Re-thinking the Defined Contribution Investment Menu

The 401(k) investment menu design practice that exists across the industry has, in general, developed as a result of the Department of Labor's QDIA (qualified default investment alternative) regulations that went into effect in 2008, resulting in the widespread adoption of target date funds (TDFs), as the plan's default/preferred investment. These TDFs focused on what is considered very simple notions of risk and risk tolerance: equities = high risk and fixed income = low risk; younger participants should consider taking more risk (hold more equities)/older participants should consider taking less risk (hold more bonds). These TDFs quickly became the main DC investment vehicle.[1]

In contrast, defined benefit (DB) plan managers—managing similar risks but operating under a different regulatory regime—have developed a longer-term and significantly more sophisticated approach to retirement finance than what we considered the simple risk-on/risk-off model that underlays TDF design. Why does that matter? Because fundamentally, DB plan managers and 401(k) plan participants are engaged in the same basic project—using current savings/contributions to finance the production of (future) retirement income.

In this article we're going to discuss how DB sponsors think about retirement savings and what 401(k) plan sponsors can (and can't) learn from DB practice.

1. Plan Sponsor Council of America, 65th Annual Survey, 2022.

Adequacy

Before we talk about investment, we have to talk about the input (contributions) and the output (retirement income) as basic variables in the retirement savings project.

In DB plans, the sponsor decides how big a benefit the plan is going to provide. Traditionally, DB sponsors targeted a benefit that would (together with Social Security) replace a percentage of a participant's pay at retirement. The ideal here was around 70-75%, based on the premise that the participant would then be able to reproduce in retirement something close to her current living standard.

In a 401(k) plan, a good rule of thumb is that every 1% of career savings produces 4% of retirement income. So, a savings rate of around 12% will, over a 40 year career, produce retirement income of around 50% income replacement. Add another 25% from Social Security and the participant is on-target for an adequate retirement.[2]

The lesson that 401(k) plan sponsors and participants can, and should, consider from DB sponsors: you don't undertake an obligation—specifically a particular retirement income target—without being prepared to put in enough money to finance it. Unless you are exceptionally lucky or an investment genius, you are not going to finance an adequate retirement benefit with minimum savings. You don't make up for under-saving by gambling on returns.

We would add here a couple things applicable to 401(k) plans that are not applied within DB plans. DB plans use a one-size-fits-all plan design. Everyone has the same income target and the same retirement age. In a 401(k) plan, individual participants can choose how much to save, reflecting, e.g., whether they want to retire earlier or later than age 65. Also, 401(k) plan participants may have insights into their own life expectancy—they may expect a longer or shorter life than the (DB) average.

Asset Management—Seeking Returns and Hedging Risk

Now let's turn to investments and investment management. Broadly, DB sponsors manage plan investments with one or both of two objectives: seeking long-term returns and hedging risk (with respect to both assets and interest rates).

Often, the equity portion of the plan's portfolio is allocated to return seeking. To be clear, this is "seeking" long-term returns, not chasing them, with the objective of having options within the DB plan that potentially enable the portfolio to optimize the portfolio's risk/return tradeoff. Thus, holdings are diversified, where diversification is understood (under modern portfolio theory) as a relatively low-cost way of reducing risk. In a 401(k) plan, however, most investment lineups that we have reviewed seek to choose higher alpha, higher beta strategies that reduce tracking error rather than consistently and predictably producing a required stream of returns.

The fixed income part of the DB portfolio is often dedicated to hedging interest rate risk, through one or more liability driven investment (LDI) strategies. This is a critical and fundamentally different objective than the fixed income components that exist in most TDFs utilized by 401(k) plan participants.

2. Source: Calculations are sourced from the retirement consulting firm, October Three Consulting, LLC.

Turning Assets into Retirement Income

Both DB plan sponsors and 401(k) plan participants have the same primary objective—to use assets accumulated through contributions and investments to produce *income* in retirement. Simple example: A DB plan sponsor knows that when a (current) 55-year-old participant retires the plan will owe him $1,000 a year. The sponsor can hedge that risk by buying (now) a fixed income instrument (e.g., a bond) that will pay $1,000 a year beginning in 10 years. That is one version of Liability Driven Investing.

If interest rates go down, the cost of that income will go up—but the sponsor has hedged against that cost increase by buying that bond now. More broadly, many DB sponsors use the fixed income portion of their portfolio to match the duration of their liability "portfolio" (the sum of all the future payments they must make over time).

A 55-year-old 401(k) plan participant is in a (nearly) identical situation. She knows that she will need income beginning 10 years from now of $1,000 per year. The fixed income portion of the TDF, however, is simply a "risk-off" investment—the duration of that portfolio (how "long" the bonds are) is not linked to the duration of risk that she faces (over how long a period she will need retirement income payments). Thus, if interest rates go down—and the cost of her buying retirement income goes up—her fixed income investment (the fixed income portion of the TDF portfolio) will typically not correlate with that increase in cost, and she won't have enough money to buy the retirement income she needs.

Inflation

There is one risk that DB sponsors are not concerned about but that every 401(k) plan participant *does* have to worry about: inflation. Traditional DB income benefits are typically stated in nominal dollar terms, e.g., the plan will pay retirement income of $1,000 per year at retirement. The present value of that promise is (in the same way that it is with a bond) a function of interest rates. If interest rates go up, the value of that promise goes down. That is true if "real" interest rates (roughly, nominal interest rates minus inflation) go up. But it is also true if interest rates go up because of inflation.

Inflation, however, reduces the value of the participant's nominal dollar benefit. After a significant increase in inflation, $1,000 won't buy what it used to. In effect, the value of the participant's benefit is cut.

Fixed income benefits—including both the fixed income portion of a participant's TDF portfolio and, e.g., an annuity the participant purchases at retirement with his 401(k) plan assets—are directly (negatively) affected by increases in inflation.

Interestingly, while equities are also exposed to inflation risk, they may also be a hedge against that risk and are generally less subject to it. Thus, participants in a traditional DB plan—where the benefit is, in effect, all annuity—sustained significant losses in retirement income buying power during the recent inflationary period. But participants in 401(k) plans with meaningful allocations to equities did not.

Takeaways

Adequate savings starting early in the participant's career is critical to retirement income security.

- Like DB plan sponsors, DC participants should begin with a contribution rate that reflects realistic assumptions about how much they can make on their savings and how much income they will need/want in retirement.
- Encourage participants to consider contributing a relatively high rate—10%-12%.

Investment/fund menu strategy

- You cannot solve inadequate savings with more portfolio risk.
- The prudent strategy is to pursue consistent returns over the long run.
- A simple "risk on (equities)/risk off (bonds)" strategy (common in most target date funds) may be considered naïve.
  - First—bonds present risks that have nothing to do with Beta
    - On the one hand, bonds of appropriately matched duration may hedge against changes in interest rates (a plus).
    - On the other, bonds are uniquely, acutely exposed to inflation risk (a minus).
  - Second—asset allocation must respect market dynamics: for instance, at peak ZIRP (zero interest rate policy) (mid-2020) it was widely understood that upside interest rate risk was primary.
- For retirement savers during the accumulation phase, what matters most is not tracking error; it is the goal of generating consistent, low volatility, positive, total returns.
- And, for a retirement saver in the distribution phase, income generated on invested capital matters more than Net Asset Value (NAV) total returns.

None of the foregoing fits within the current design of the typical target date fund—which has changed little since 2008. It's time for sponsors to think more broadly about how 401(k) plan participants can deal with the risks they face.

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Definitions

Accumulation Phase is the stage wherein a retirement saver is contributing to retirement accounts and investment portfolios in preparation for retirement.

Alpha is a risk (beta-adjusted) return measurement. If two managers had the same return, but one had a lower beta, that manager would have a higher alpha.

Distribution Phase is the stage where the accumulated funds are managed and withdrawn in ways that provide the biggest benefits and advantages to the retiree.

Beta is a measurement of a security or portfolio's volatility—or systematic risk—in comparison to the market as a whole.

A **defined-benefit plan** is an employer-sponsored retirement plan where employee benefits are computed using a formula that considers several factors, such as length of employment and salary history.

A **defined contribution plan** is a type of retirement plan in which the employer, employee or both make contributions on a regular basis.

A **401(k) QDIA (Qualified Default Investment Alternative)** is the investment used when an employee contributes to the plan without having specified how the money should be invested.

The **Modern Portfolio Theory (MPT)** is a practical method for selecting investments in order to maximize their overall returns within an acceptable level of risk.

Net Asset Value (NAV) is the net value of an investment fund's assets less its liabilities, divided by the number of shares outstanding.

A **target-date fund (TDF)** is a fund offered by an investment company that seeks to grow assets over a specified period of time for a targeted goal. While target-date funds aim to reduce risk overtime, they—like any investment—are not risk free, even when the target date has reached. Target-date funds do not provide guaranteed income in retirement and can lose money if the stocks and bonds owned by the fund drop in value.

Tracking Error is the divergence between the price behavior of a position or a portfolio and the price behavior of a benchmark.

Risk Disclosures

Duration risk is the risk that changes in interest (borrowing) rates may reduce or increase the market value of a fixed-income investment.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Funds that invest in bonds are subject to interest-rate risk and can lose principal value when interest rates rise, while they typically increase their principal values when interest rates decline. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline.

All investments involve the risk of loss of principal.

Past performance is no guarantee of future results.

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