THE PATH FORWARD:
DEFINED CONTRIBUTION PLANS CAN ACHIEVE MORE

ACTIONS TO DRIVE IMPROVED RETIREMENT OUTCOMES

Ten years since the passage of the Pension Protection Act (PPA), one thing is clear: defined contribution (DC) plans can achieve more. In Northern Trust Asset Management’s 6th edition of The Path Forward, our research series exploring topics at the forefront of DC plan design, we surveyed plan participants, plan sponsors and industry experts and found the ideals at the heart of PPA have only been partially realized. As an industry, we can learn from the PPA’s success and missteps.

This year’s research has revealed three lessons crucial to optimal retirement plan design. With these lessons as our foundation, we’ve identified specific actions plan sponsors can take to harness the PPA’s power and guide participants toward a secure and successful retirement.

✔️ LESSON #1
AUTO FEATURES WORK — IF IMPLEMENTED EFFECTIVELY

The PPA clarified the use of auto enrollment and auto escalation in DC plans and offered plans a “safe harbor” exemption from annual compliance testing if their plans included elements such as automatic enrollment and a qualified default investment option. Interviews with thought leaders conducted as part of The Path Forward research suggest the PPA succeeded in countering participant inertia with these automatic options.

PPA provided a very blunt and simple tool for plan sponsors to encourage savings and provide a single investment solution, but it fell short in the implementation.

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THE PATH FORWARD 6TH EDITION SURVEYED:

1,000+
PLAN PARTICIPANTS

100+
PLAN SPONSORS

10+
INDUSTRY EXPERTS
Plan sponsors clearly recognize the benefit of automatic options. When we asked sponsors how their DC plan had improved over the past 10 years, seven in 10 cited increased plan participation as the top improvement. In fact the largest share (32%) of sponsors agree that increased plan participation as a result of auto enrollment is the biggest benefit of the PPA.

And participants largely agree. One in three participants indicated the 401(k) feature they most value is the ability to save painlessly through automatic deductions.

Although auto enrollment and auto escalation are seen positively by both plan sponsors and participants, plan participants are still not effectively challenged to save. Our survey of plan participants found that nearly two-thirds (64%) have deferral rates under 10%, although that same percentage of participants (63%) think they could afford to contribute 10% or more if they pushed themselves. Indeed, if they could go back in time five years, two-thirds (65%) wish they had contributed a higher proportion of their salary to their 401(k) plans. This regret is understandable; if workers were to contribute an additional 2% of their pay, 12% more households would achieve their retirement goals.¹

Why do savings levels remain low? Our analysis of survey responses uncovered that while most plans use auto enrollment, just a third (32%) of plan sponsors implement auto escalation. Participants are clearly ready for it: two-thirds (66%) of participants who do not have auto escalation in their plans say they would likely accept the automatic annual increase. And with good reason – assuming an annual contribution increase of 0.5% with a cap of 10%, auto escalation has the potential to enhance the growth of retirement accounts by about 60%.

"Auto escalation of savings," explains Gaobo Pang, Ph.D., Head of Investor Analytics, Retirement Solutions, “addresses the lack of willpower, offers a path of least resistance due to its gradual nature and has a lasting efficacy in empowering retirement.”² We believe it is time for plan sponsors to strongly consider the potential positive impact of adding auto escalation to their plans.

The benefit of using auto features is clear. Among plan sponsors using auto enrollment and/or auto escalation, nearly two-thirds (64%) think that participants using these features are better prepared for retirement.

➤ TAKE ACTION: USE AUTO FEATURES IN TANDEM
Use both auto enrollment and auto escalation to maximize participant preparedness for retirement. Identify past hurdles to implementing these features and create a comprehensive plan to implement both. It can be helpful to work with your recordkeeper to identify the best time to make the changes.

We have to have 401(k) plans work as well as possible, and for that they need to be automatic and easy. We have made some progress in that direction, but not enough.

ALICIA MUNNELL
Director, Center for Retirement Research at Boston College
One of the PPA’s unintended consequences has been low starting contribution rates for plans that implemented auto enrollment. The relative ease of enrollment resulted in participant inertia, thereby keeping deferral levels low and inadequate – particularly in plans without sufficient auto escalation. In fact, one in two plan sponsors with auto enrollment start deferral levels at 3% or less although the experts we interviewed suggest a 6% minimum.

Similarly, of the plan sponsors who auto escalate, 46% cap rates at 8% or less, even though experts suggest an effective ceiling would be 12% to 15%, depending on workforce characteristics and plan design.

While there is not a “one size fits all” deferral rate and escalation cap, industry experts agree current levels will fall short of getting workers in good, or even passable, financial shape for retirement.

**TAKE ACTION: DETERMINE THE RIGHT DEFERRAL RATE CAP**

Analyze your employee demographics and determine the appropriate baseline enrollment rate and escalation cap for your plan. It may be helpful to enlist the assistance of a DC expert to guide you and provide a perspective on what others in your peer group are implementing.

**LESSON #2**

**EFFECTIVE DEFAULT INVESTMENTS EMBRACE RISK**

The PPA permitted use of a Qualified Default Investment Alternative (QDIA), which enables plan sponsors to determine the default investment for their participants. Seventy-two percent of participants who were auto enrolled kept their assets in the default option, demonstrating a sponsor’s choice for this default investment can have a powerful impact on outcomes for participants.

A key factor to consider with the default investment is risk – and participants are looking to plan sponsors for guidance. That’s why it is crucial for plan sponsors to select a default investment option that can help plan participants appropriately deal with a variety of risks. While both plan participants (53%) and plan sponsors (46%) cited market risk (volatility) as a key concern, they also mention a variety of other risks, such as inflation, longevity and concentration. While participants are aware of these risks, they are not confident they understand how these risks vary in importance during each life phase. In fact, eight in ten (79%) plan participants are concerned about taking the right type of risk at the right time.

By constructing a robust default option, such as a target date fund that adjusts for a variety of risks over time, sponsors can help participants manage risk exposures. To be effective, such investments must take into account a spectrum of risks, particularly market risk. Plan sponsors were specifically asked their views about the seriousness of different risks plan participants face when investing for retirement, and 79% of plan sponsors cite market risk as a key risk for plan participants over the next five years. Plan sponsors can help participants manage this risk through a well-thought out target date strategy.

*We found that our participants who enrolled in the plan on their own, prior to automatic enrollment, are actually at a higher [contribution] rate than those we auto enrolled.*

*If you look at DC plans today vs. prior to PPA and even a little bit earlier than that, it’s a much healthier blend of equity-based and long-term, low-cost investing.*
TAKE ACTION: EVALUATE TARGET DATE FUND
Evaluate whether your investment strategies are effectively managing various risks that are critical when investing for retirement. Take a closer look at how your target date funds can address key risks for your participants. There are quality packaged solutions that might be a fit; if not, consider a custom solution designed to meet the specific needs of your plan and participants.

Inflation is another risk plan sponsors think is on the rise. Fifty-three percent say it has been a serious risk in the past five years, and 74% believe it will continue to be so over the next five years.

TAKE ACTION: PREPARE FOR POTENTIAL INFLATION
Consider providing a menu option to address inflation sensitivity. Explore available solutions such as TIPs or multi-asset class strategies. Keep in mind that after inflation has begun, it will be too late to effectively address.

LESSON #3
LOOK BEYOND EARNING YEARS AND ADDRESS RETIREMENT INCOME NEEDS.

Despite the far-reaching effects of the PPA, it did not help plan sponsors provide tools for participants to deal with income needs in retirement. But there is a need for these tools. Among plan sponsors, 86% think it is important for a 401(k) plan to include investment options designed specifically for retirees; a comparable proportion of plan participants (87%) share this sentiment. We believe income-focused investment options would offer retired participants a way to help ensure they don’t outlive their savings. By selecting income-focused options within the plan, participants could benefit from the same institutional pricing and oversight by the plan provider they enjoy during their earning years.
Although default options work well for most participants during the accumulation phase, people’s needs, circumstances and priorities tend to be very different when they retire. Among the factors contributing to the diversity of retiree situations are their assets outside of the plan, level of income needs, spousal benefits, health considerations, investing style, desired lifestyle and legacy expectations.

We believe a menu of options, created specifically for participants in retirement, can help address a variety of retirement income needs. To be comprehensive, a menu should contain options to address each of three primary concerns:

**Efficiency:** A key starting point when building a menu to address retirement income needs is a target date fund with an asset allocation, or glidepath, that continues to evolve throughout retirement. (The Northern Trust glidepath, for instance, continues to change until the age of 75.) Participants who use target date funds tend to be satisfied with them, and 65% agree the elimination of the need for rebalancing is an important advantage of using them. Because they are designed to efficiently evolve with them over time, target date funds could be an appropriate option for participants who want to stay invested in their plans after retirement.

**Safety:** To some participants, especially the 84% concerned about outliving their resources, the safety of their assets is most important. Plan sponsors agree, with 84% of sponsors viewing longevity risk as one of the most serious risks facing participants in the future. To protect participants from depleting financial resources too soon, plans can turn to a Qualified Longevity Annuity Contract (QLAC), a deferred income annuity recently approved by the U.S. Department of Labor and the U.S. Treasury Department as an investment option under the safe harbor rule. Should the plan sponsor wish to offer institutionally priced annuities outside of the plan, they can review and implement an annuity bidding service to help participants address the need for asset safety.

**Flexibility:** Finally, to address the need of income draw-down flexibility, plan sponsors can offer a systematic withdrawal option. This type of investment option can be adapted to retired workers’ individualized needs, risk tolerance, and other preferences, all of which can vary widely. In fact, according to a past The Path Forward survey, 85% of participants wanted to achieve a lifestyle at least as good as what they had currently. Given the large variation in participant lifestyles, it is important to provide a flexible approach to income drawdowns such as a systematic withdrawal option.
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TAKE ACTION: CREATE A DECUMULATION MENU
Create a menu of options to address decumulation needs that includes three types of investments: a target date fund series, access to an annuity option and access to customizable systematic withdrawal. Understand the options that make the most sense for your plan and determine which options are best implemented within the plan versus out of plan. This type of menu would provide retired employees more choice than most currently have today, without overwhelming them.

A PATH TO RETIREMENT READINESS
The retirement crisis the PPA sought to address 10 years ago still exists today – but the decade ahead is full of opportunity for improvement. Lessons learned from the PPA are linked to action steps plan sponsors can take to help achieve more in their DC plans:
1) implement auto features effectively
2) embrace risk in the default option and investment menu
3) address the retirement income gap with a decumulation investment menu option
As the retiree population grows, effective plan design and implementation have never been more important. These action steps can drive improved retirement outcomes and harness the power of the PPA to make DC plans even better.

Northern Trust Asset Management Can Help Drive Better Outcomes
Our team of experts have been collaborating with DC plan sponsors for more than three decades and can:
• Provide guidance on setting initial contribution rates and auto escalation strategies, which constitute the path of least resistance toward higher savings.
• Help you uncover the various dimensions of risk, as well as provide risk-focused investment solutions to help you address them. From our target date strategies – Focus Funds and Life Engineered™ Funds — to our Inflation Sensitive Assets fund, we are prepared to help you address the various aspects of risk in your participants’ portfolios.
• Assist as you construct a suitable menu for your participants aimed at providing retirement income.

I think providing individual flexibility on how they want to provide lifetime income makes a lot of sense, but in a controlled fashion
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And we’ve got 10 years of data to show that for the plan sponsors that have adopted robustly and implemented thoughtfully, they’re driving positive retirement security outcomes within their workplace.
LEW MINSKY, DEFINED CONTRIBUTION INSTITUTIONAL INVESTMENT ASSOCIATION
About the Research
Northern Trust partnered with Greenwald & Associates to gauge the attitudes of plan participants, plan sponsors and industry thought leaders.

• We surveyed 1,001 participants in DC plans and 103 DC plan sponsors through a 17-minute online survey.
• We interviewed a diverse range of 13 DC industry subject matter experts, including consultants, record keepers and plan sponsors.
• The surveys were completed between April 19 and May 24, 2016.
• The data set was weighted by age, education, and gender to reflect the distribution of those characteristics among private sector 401(k) plan participants aged 21-70.3
• The data set was weighted by plan size to reflect the distribution of private sector 401(k) plans.4

TAKE THE PATH FORWARD
The Path Forward, Northern Trust Asset Management’s annual DC research series, explores topics at the forefront of DC plan design and offers actionable solutions plan sponsors can take – today and in the future – to help their participants achieve better retirement outcomes.

Explore our past research and DC capabilities at northerntrust.com/thepathforward, where you can learn more about our findings. Subscribe to receive updates to The Path Forward research and be the first to receive our latest insights and recommendations.

To receive personalized guidance about ways you can implement the action steps provided, contact us at 312-444-7272 or dc_solutions@ntrs.com.

NORTHERN TRUST RETIREMENT SOLUTIONS
As one of the largest managers of DC assets6 in the United States, Northern Trust has deep expertise in developing innovative answers to challenges faced by many of the world’s largest DC plan sponsors. Collectively, these sponsors have entrusted us to manage more than $118 billion and to provide custody and administrative services to more than $297 billion in DC assets.6 We take a consultative approach to addressing the needs of plan sponsors and participants while offering a suite of solutions – including an inflation-sensitive asset fund and target date funds – aimed at improving retirement outcomes. Visit us at northerntrust.com/dcsolutions to learn more about our DC capabilities.
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Founded in 1985, Greenwald & Associates is a Washington, D.C.-based full-service market research firm with unique industry expertise in financial services, employee benefits and healthcare. The firm is a co-sponsor of the Employee Benefit Research Institute’s annual Retirement Confidence Survey, now in its 26th year of publication.

1 Pang, Gaobo and Warshawsky, Mark J., Retirement Savings Adequacy of U.S. Workers, Benefits Quarterly, First Quarter 2014
2 Pang, Gaobo, Save Early, Save Often, Save 10 (January 2016).
3 The U.S. Census Bureau’s current population survey
4 2014 data from the Employee Benefit Research Institute
6 As of June 30, 2016.

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