Looking back on the defined contribution industry and the U.S. retirement system in 2014, we have highlighted nine trends that plan sponsors, committee members and plan participants can expect in 2015.

1. CONTINUED SHIFT TOWARDS 401(K)-STYLE RETIREMENT PLANS AND EXPANSION INTO OTHER MARKETS

According to the Investment Company Institute, as of 3rd quarter 2014, the U.S. retirement system boasts close to $24 trillion in total assets spread across traditional defined benefit pension and defined contribution plans, IRAs and annuities. Defined contribution plans represent close to $7 trillion of that total and it is expected to be an area of continued growth year-over-year. The shift to defined contribution plans as a primary retirement vehicle has already occurred in the corporate and tax-exempt marketplaces. This trend is carrying over to the governmental marketplace, as well.

Over the past several years, many states and municipalities have considered utilizing enhanced defined contribution plans for new and/or existing employees. States like Tennessee and Rhode Island have led the way in implementing so-called “hybrid” plans, as they wrestle with the underfunded status of their traditional pensions. The weight of these financial burdens has been significant and has forced some major U.S. cities toward bankruptcy (e.g. Detroit, MI and Stockton, CA). Led by the success of Washington State’s Plan 3, this trend will continue to gain momentum in 2015.

2. A CONTINUED FOCUS ON BEHAVIORAL FINANCE AND RETIREMENT READINESS

Plan sponsors continue to incorporate the principles of behavioral finance into their thought process prompting employees to participate in their organization’s retirement program. They have been encouraging employees to contribute from their paychecks at least to the level that maximizes any employer matching contribution, and to select an investment vehicle that will lead to a satisfactory level of income in retirement. This will continue to evolve.

Retirement committees have traditionally focused attention on fulfilling fiduciary responsibilities, like selecting and monitoring prudent investment options for their plans, or ensuring reasonableness of fees. Current behavioral finance research and data has slightly expanded this approach; it adds emphasis on monitoring participant usage of the plan, and on developing effective participant education, communication and messaging. Recurring studies, conducted by behavioral finance economists such as UCLA’s Dr. Shlomo Bernartzi and Harvard’s Dr. David Leibsen, reinforce a key finding: a reduction in the number of plan investment options makes employees more likely to participate in the plan. In addition, such reductions can help lower the overall plan expenses.

Plan sponsors continue to evaluate auto features like auto enrollment and auto escalation and it is expected that the typical default rate of 3% will be increased to assist participants in achieving retirement readiness. The typical escalation of 1% per year up to 10% will be increased, as well, to 2%, 3%, 4% or even 5% to allow participants the opportunity to achieve a positive retirement outcome. Plan sponsors are also considering an annual re-enrollment process to capture participants who may have previously opted out.

3. CONTINUED CONSOLIDATION OF INVESTMENT MENUS

This has been an ongoing trend. As discussed above, now that plan sponsors are focusing on their plans and applying the principles of behavioral finance, in an effort to maximize plan usage and successful participant outcomes, consolidation of plan investment line ups will accelerate. This consolidation consists of a formal process to review and evaluate the funds available in the lineup, and the selection of one fund,
or possibly two funds, in each of a core set of asset classes. A typical consolidated plan investment menu might range from 15-20 investment options (counting the target date suite of funds as just one fund).

4. ADDITIONAL ASSET CLASSES FOR GREATER DIVERSIFICATION

Having reduced the number of funds in each asset class, plan sponsors continue to consider additional asset classes as a hedge against rising inflation or rising interest rates and as a path to greater diversification. Such asset classes include Treasury Inflation Protected Securities (TIPS) and Real Estate Investment Trusts (REITs), as well as shorter duration fixed income products (e.g., short-term bond funds) suited to a low interest rate environment. Especially within asset allocation funds (e.g., target date funds, lifestyle or balanced funds), consideration is being given to weightings towards alternatives, such as direct real estate, commodities, hedge funds and private equity. Challenges with valuation of these particular asset classes has led to the creation of liquid alternatives which are valued daily but still lack in performance.

5. CONTINUED FEE SCRUTINY LEADING TO GREATER CONSIDERATION AND USE OF ALTERNATIVE INVESTMENT VEHICLE STRUCTURES

With respect to the core investment menu, most plans today utilize mutual funds, and in some cases, variable annuities. Plan sponsors (excluding those that sponsor 403(b) plans) are considering alternative investment vehicle structures, such as collective trusts, separate accounts and exchange traded funds, which tend to carry lower expense ratios. A focus on fee disclosure in 2014 led these committees to review and evaluate alternative structures, in an effort to reduce overall plan costs. This has helped direct them toward passive investments or index funds, like those reflecting the S&P 500, where very little portfolio turnover results in lower trading costs. Certain Federal and status regulations prohibit 403(b) plans from utilizing collective trusts. This is not expected to be resolved in 2015.

6. ADAPTATION TO THE CHALLENGES OF THE FIXED ANNUITY AND STABLE VALUE FUND MARKETPLACE

Based on the most recent information from industry trade groups, the majority of plan assets remain invested in fixed annuities/stable value funds, or in the Qualified Default Investment Alternative (QDIA), which is typically a target date, lifestyle or balanced fund.

Fixed annuity/stable value funds are available for participants who seek preservation of principal, with a modest investment return. In these funds, however, sponsors will continue to face the effect of shrinking “insurance wrap capacity”, which is a critical component for participants seeking a safe investment return. Since the economic downturn in 2008, many banks, insurers and investment management companies have departed from the stable value business, resulting in limited space to provide the wrap or guaranteed return of some percentage equal to or greater than 0%.

Though the “wrap” market has begun to “loosen”, the shrinking wrap capacity has driven up the expense associated with stable value funds, and limited the investment strategy available to the managers of those funds (usually related to the duration and quality of the fixed income securities). Meanwhile, participant crediting rates and minimum guarantees continue to fall. Indeed, today’s low interest rate environment (and potential increase in rates) presents a challenge to plan sponsors. They must perform manager due diligence with vigilance, ensuring that any selected fund remains a prudent investment, backed by a financially secure guarantor today and in the future.

7. CONTINUED GROWTH OF QUALIFIED DEFAULT INVESTMENT ALTERNATIVE (QDIA) APPROPRIATE FUNDS

QDIA-appropriate funds will continue to grow significantly. Surveys and actual asset flows suggest that participants like the ‘set-it-and-forget-it’ approach. These products have helped address the savings and accumulation phase of retirement touted by behavioral finance economists, and they come in a variety of flavors – managed accounts (a fee-based third-party service), target date funds and lifecycle funds and custom portfolio funds. Custom portfolios remain a topic of discussion with Committees, but the lack of large cash flows and plan assets in smaller plans impacts the economics and continues to limit these investment structures to the largest defined contribution plans, only.
8. CONTINUED PARTICIPANT DESIRE FOR GUARANTEED INCOME

Surveys continue to indicate that participants desire a guaranteed stream of income at retirement, similar to that of a defined benefit pension plan. The next challenge for investment managers, insurance companies and third-party providers will be to develop products and services to meet this demand, and for regulators to provide some type of fiduciary protection to encourage adoption. This represents an area for significant potential growth, especially as baby boomers continue to retire. Plan sponsors will need to scrutinize such products, though, to determine whether they are appropriate investment options for their plan. In 2014, the Treasury and Internal Revenue Service released new regulations for the inclusion of deferred annuities in defined contribution plans. In conversations with product manufacturers, there is renewed interest, but the market demand by plan sponsors remains soft given the unknowns around fiduciary protections.

9. SUSTAINED REGULATORY SCRUTINY AND LEGISLATION

Retirement plans will remain heavily regulated in 2015. Regulatory bodies such as Treasury and Internal Revenue Service continue to issue new rules designed to enhance retirement security and provide protections to both plan sponsors and participants.

Key areas of focus of both regulators and legislators include promoting a positive financial outcome, fees paid to service providers (recordkeepers, asset managers, consultants/advisors, attorneys, etc.), withdrawal of balances before and after retirement and better defining target-date fund vintages.

We fully expect that 2015 will provide an update on the new fiduciary rules. Treasury has indicated it expects to release the first revision to these rules since the passage of ERISA in 1974. This will mostly impact advisors working and providing advice and guidance directly to plan participants and could alter the retirement landscape greatly, depending upon what changes are mandated by the new rules.

At the end of 2014, President Obama signed into law a massive spending bill that included a provision allowing multiemployer plan sponsors the ability to reduce benefits to retirees currently receiving defined benefit pensions. While this impacts a small segment of underfunded multiemployer pension plans, this should at least cause a moment of pause for plan sponsors and participants alike. Preparation for a bright financial future and a successful retirement remains a shared responsibility between the employer and employee and, therefore, both parties should be engaged in understanding their current situation, their plans and to plan accordingly.

The U.S. retirement system remains strong, but the wheels of change will keep turning in an effort to meet the needs of participants in all types of retirement programs.

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