CAPTRUST

Optimizing Your Retirement Plan

We are now more than a decade into the era of the Pension Protection Act of 2006 (PPA), which ushered in a range of new ways to encourage retirement savings in defined contribution plans, including automatic enrollment, automatic escalation, and qualified default investment alternatives (QDIAs). This is a long enough period to begin drawing some conclusions about the utilization, success, and shortcomings of new and existing tools for participants. At CAPTRUST, our experience working with more than 2,000 defined contribution plans provides insights into plan sponsor challenges and successes that we can learn from and share. Synthesizing these insights has led to a set of best practices that help plan sponsors optimize the effectiveness of their defined contribution plan.

Impact on the Employer

A successful retirement savings program has the potential to improve participant outcomes, but also impact company performance. Employees who are confident about their retirement savings are likely to be more productive and have better attendance than those who are concerned about their finances. These employees are also less likely to have to delay retirement due to inadequate savings, which can help employers with workforce management.

Lowering the need for employees to keep working beyond their targeted retirement age can also avoid the negative financial impact on the company of assuming higher healthcare and benefits packages for older workers. A study by Prudential showed an incremental cost of over $50,000 for an individual who delays retirement by one year and an estimated incremental cost of between 1 and 1.5 percent across an entire workforce. Prudential also found that more than 50 percent of employers believe a significant portion of their workforce will have to delay retirement due to inadequate saving.

These risks should give plan sponsors ample motivation to do what is necessary to turn retirement savings from a potential liability into an asset.

What constitutes an optimized defined contribution plan will vary by employer and will often be based on employee demographics and needs. To make the most of their defined contribution plans, plan sponsors should focus on four key elements:

- getting employees into the plan;
- getting them to save an adequate amount of money toward their retirement goals;
- getting them invested appropriately based upon their specific circumstances; and
- getting plan participants engaged in the saving, investing, and, ultimately, retirement planning process.

Many tools are available to improve outcomes in these areas. This article focuses on helping plan sponsors best utilize these tools and monitor success across these four key elements.

What Is Success and How Do You Measure It?

To optimize their defined contribution plans, plan sponsors need to promote the success of plan participants. The four key elements of plan optimization—what we call the “road map”—are a helpful guide in assessing employee success and can be measured by:

- Participation rates—How much of your workforce is in the plan?
- Deferral rates—Are participants deferring enough of their compensation?
- Diversification—To what extent are participants utilizing diversified investment options such as target date funds, risk-based funds, managed accounts, or models?
- Engagement—Are participants engaged, as measured by their usage of websites, call centers, and in-person employee events and meetings?

The Road Map

1. Getting Employees into the Plan

Of course, employees cannot use the plan to save for retirement unless they are enrolled and setting aside a portion of their earnings. The more traditional multichannel approach to driving plan participation through print communications, web tools, and (possibly) in-person meetings got plan sponsors only so far. Since the effective date of the PPA, however, these traditional tactics have been overshadowed by employers adding an automatic enrollment feature, which has proven to be a key driver of increased participation; plans with automatic enrollment consistently show higher participation rates than those without this feature.

For all industries, the average retirement plan participation rate has risen 18 percent in the past decade, primarily due to the rising popularity of automatic enrollment. As Figure One illustrates, the growth and the use of automatic enrollment features is on an upward trend.

Figure One: Growth of Automatic Enrollment (2006-2016)

Source: 60th Annual Survey of Profit Sharing and 401(k) Plans; Vanguard "How America Saves 2017"

2. Getting Employees to Save Enough

Once participants are enrolled in the plan, the focus shifts to adequacy of savings, commonly termed retirement readiness. Plan sponsors can help participants gauge if they're on track for retirement with readiness tools. These tools forecast retirement income and savings adequacy by calculating the total amount of assets needed in retirement or by showing the percentage of monthly income that a participant is on track to replace in retirement.

The first step to saving enough is maximizing the percentage of pre-tax compensation an employee contributes to his or her plan, known as deferral rate. Once again, automatic features have proven to be key catalysts in improving outcomes, starting with higher default percentages for automatic enrollment. Three percent has been the most common starting percentage, but we are now seeing a shift toward higher default rates. In fact, more than 40 percent of CAPTRUST plan clients offering automatic enrollment now start at a default rate of 4 percent or higher. Further, adoption of automatic escalation, where a participant's deferral rate increases annually—typically by 1 percent each year—can lead to substantially higher deferral rates over time.

We see a direct correlation between plan size and plan designs that include automatic features. Companies with more than 5,000 employees are much more likely to offer them than smaller firms, as shown in Figure Two. One thing we have observed is that innovations that take root with larger plans often work their way into smaller plans, so we may see higher adoption of automatic features among smaller plans over time.

Figure Two: Adoption of Automatic Features by Plan Size

Source: CAPTRUST 2017 Plan Design Benchmark

3. Getting Employees Invested Appropriately

Once enrollment and deferrals are in place, the next step to retirement readiness is ensuring participants are appropriately invested. Most plan sponsors accomplish this by adding diversified asset allocation funds that serve as the plan's QDIA. Participants who do not make an investment election are defaulted to the plans QDIA. Among the investment options and solutions eligible for QDIA protection, target date funds are the most popular—with 89 percent of our defined contribution plan clients utilizing them.

Target date funds, along with other types of professionally managed options, benefit employees by reducing the likelihood of holding extreme or undiversified allocations. According to Vanguard's "How America Saves" study, 0 percent of participants in a professionally managed investment option held either a 0 percent or 100 percent equity exposure. In comparison, 20 percent of investors not in a target date fund or similarly managed investment option held one of these extreme allocations. Target date funds provide meaningful benefits by promoting diversification and automatically lowering the risk of retirement portfolios over time.

Managed accounts are also gaining traction in defined contribution plans. While few plans use managed accounts as their QDIA, we see this changing as they gain further acceptance. Managed accounts consider a participant's age when designing an asset allocation but can be further customized based on factors such as salary, deferral rate, account balance, and marital status. And because managed accounts are more customized to the individual, studies have shown increased participant engagement. According to Morningstar, investors who use a managed account service increase their deferral rates by an average of 2.19 percent.

Regardless of the type of professional help utilized by a plan—whether the plan uses target date funds or managed accounts—the benefits of offering help to plan participants can be meaningful. A multiyear study found that participants receiving professional help, which included those using target date funds, advice services, or managed accounts, had median annual returns more than 3 percent higher than those who did not receive help.

4. Getting Employees Engaged

The final optimization step is getting participants engaged. The first element of an integrated engagement program is print communications. To resonate with participants, print materials should be personalized and targeted to a specific audience. One method is to create content specific to each separate generation of participants. These groups have different views of retirement and are facing very different decisions based upon their life stages. Communications also need to be action oriented—for example, challenging participants to take advantage of their employers' matching contributions.

Call centers are another important component in engagement that can deliver anything from fund information to tailored investment advice to participants, depending on the services engaged. When this service is utilized, it's important that plan sponsors have the capability to monitor call activity—both why their participants are calling and what is being recommended to specific groups of employees on outbound calls.

Plan websites are another way to engage participants, and better technology has improved the effectiveness of these websites over the years. Sites now offer customized retirement readiness tools, personalized messages, monthly retirement income projections, and recommended next steps that participants can easily execute.

While technology provides convenience, personal meetings are a very effective way to drive individual engagement. Participants still generally feel most comfortable talking to an expert about retirement planning, and the ability to give employees one-on-one advice is a significant driver of long-term success. This advice should take a holistic approach that considers a participant's complete financial picture rather than just retirement assets.

Each channel of engagement can impact employees to varying degrees, and plan sponsors should strive to measure each method to determine effectiveness and make necessary changes.

What Are the Roadblocks to Success?

The many behavioral biases that confound investors in general also have an impact on retirement investing. Individuals are inherently biased in ways that can interfere with their ability to adequately save for retirement. Status quo bias—or investor inertia—describes the tendency for employees to prefer their current state and delay decisions that they know are in their best interest. One such decision is starting to save for retirement as early as possible. Decisions that require action now, such as enrolling in a retirement plan or choosing the right investments, are often delayed.

To combat inertia, many plan sponsors have added automatic enrollment to their plan designs. Initiating that first step for participants and getting them into the plan makes it unlikely that they will opt out. In fact, the average participation rate of plans with automatic enrollment is about 87 percent—compared to 50 percent for plans without it.

Another major challenge to address is present bias, the tendency to place a greater value on the current benefits versus future benefits. Most employees would prefer to receive a higher paycheck now over accumulating more for their retirement later. To overcome present bias, plan sponsors have added automatic escalation features. Combining automatic escalation with automatic enrollment increases the likelihood of participants saving enough. Placing participants in diversified investment portfolios that serve as QDIAs can further neutralize inertia by automating the asset allocation and de-risking of portfolios over time.

Plan sponsors must also navigate several other roadblocks. These include the degree of financial literacy among plan participants, the financial cost of implementing programs that drive success, and addressing the needs of varying demographics within their employee base. Most defined contribution plans serve multiple generations of participants, all with different financial needs and communication preferences.

What's Next?

Advancements in technology have been a huge driver in what's next in helping plan sponsors engage their participant base and improve retirement readiness. Examples of these advancements include gamification, improved mobile access, and aggregation tools.

Gamification is the application of elements of game playing to areas meant to improve engagement.

In the case of defined contribution, an employee could get points for achieving certain goals or passing different life stages. The higher the score, the more prepared they are for retirement. Benchmarking a participant against those in their own peer group has also proven effective.

More access to retirement accounts through mobile devices is also gaining traction among plan participants, particularly younger employees. Participants want access to their retirement accounts through mobile devices, along with the ability to transact and get help; technology among recordkeepers is quickly catching up to meet this demand.

Finally, account aggregation tools are a way for participants to be holistic and consider all their retirement assets, not just those accrued with their current employer, when making investment decisions. Account aggregation tools allow plan participants to add outside accounts when calculating retirement readiness or when making allocation decisions among investments. If managed accounts are utilized, the investment manager, with the help of the participants, can use an aggregation tool to consider these outside accounts when making investment decisions.

The Destination

The optimal defined contribution plan will be unique to the circumstances of each plan sponsor, yet each should focus on a few key priorities: getting employees into the plan, getting them saving enough, getting them invested appropriately, and getting them engaged in the process. To help support retirement readiness, plan sponsors should keep participants engaged and active throughout the savings process.

Plan sponsors can stack the odds of success in the favor of participants by implementing plan design features such as automatic enrollment and automatic escalation and combining them with qualified default investment options such as target date funds or managed accounts. These features can be enhanced with advice or financial wellness programs and targeted communications. All these things, along with technology enhancements, are moving the dial forward on participant retirement readiness, making it easier for plan sponsors to help participants reach their destinations.