2016 DEFINED CONTRIBUTION OUTLOOK

As plan sponsors realize a redesign is needed, target date funds get a second look.

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JULY 2016

This summary is part two of a three-part plan sponsor research series on the design and oversight of defined contribution plans.

PART TWO —OF— THREE

EXECUTIVE SUMMARY

Today, the defined contribution (DC) plan is viewed as the primary source of retirement income by nearly two-thirds (62%) of all survey respondents, yet over three quarters (84%) of those polled are not very confident their plan's participants will have the needed amount of income to retire at retirement age (62 to 65). If their employees cannot stop working at retirement age, a vast majority (88%) feel their businesses would be impacted in meaningful ways including increased healthcare costs, retention of younger employees potentially blocked in the organization and the added expense of higher salaried employees.

More than half (57%) of the plan sponsors surveyed said they feel DC plans were not initially built to be the primary retirement vehicle, and therefore, the plans need to be redesigned. This redesign is currently underway and it is made up of a variety of components. Some plan sponsors feel core lineups offer too many choices and have embarked on efforts to simplify plan lineups. In many instances, sponsors feel that brand has failed and are implementing customized white-label options as part of this simplification. Many plans are separating asset management from recordkeeping. In addition, as plan re-enrollments continue, more assets are being shifted into target date funds (TDFs), prompting significant dependence on these funds moving forward.

Getting the TDF decision right

Changes made to TDFs could ultimately be the most meaningful and impactful changes made as part of the redesign of DC plans. The reason is quite simple — if industry reports are accurate, the majority of DC plan assets could end up invested in these products within the next couple of decades. According to Cerulli, TDFs will continue to grab more 401(k) assets, capturing 90% of new contributions to 401(k) plans by the end of 2019.[1] This ultimately means that the success of DC plans — success being defined as participants having enough income to retire at retirement age — could ultimately depend on the effectiveness of TDFs. The results of this survey outline three high-level observations about the current state of TDFs in DC plans:

1. Plan sponsors are just as likely to offer non-recordkeeper or custom TDFs than to offer their recordkeeper's TDFs.
2. Plan sponsors would like to improve the percentage of employees using the TDFs they offer in their plan.
3. Re-enrollment is a tool being used to increase participation with a simultaneous change to off platform or non-recordkeeper TDFs.

The revision of DC plans will come down to how proactive plan sponsors are in creating a sophisticated retirement plan that can be used by participants to adequately save for retirement. The following is a detailed outline of the statistics found in part two of a three-part research series on the outlook for defined contribution plans and the role TDFs will play.

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[1]Cerulli Associates. "Retirement Markets 2014: Sizing Opportunities in Private and Public Retirement Plans," November 2014.

CONTENTS

SECTION I:

PLAN SPONSORS SHIFTING AWAY FROM RECORDKEEPER TDFs

A significant majority (90%) of participating plan sponsors offer TDFs as an investment option in the DC plan. This number increased from our 2014 survey, where the total was 81%.[2]

Target date funds have been offered in DC plans since the early 1990s, yet the majority of their growth has occurred in the past decade. In 2006, the Pension Protection Act (PPA) directed the Department of Labor (DOL) to assist employers in selecting qualified default investment alternatives (QDIAs) that best serve the retirement needs of workers who do not direct their own investments. In the years that followed, target date funds became the most popular QDIA and over the past 10 years have grown from $116 billion in assets to $763 billion.[3]

Nearly half (46%) of those offering TDFs, use non-recordkeeper or custom TDFs.

Nearly two-thirds (62%) of those surveyed felt it is a good idea to separate asset management services from recordkeeping. This highlights a trend of DC plan investments moving to more institutional products not offered by most recordkeepers.

While use of TDFs is popular, the assets in those funds are not well dispersed in terms of where they are being managed. As of 2014, the three largest U.S. retirement plan recordkeepers managed three fourths of all target date mutual fund assets.[3] However, those assets might be on the move. Over the past five years, the rapid growth and interest in defined contribution investment only (DCIO) options has resulted in plan sponsors having the ability to offer non-proprietary funds on their recordkeeper's existing platform. The survey results show a near split between plan sponsors using recordkeeper, proprietary TDFs versus non-recordkeeper or custom TDFs.

[2]SEI. "Sponsors Focus on Better Designing Plans to Meet Retirement Income Needs," April 2014.

[3]Yang, Janet. "2014 Target-Date Series Research Paper," Morningstar, July 2014.

While a slight majority of plan sponsors still use recordkeeper funds, there is a trend among larger plan sponsors to look off platform for non-recordkeeper or custom alternatives. Of the poll respondents using non-recordkeeper or custom TDFs, the mega plans with over a billion dollars in assets appear to be leading the way. Nearly two-thirds (64%) of the mega plans (over $1 billion) use non-recordkeeper or custom TDFs.
In comparison, only about a third (32%) of the smaller plans (under $100 million) use non-recordkeeper or custom TDFs.

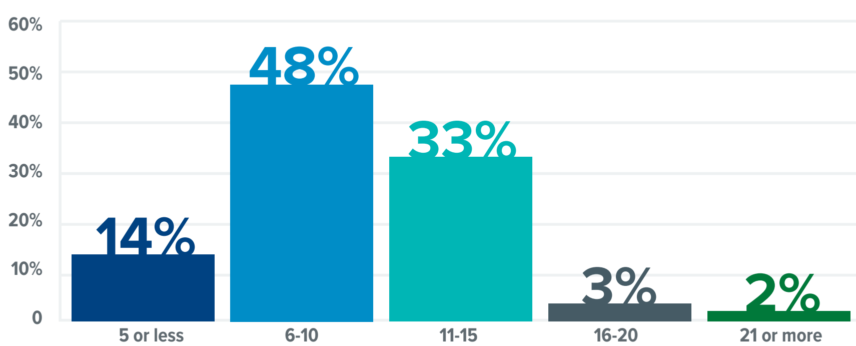
Those with under $1 billion in assets appear to be slower to switch from their recordkeeper's products. Of that group, nearly two-thirds (60%) offer their recordkeeper TDFs. Replacing the recordkeeper's TDFs was not on the immediate agenda for that group as a vast majority (87%) said it was not likely they would change to nonplatform (nonproprietary) TDFs in the next 12 months. The following table shows a breakdown of what type of TDF is offered based on size of the DC plan in terms of assets.

Plan size	Recordkeeper	Non-recordkeeper or custom
Small (<$100M)	68%	32%
Mid-market ($101M-$300M)	51%	49%
Large ($301M-$1B)	61%	39%
Mega (>$1B)	36%	64%

Under the hood — how many TDFs are being offered in DC plans?

More than three quarters of those polled (81%) said they offer between six and 15 funds in their target date series with nearly half (49%) saying they have six to 10 funds.

Number of funds offered as part of target date series



Fast fact: More than a third (38%) of the mega plans (over $1 billion in assets) said they feel plan sponsors should not be offering their recordkeepers' TDFs.

SECTION II:

USE OF TARGET DATE FUNDS BY PARTICIPANTS IS LOWER THAN WHAT PLAN SPONSORS WANT

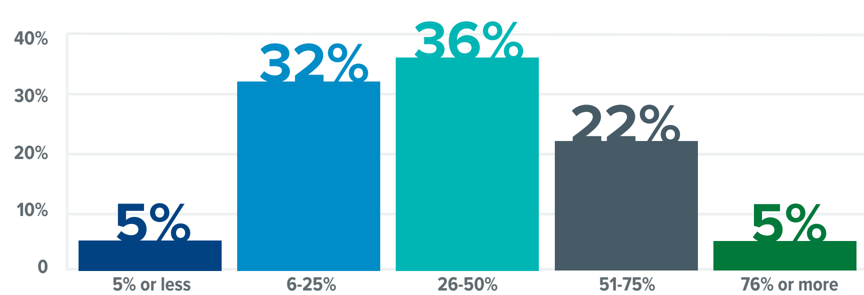
More than half (58%) of all poll respondents offering TDFs said ideally more of their participants would use the TDFs they offer.

The poll results suggest that the number of participants using the TDFs provided by plan sponsors is far from ideal.

While the industry predicts significant growth in target assets to continue, it is not representative of more participants electing to use TDFs. The overall asset growth in TDFs could be driven by the investment performance of current assets, additional contributions by current users or re-enrollments forcing assets into these funds.

At year-end 2013, 41% of 401(k) participants held at least some plan assets in TDFs.[4] Over the past couple of years, that number does not appear to have moved significantly as nearly three-quarters (73%) of the plan sponsors surveyed said that the number of employees investing in these funds is less than half.

% of plan participants investing in target date fund option



Did you know? Plans with between $300 million and $1 billion in DC plan assets were the second highest user of recordkeeper TDFs and the lowest user of custom TDFs. They also had the lowest rate of participants investing in their TDFs and more than half (55%) of that group felt ideally, more participants would be using the TDFs they offer.

[4]Investment Company Institute. “2015 Investment Company Fact Book: A review of trends and activities in the U.S. investment company industry,” Chapter 7, icifactbook.org/fb_ch7.html#asset, 2015.

SECTION III:

WHAT'S NEXT FOR TDFs AS PART OF THE REDESIGN OF DC PLANS?

Plan sponsors clearly believe that participants should be provided with high-quality investment options in the DC plan. Nearly all (93%) of those polled said plan trustees have a fiduciary responsibility to make certain every effort is made to provide the plan participants with the best investment options possible. Further supporting that statement is that nearly half (46%) said the quality of investment options is the top priority importance when making investment decisions for DC plan. However, the survey results show a high percentage of plan sponsors offering TDFs as part of their DC plan lineup but less than ideal usage of these options by participants. What are some ways plan sponsors can change that?

- **Increase participation via re-enrollment**

  Nearly half (42%) of all polled said it is likely their organization conducts a re-enrollment in the next 12 months.

  Historically, one of the reasons plan sponsors have been reluctant to conduct a re-enrollment is concern over a potential fiduciary liability. Those concerns appear to be subsiding. According to a white paper from Drinker Biddle & Reath, "fiduciaries are well advised to add TDFs to the investment line-up and to take steps to cause as many participants as possible to be invested in those funds."[5] In fact, 20% of the poll participants said that a re-enrollment needs to take place in order for their plan's participants to increase the likelihood they have the necessary savings upon retirement. There is a clear motivation behind plans wanting to get participants invested in TDFs, however only one in four have more than half of their DC plan participants using the TDFs they offer. Conducting a re-enrollment is a path nearly half of those surveyed plan to take to help increase usage by defaulting more participants into the TDFs.

Fast fact: Nearly a quarter (23%) of the mega plans ($1 billion or more in assets) offer custom target date funds to their participants.

[5]Reish, Frederick & Ashton, Bruce. "Fiduciary implications: Using re-enrollment to improve target date fund adoption," DrinkerBiddle (Drinker, Biddle & Reath LLP). Accessed on June 7, 2016.

› Combining re-enrollment with implementation of custom TDFs

More than a third (37%) of those planning to conduct a re-enrollment in the next 12 months also plan to shift to more custom TDFs in the same time frame.

It's been three years since the DOL issued guidance about researching whether or not nonproprietary or non-recordkeeper TDFs made sense for individual plans. The report suggested "a custom TDF may offer advantages to your plan participants by giving you the ability to incorporate the plan's existing core funds in the TDF and investment manager diversification."[6] That guidance appears to be resonating with some plan sponsors as they are changing to custom TDFs when they are conducting a re-enrollment.

The reason for this is that a re-enrollment requires resources and extensive communications to participants. Plan sponsors are realizing that if they have decided to implement a re-enrollment strategy it makes sense to simultaneously review the investment options in the plan and make those changes at the same time. As these changes are taking place, some plan sponsors are building out the oversight process moving forward. A discretionary investment provider takes on oversight responsibility for investment managers and ongoing asset allocation changes within the TDFs. Of those who said they either currently do or would use a discretionary investment management provider, more than a third (34%) said they would use the provider to develop custom glidepaths for their participants.

› A move away from recordkeeper TDFs could result in more participants using this option

As more plans continue to move away from recordkeeper TDFs and subsequently conduct re-enrollments, the goal would be to see participation rates increase. The survey results show higher participation rates among those plan sponsors offering non-recordkeeper or custom TDFs. Of the plan sponsors offering non-recordkeeper or custom TDFs, 10% said they have a participation rate of 75% or greater. In comparison, only 2% of the group offering recordkeeeper TDFs could make that claim.

› TDFs preferred over managed accounts

Just over half (51%) of those surveyed offer managed accounts in their DC plan, paling in comparison to the 90% that offer TDFs. More than two-thirds (69%) who offer managed accounts see less than a quarter of their participants using this option. When comparing the two options, just about three-quarters (74%) of those polled said they feel custom TDFs provide better diversification for less costs compared to managed accounts.

Did you know? 37% of those plans already offering custom TDFs said that over the next 12 months they were going to revise the funds to be even more customized to their participants.

[6] U.S. Department of Labor. "Target Date Retirement Funds — Tips for ERISA Plan Fiduciaries," February 2013.

CONCLUSION

TDFs are here to stay and might be the most critical component of DC plan construction moving forward. Per guidance being suggested by groups such as the DOL and the Defined Contribution Institutional Investment Association (DCIIA), plan sponsors should review the TDFs they offer participants and determine if they are the best option. Adding to the fiduciary aspect of this oversight is that re-enrollments continue with TDFs typically being the QDIA, meaning plan sponsors are proactively moving their participants into these funds. It's imperative to make sure the TDFs being offered are sophisticated, diversified and designed to accomplish the best possible outcomes. It's also imperative to have a well-established oversight process moving forward to make changes in response to market conditions and manager performance. This should be done with as little interruption to participants as possible.

This was the second of a three-part series of the results of this survey. If you would like an advance copy of the release of the final part of the series, visit **seic.com/dcpoll2016** or email **seiresearch@seic.com.**

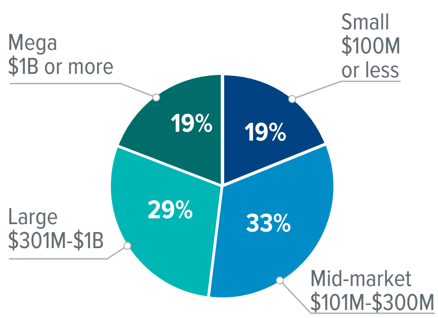
- **Part 1** — Do DC plans need to be redesigned? (released in February 2016)
- **Part 2** — Is a shift to custom target date funds a component of the redesign of DC plans? (released July 2016)
- **Part 3** — As DC plans are redesigned, what is the most effective model for fiduciary oversight? (coming in August 2016)

Participant demographics and survey information

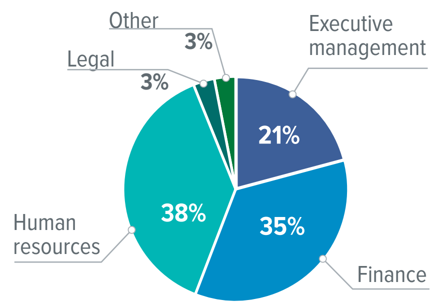
SEI's Defined Contribution Research Panel completed a comprehensive survey of executives from defined contribution (DC) plan sponsors in the U.S. to gauge their views on a number of areas of plan management. The poll was completed by 231 executives, representing DC plans ranging in size from $25 million to over $5 billion. Of the respondents, 47 are current clients of SEI. The poll was conducted in November/December 2015.

The accompanying charts show some demographic breakdowns of the participants:

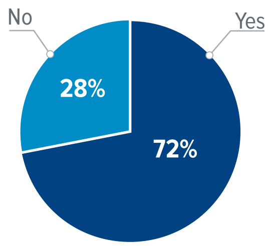
Size of participating plan sponsor's DC plan assets



Role or department within organization



Are you a member of the investment committee for your organization's DC plan?



DEFINED CONTRIBUTION
Research Panel

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