MICHELLE RAPPA
Managing Director, Retirement Client Advisor

Exploring the DC Retirement Tier

Can adding solutions for near- and current retirees help plan sponsors retain a valuable participant group?

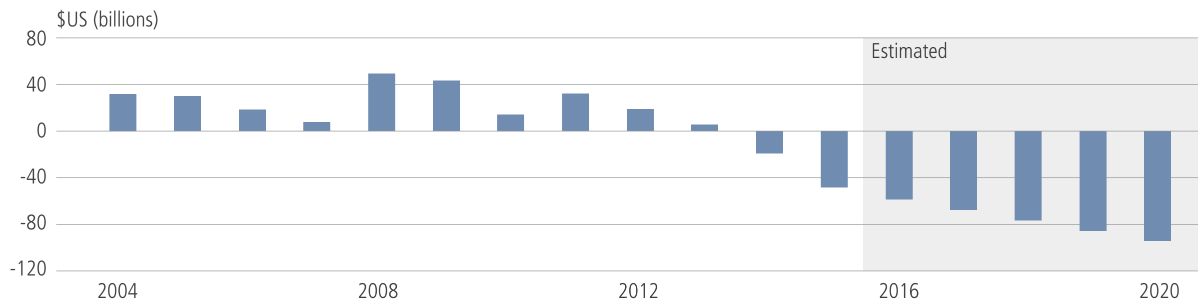
Defined contribution plans have historically focused on the accumulation phase of the investor life cycle. In theory, employees make contributions, often benefiting from an employer match, and gradually capitalize on appreciation potential to build a nest egg expected to last through retirement. Investment choices are geared toward growth, with a few token income funds for diversification. Assuming all goes well, the employee retires and rolls over savings into an IRA or other vehicle. Distributions usually take place outside the plan.

Unfortunately, we see a couple of serious problems associated with this model. First, it assumes a readiness on the part of the participant to assume more responsibility for investing, which may not jibe with reality. Without the support of an institutional fiduciary, former participants may struggle to maintain a portfolio associated with their needs, and may lack the knowledge to seek the advice of a financial professional.

The second concern relates to the impact on the plan sponsor of shedding those assets. In some cases, having a retired employee leave the plan may be more cost effective, but in many others it can rob the sponsor of a lower cost structure that benefits all participants.

Today, this issue is of more than passing interest, as demographic changes, including the retirement of baby boomers, are moving 401(k) plans from net inflows to net outflows (see display).

401(K) DISTRIBUTIONS ARE OUTPACING CONTRIBUTIONS



Source: Cerulli, 2015. U.S. Retirement Market.

Not surprisingly, many plan sponsors are becoming highly focused on the departure of retirees. According to Cerulli, 33% of large 401(k) plan sponsors (those with over $250 million in plan assets) say they would prefer participants to stay in their plan.[1] As large sponsors represent 64% of the $5.5 trillion 401(k) market,[1] their interest could be very influential in determining whether participants that are retiring or separating from employment stay in the 401(k) system. If they do not, Cerulli believes the 401(k) market could be "derailed" due to negative flows from participants retiring and pulling their assets from the plan.

An additional worry may be contributing to plan sponsors' interest in retaining participants' assets: Although in theory plan sponsors are not responsible for assets that have "left the building," the break may not be as clean as they would like. If market declines or expense burdens cause retirees' portfolios to fail, they may look to the past employer to be made whole. Regardless of the merits, this could create litigation exposure sponsors would rather avoid.

Strategies

Assuming a given plan sponsor comes down on the side of wanting to retain assets (and keep retired participants in the plan), we believe the development of a retirement tier of investment services can go a long way in dealing with this issue.

As defined by Mercer, "a retirement tier can consider any product solution, tool or service that simplifies or facilitates the decisions that need to be made by plan participants prior to, and during retirement, taking into account their specific household circumstances, in order to ultimately generate income."[2]

As a first step, sponsors will want to evaluate their investment options and consider whether they include strategies suitable for both the accumulation and spending phases. They may wish to consult with record keepers about potential distribution strategies (including systematic withdrawals) that accommodate the retiree segment. They may also consider whether their communication and outreach programs are well suited to reinforce the need for careful investment and convey an understanding of what the retirement tier is all about.

What investments could work for a retirement tier? Keep in mind the particular risks of near-retirees and retirees. Toward the end of a career, the need for preservation of assets becomes more essential. In what's known as sequence risk, a sharp decline at the cusp of (or early in) retirement can have devastating consequences as investors may soon need to tap into depleted capital to make ends meet. This is particularly worrisome in the early stages of retirement, when investors are likely without wages or other resources to replenish capital. At the same time, both near-retirees and retirees may require some growth potential to offset the impacts of inflation and spending in order to preserve portfolios across today's longer lifespans.

Along these lines, we believe potentially suitable retirement tier options may include opportunistic fixed income strategies that aim to provide reduced volatility and portfolio ballast, but have flexibility to allocate to less traditional fixed income sectors, including high yield and emerging markets debt for additional return potential; multi-asset income strategies that further expand that investment universe to include real estate, dividend-producing stocks and other income-producing assets; and equity income funds that combine stocks and bonds to provide both income and capital appreciation potential.

Considering Retirement Tier Potential

Creating a retirement tier within a DC plan provides key advantages to both departing employees and sponsors. Retirees can benefit from institutional pricing and carefully selected investment options while avoiding the uncertainty and pitfalls associated with moving their assets elsewhere. Sponsors can benefit from lower costs associated with scale, improve the quality of their plan offerings to attract and retain employees, and maintain more flexibility with regard to timing of retirement across the workforce. A retirement tier may not work for every company, but we believe it is worth considering as employers deal with demographics that could fundamentally change the DC landscape.

[1]The Cerulli Edge, U.S. Retirement Edition, 2018.
[2]Top Priorities for Defined Contribution (DC) Plan Sponsors for 2019. Mercer, 2018.

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Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

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