

TRENDS IN THE DC PLAN UNIVERSE

The U.S. Pension Protection Act of 2006 sparks a surge in auto enrollment and target date funds.

More than a year after its enactment in the United States, the Pension Protection Act of 2006 (PPA) has changed the way plan sponsors think about their defined contribution (DC) plans. From auto enrollment to qualified default investment alternatives, PPA empowers sponsors to help participants achieve their retirement goals. Has the legislation had the effect that the industry expected? More important, are participants any closer to achieving retirement security? Northern Trust's Susan Czochara, senior product manager, and Janet Yang, product manager, discuss these developments in the following interview.

The passage of PPA created many incentives for plan sponsors to rethink the way plans were administered and to re-evaluate the investment choices offered to participants. What changes have you seen plan sponsors adopt during the past year?

Czochara: There has been a surge in plans implementing auto enrollment programs. The number of plans with auto enrollment increased from 15% in 2005 to 50% of current plans. And, another 25% of plans are considering adding the feature within the next two years, according to research by Spectrem Group. Clearly the safe harbor incentives provided by PPA have led to this increase, despite the fact that plans continue to struggle with the additional costs associated with auto enrollment. In fact, these costs have had a bigger impact on the adoption



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—Susan Czochara, senior product manager at Northern Trust

of escalated contribution programs because of the significant expenses of matching the higher participant contributions. Nevertheless, many plan sponsors are seeing the benefits of these programs and are in the process of implementing them.

Yang: Of the qualified default investment alternatives set forth by PPA — target date, balanced and managed accounts — plan sponsors overwhelmingly chose to adopt target date funds. Hewitt Associates reports that already about 50% of plans default their participants into target date funds. I could see that number growing to 60% to 70% in the near future, especially now that the final regulation has been issued.

Why do you think plan sponsors have been so quick to adopt target date strategies?

Czochara: I believe the appeal of target date funds is driven primarily by the simplicity they offer in their ability to provide a single fund option that represents a diversified portfolio that adapts over time to match the investor's time horizon.



In addition, plan sponsors are recognizing that they can provide institutional-quality management to their participants through these funds as investment managers continue to add more sophisticated asset classes within their target date strategies.

The active vs. passive management debate has been around for years. What do you think is the most appropriate target date implementation strategy for a qualified default investment alternative vehicle?

Czochara: There are benefits to both approaches, but from a default perspective, a passive approach is appropriate because it offers a more risk- and cost-efficient investment strategy. Given that participants are automatically invested in the default vehicle because of their lack of interest in taking control of their

investment decisions, it is prudent to place them into a lower-risk, lower-cost option that provides them with diversified market exposure. And, despite the lower risk, passive strategies have shown over extended periods of time to perform as well as, if not better than, many active strategies.

Yang: It is important to note that there are no target date strategies that are entirely passively managed because target date fund managers are making active decisions about how participant retirement funds are invested when constructing the glide path. Plan sponsors should be very sure that they are comfortable with the investment process used to manage their target date allocation and glide path. In addition, because market inefficiencies still exist in certain asset classes, with the proper due diligence and monitoring, it's possible to find active managers who add value over the long run and allow



participants the opportunity to enhance their portfolio returns. Therefore, a potential solution for some plan sponsors might be to create a custom strategy that includes a combination of passive and active strategies to capture alpha in certain asset classes while controlling risk in other more efficient asset classes.

What do plan sponsors need to consider when deciding between proprietary and non-proprietary target date solutions?

Yang: Historically, plan sponsors selected their recordkeeper's target date solution to simplify their decision-making process. Today, many sponsors are much more focused on fees and transparency, which is leading them to consider unbundling their investments from recordkeeping and adopting a more open architecture. I think this is a very important evolution of the target date fund market because the bottom line remains that even very strong managers are not successful in every asset class and in every market environment. All-proprietary funds have greater manager risk and must work against ingrained house views that tend to produce higher

internal correlation between the underlying funds. Custom target date funds made up of a plan's carefully selected and monitored core investment options remain the industry's best-practice standard. Multi-manager funds constructed from a diversified group of specialist firms are a close second.

Czochara: It's important to remember that the propriety vs. non-proprietary debate is not really an issue in the context of indexed target date funds given the commodity-like nature of index funds.

Mutual funds have received the most target date inflows in the past, but there has been a lot of attention on collective funds. What is drawing plan sponsors to this particular vehicle?

Czochara: The trend toward collective funds is really part of a larger movement of plan sponsors "institutionalizing" their defined contribution plans. In many cases, the defined contribution plans become more like their defined benefit plans. As such, plan sponsors are approaching their plans from a total cost perspective, which is leading them to

collective funds. Not only are collective funds typically less expensive than mutual funds, they also offer a greater amount of transparency because the management fees are separate from the recordkeeping or other administrative costs. Selecting collective funds really advances the mission and intent of PPA to provide participants with the institutional-quality tools necessary to effectively save for retirement.

With all the new entrants in the market, many target date strategies don't have a track record.

What other criteria can plan sponsors use to evaluate target date strategies?

Yang: Plan sponsors and their investment consultants can use a two-prong approach to measure the quality of target date fund performance and design. On a micro level, sponsors should be comfortable with the underlying investments that make up the target date funds. This is not really an issue if index funds are used as the underlying investments. However, for actively managed funds, plan sponsors should essentially be comfortable recommending each underlying fund on its own merits.

On a macro level, plan sponsors should have confidence that the target date manager has a tested and robust glide path. Target date managers use a surprisingly wide range of assumptions, from life expectancy to average income, and



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sponsors should have confidence that those assumptions are comprehensive enough to cover their participant demographics.

What's to come in the evolution process of target date funds?

Czochara: The newest target date funds have moved beyond what I consider first- and second-generation funds. Within third-generation target date strategies, providers are offering funds with sophisticated underlying investments in combination with leverage and tactical allocation overlay strategies. And providers who historically focused on differentiating their approach in the pre-retirement accumulation phase are developing strategies to differentiate themselves in the post-retirement distribution phase. As a result, providers are incorporating annuities and other guaranteed-income strategies in their target date funds to address retiree's income needs. ♦

THE EVOLVING TARGET DATE FUND

Since their introduction to the marketplace in the mid-1990s, target date funds have evolved on multiple levels. Here's a brief guide on how to tell the difference between the more than 50 target date solutions currently on the market.

First Generation: The first generation of funds pioneered the way for today's target date funds. As a result, these funds have the longest track record. Even as first-generation funds have had to adapt to changing market expectations (generally, by becoming more aggressive in their asset allocation), these funds still use primarily traditional equity and fixed-income asset classes in their asset allocation decisions.

Second Generation: These funds expanded on the equity/fixed-income dichotomy to include a broader range of asset classes as diversifiers. Asset classes such as real estate, commodities and high-yield bonds offer investors equity-like returns with very low correlation to the rest of the portfolio. Adding these investments results in more efficient and risk/return-controlled portfolios.

Third Generation: Third-generation target date funds give investors exposure to asset classes and investment management tools typically used by highly sophisticated investors. These funds are notable for their use of leverage (130/30 strategies) and other more exotic investment vehicles.