's just inertia on the part of individuals. But whatever the reason, we know that plan sponsor choices matter.

I would like to see income options integrated in the plans from the beginning, during the wealth accumulation phase. Having said that, I am open to alternative approaches, and we have witnessed terrific innovation in this area. If plan sponsors view out-of-plan options as either more cost effective, or as a way to limit their fiduciary or regulatory risk, then that's fine. But regardless of the approach, I'd like to see these options clearly communicated from the beginning and I'd like to see employers educate their employees about the importance of lifetime income.

**Susan Czochara:** *You mentioned how auto-enrollment has helped reduce participant inertia. Do you think having a retirement income solution as part of either a target date*



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finance professor and  
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*fund or within a plan would boost appeal for participants and help combat inertia?*

**Jeffrey Brown:** I think so. We know default, or automatic, mechanisms work. They work in every other part of the retirement savings process, whether it’s to boost participation, to increase contribution rates or to influence portfolio decisions. There’s no reason to think when it comes to the payout decision that consumers will not be subject to the same forces.

It’s time we start thinking about how to design and put together an auto-annuitization mechanism as the default option for withdrawals. It’s admittedly a bit trickier to implement than auto-enrollment because of concerns about defaulting someone into a product that is difficult to get out of. However, my work in this area, as well as that of others, suggests that there are ways to design auto-annuitization policies that achieve the desired retirement security goals while preserving flexibility and choice for participants.

**Susan Czochara:** *How do you think policymakers might be able to help plan sponsors support these income solutions for their participants?*

**Jeffrey Brown:** The Qualified Default Investment Alternative and auto-enrollment models provide some direction. Those took place over a decade when regulation helped ease the path by clarifying that employers weren’t going to get into trouble if they experimented. So companies did. Then we were able to collect data, and show a positive effect. Then plan sponsors, financial services providers and policy-makers got interested in expanding the idea more broadly. They ultimately passed the U.S. Pension Protection Act that paved the way to take the successful models mainstream. We need something similar here. But we’ll have to provide incentives and/or eliminate the disincentives that stand in the way of plan sponsors being willing to move forward.

**Susan Czochara:** *Washington is focused on healthcare reform right now, but will we see new regulations coming from the Department of Labor and U.S. Congress? And when do you think it might happen?*

**Jeffrey Brown:** There's a lot of interest in this topic. Policymakers understand we don't have an optimal retirement system. They understand that the lack of income options is one of the most critical issues. Having said that, Congress is in the middle of healthcare reform, and they have climate change on their agenda. There are plenty of major foreign policy challenges on our plate, and we aren't out of the woods on the

macroeconomic issues either. So, I cannot say where exactly retirement income lies on the list of priorities, but I do know that there are a lot of key staffers in the administration and in Congress working on these issues.

**Susan Czochara:** *How can plan sponsors begin to address some of the gaps in retirement income within their plans?*

**Jeffrey Brown:** First, most plans don't offer any guaranteed income options. You can't have a conversation with participants if you're not even offering an option, whether it's in-plan or out-of-plan. I would love to see plan sponsors take the important step of at least making some

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type of option available. Second, I'd like to see employee communication about retirement focus on income security and not just on saving enough money for some magical retirement date. If you reach age 62 or age 65 with a lump sum of wealth, you've only solved half of the problem. You have to turn that wealth into a sustainable income stream. Those conversations are just not happening.

**Susan Czochara:** *So if plan sponsors start having conversations with their participants, what should sponsors be saying?*

**Jeffrey Brown:** Research shows that if you talk to people in an investment framework where the conversation focuses on account balances, rates of return and the like, then annuities and other retirement income products do not look attractive. If, instead, you provide the same information but frame the conversation as being about having sufficient income that is guaranteed to last for life, then annuities look like extremely attractive forms of insurance. Even during the accumulation phase, sponsors should be focusing on how much monthly income a person will have in retirement, rather than on an account balance. A lot of plan participants think they are doing really well when they have accumulated \$100,000, but then are shocked when they discover that this might provide only \$500 in monthly income if they buy an annuity, or even less if they don't. We have to help people understand that retirement saving is about providing a secure source of income for the rest of their lives, not simply retiring with a large account balance.

**Susan Czochara:** *Changing the framework of how participants think makes a lot of sense. It's our hope that everyone will begin to recognize the difference between wealth accumulation and retirement income. As we look to the next generation of our target date solution, we plan to explore the inclusion of a retirement income component. We agree that there are significant benefits of bundling the income component within the target date strategy for both the plan sponsor and their participants. ❖*



## Sponsors Consider Annuity Options

Several recent research efforts point to an expected increase in the use of annuities in defined contribution plans.

- The "2009 American Dream Study" by New York-based MetLife Inc. found 80% of the 2,243 U.S. residents surveyed are more concerned with stability and guarantees in retirement than investment returns.
- Watson Wyatt's "Managing Defined Contribution Plans in the Current Environment" found 22% of the 149 companies surveyed offer an annuity option within their defined contribution plan and 10% are considering adding it.
- Hewitt Associates' "Hot Topics In Retirement 2009" study found that 22% of the 146 employers surveyed are likely to add an annuity to their retirement plan offerings this year and 8% already do.
- According to the "2008 Fact Book" for the Washington-based American Council of Life Insurers, sales of employer-sponsored group annuities totaled \$122 billion in 2007, up 5% from the previous year.

Plan sponsors often debate the merits of offering target date funds with underlying asset classes that expand beyond their own plan's core investment options. Target date funds allow participants to thoughtfully take advantage of globally diversified and inflation-hedging asset classes that were traditionally only available to institutional pension plans. In the next issue of *Point of View*, Jim Danaher, and Janet Yang of Northern Trust's DC Solutions Group examine the contribution of adding a more robust range of asset classes to the typical target date fund's traditional stock and bond allocation.