Simple Wins by Design

Strategies to Improve Outcomes and Increase Assets under Management

A retirement program does not need to be complex in order to be successful. Participant engagement, savings rates, and retirement account balances show positive long-term trends in plans which embrace simplicity as one of their guiding principles. Two particular 'simplification' strategies produce quick, measurable, and effective wins for both plan participants and sponsors in areas of enrollment (when and how much to save) and investment decisions (how to allocate contributions). The same strategies help advisors grow and retain assets under management.

A simpler way to start – when and how much…

Traditional retirement plan enrollment approach consisting of lunch-room meetings, brochures, forms or online visits is too complex, long, and cumbersome. Faced with too many upfront decisions - savings rates, investment choices, beneficiary designations, and so on – many participants get confused, enter a vicious cycle of 'analysis paralysis,' and delay their participation or choose to do nothing. And while participant education may help some, it hasn't proven to be very effective in combating indecision.

Inertia has been called one of the leading causes of poor participation, low savings rates, and small balances. But, turning the proverbial lemons into lemonade, behavioral finance scientists say that the very force that prevents plan participants from building sound savings behaviors may be used for their benefit. How? By taking the enrollment decision out of participants' hands through **automatic enrollment.**

Automatic enrollment converts an employee into an active plan participant. Plan document lays out all the details and rules including when an employee is eligible and how much is to be deducted from the paycheck. Usually, the initial savings rate is 3% of pay. Lately, in response to industry research on recommended savings levels, many plans raised the default contribution to 5-6%. In addition to auto-enrollment, plans may incorporate an **annual contribution escalation feature** typically designed to increase savings rates by 1% per year up to a certain threshold, often 10%. Experts recommend a target savings rate of 10-15%; auto-escalation – combined with employer match – helps employees move closer to that goal.

A recent Merrill Lynch survey showed that while employees are free to opt-out and discontinue plan participation, over **90% appreciate and embrace it;** moreover, **41% of participants** who were automatically enrolled **voluntarily increased their contribution rates** (*Employee Workplace Benefits Report, 2013*, Bank of America Merrill Lynch).

Plan sponsors also benefit. Increased deferral rates help address the **top-heavy** plan dilemmas, improve non-discrimination **test results**, enable **transition to a vested-match** (valuable to plans which use safe harbor features), and provide a boost to employee morale and retention.

Uses and applications of auto-enrollment and escalation vary from plan to plan: some apply it exclusively to new employees, others use it as an opportunity to engage those who had met eligibility but chose not to defer in the past or help increase deferral rates of those who save less than plan's default rate.

Automatic enrollment is catching on: 44% of plans today offer automatic enrollment, 39% annually re-enroll disengaged participants at plan's default deferral rate, and 26% offer automatic escalation feature (*Supporting Retirement Savings Survey*, Brightwork Partners LLC, 2013).

A simpler way to invest – how to allocate contributions…

The more investment options a plan offers, the greater is participant confusion over what options to choose. This confusion often leads to disengagement. Researchers at Columbia University demonstrated that with increase in investment options plan participation rates fall (*How Much Choice Is Too Much? Determinants of Individual Contributions in 401(k) Retirement Plans,* Sheena Sethi-Lyengart, et al, 2003). When it comes to plan investment choices, less is definitely more.

According to Deloitte's Annual 401(k) Benchmarking Survey (2012), 85% of plan participants find it confusing where to invest and which funds to choose. So, what can be done to make it easier and simpler for participants to invest their contributions? **Automatic default into investment options designated by the plan may be the right answer.**

Pension Protection Act of 2006 created a special exemption for plan fiduciaries which makes this strategy particularly attractive. As long as proper due diligence has been exercised in selection of the investment options and these investments fall into categories outlined by the Department of Labor, participants are deemed to exercise control over those investments. In other words, fiduciaries get a complete pass as though participants picked those investments on their own. Plan sponsors can retain services of an investment manager, a 3(38) fiduciary, to take charge of investment selection and monitoring, thus gaining another layer of protection. Plan sponsor would be required to monitor and conduct periodic due diligence on the investment manager in order to divest their investment selection duty.

The special investments designated by the DOL for this purpose are called **Qualified Default Investment Alternatives**, or QDIA. There are three kinds of QDIAs: **target date funds, lifestyle funds, and managed accounts**. Plans can utilize QDIA as a default investment for all plan participants or limit their application to auto-enrolled participants. Before the QDIA kicks in and annually thereafter, plan sponsor needs to provide a notice which explains plan's default options and participant's ability to reallocate their contributions using investment options available in the plan.

A 2013 survey conducted by MFS revealed a major disconnect between participant allocations, their understanding of risk, risk profiles across different asset classes, and their expectations. **By placing participants in a professionally managed solution, plan sponsors may ultimately help participants improve their investment experiences and outcomes.**

Building on the concept of auto-default, some plan sponsors have adopted a practice of **annual re-enrollment: a reset of the plan from an investment perspective.** The plan provides a notice to all participants requiring them to redirect their investments by a specified date; the same notice contains a description of plan investments including QDIA. Participants are asked to (1) elect to make no changes, (2) alter the mix, or (3) do nothing. After the deadline passes, those participants who do nothing are defaulted into a QDIA. This approach helps to ether actively engage plan participants in revisiting their investment allocation or place them into an appropriate professionally managed solution.

How We Can Help

Retirement Services is available to consult and assist in implementation of these plan simplification strategies to remove barriers to participation, improve outcomes, and help you grow assets under management. Consultants will prepare a new plan proposal or review and redesign current qualified plans to add auto-enrollment, auto-escalation, and QDIA options. Call us at (888) 926-0600 or send a message to pensions@firstallied.com .