Managed Accounts Within Defined Contribution Plans

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INTRODUCTION

There is a paternalistic trend underway among defined contribution plan sponsors today. The concept of boosting participant retirement readiness is accepted by many as a primary fiduciary objective.[1] Sponsors are increasingly offering professionally managed portfolio solutions in an effort to reduce barriers to participation and to ensure proper diversification. There are reasons to believe the trend toward paternalism will continue as plan sponsors focus increasingly on retirement income adequacy as a key measure of success.[2] There is clearly room for improvement in this area, as 39% of workers still lack confidence in their level of retirement readiness, according to a 2017 study by the Employee Benefits Research Institute (EBRI).[3]

Following the 2008 market collapse, many sponsors' educational programs focused on helping participants select a diversified and efficient portfolio at an age-appropriate risk level. More recently, sponsors have shifted their focus towards holistic financial strategies considering both accumulation and distribution life stages. Financial wellness programs that can help participants view their retirement plan in the context of their overall financial picture are on the rise. Ongoing plan design and policies seem to be aimed at keeping more participants in the plan during their retirement years, where they can leverage the institutional pricing benefits that come from being a part of a large asset pool.[4] On the investment front, new conversations are taking place around the need for portfolio management solutions that account for the unique goals and circumstances of each participant, including periodic distributions post retirement. These conversations frequently lend themselves toward managed account solutions.

Managed accounts use data about individual participants to provide personalized portfolios that are professionally managed. They offer participants a total retirement solution, based on their individual goals and financial circumstances. The managed account is an ongoing service where the provider takes discretion over the management of the portfolio and accepts fiduciary responsibility. Managed accounts can be a powerful tool in the retirement savings process, but they may also add a level of cost and complexity that makes some plan fiduciaries uncomfortable. In this white paper we will discuss several considerations to take into account when evaluating whether a managed account is appropriate for a particular plan.

THE BENEFITS OF MANAGED ACCOUNTS

Aside from offering diversified and professionally managed portfolios, there are a few ways in which managed accounts may add value relative to other commonly used asset allocation solutions.

Portfolio Customization at the Participant Level

Before discussing the key benefits of portfolio customization, let us first consider the attributes that have driven the adoption of another type of professionally managed portfolio solution – target date funds. Target date funds are simple to understand and are designed to deliver asset diversification in a way that is generally suitable for broad swaths of the population. Target date funds have become one of the most popular investment options within defined contribution plans over the past decade due to these factors. By simply choosing the fund with the target date closest to their expected retirement date, participants are placed into a diversified portfolio that decreases in risk as they age. Rather than worrying about picking the right investments and allocating appropriately on their own, participants have access to a professional manager and an efficient portfolio in a single product. Understandably, both plan sponsors and participants are attracted to this easy-to-use solution.

However, given the wide disparity in financial profiles and risk capacities among retirement savers, a single suite of target date funds may not be a good fit for all investors within a plan. There are several factors aside from retirement dates that impact investors' optimal asset allocations, such as savings habits, spending levels, and risk preferences. Consider two participants who both expect to retire in 10 years - one makes $100,000 per year, saves 9% of her salary, and has a large nest egg built up, while the other makes $32,000 per year, saves 4% of his salary, and has very little in the way of existing savings. Even with the same retirement date, these participants most likely have very different investment needs, and the same target date portfolio may not be suited for them both. In addition to having very different financial resources and income needs, they likely have different personal goals and risk preferences. In the event that their financial resources are inadequate to fully fund their desired level of retirement income, the two participants may reach different conclusions concerning the best way to address the income gap. One may choose to work longer versus saving more, while the other may elect to spend less in retirement. Due to these differences, it can be difficult for a plan sponsor to choose one asset allocation solution that will fit the needs of an entire employee population.

Managed accounts address this issue by providing customization at the participant level. Like a target date fund, managed accounts provide professional management and diversified portfolios that gradually become more conservative over time. But rather than assigning investors to portfolios based solely on their expected retirement dates, the managed account provider also considers other factors, such as salaries, savings rates, account balances, and risk tolerances. Based on these inputs, the manager constructs portfolios that are tailored to each particular investor. As the participant's financial status changes over time, the manager will adjust the portfolio to account for those new inputs, always with the goal of maximizing the chances of a successful retirement.

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[1] "2018 Defined Contribution Trends", Callan, pg.14.
[2] "2018 Defined Contribution Trends", Callan, pg. 12.
[3] Lisa Greenwald, Craig Copeland Ph.D., Jack VanDerhei Ph.D., "The 2017 Retirement Confidence Survey: Many Workers Lack Retirement and Feel Stressed About Retirement Preparations", Employee Benefits Research Institute, 21 March 2017, 5.
[4] "2018 Defined Contribution Trends", Callan, pg. 39.

A Holistic Retirement Strategy

Many managed account providers offer investors more than just a simple to use asset allocation strategy. Most solutions provide a total retirement strategy, including a suggested retirement age, a target savings rate during the accumulation years, and a sustainable spending rate during retirement. In many cases, providers will even calculate the ideal drawdown strategy across various investor accounts based on tax efficiency. Participants are presented with retirement income targets and can track their progress toward achieving that goal over time. With most providers, participants can adjust their income goals, retirement dates, or savings rates, and see the effect that those changes have on their overall retirement readiness. Presenting a personalized plan in this way provides participants with an estimate of the retirement lifestyle that they are tracking towards, which they otherwise may not be aware of. It allows them to see how making certain small adjustments now impact spending flexibility in retirement, or can enable them to retire sooner. Retirement savers may be more likely to take action when they have this information at hand. In a research study conducted by Morningstar Investment Management, who is one of the major managed account providers, they found that 87% of participants increased their deferral rates after enrolling in the managed account service. Savings rates rose by an average of 2.19%, a relative increase of 27.69%.[5]

A Retirement Income Solution

Managed accounts may also be part of the solution to the retirement income challenge that many investors face today. The estimated 10,000 baby boomers that retire each day will have to fund their lifestyles for the next 20 to 30 years, and doing so in an extended low-interest rate environment can be a difficult task. Fewer retirees can count on defined benefit pension payments today than in the previous generation, so many are left to generate income from their defined contribution savings. The financial services industry has many solutions to help investors accumulate wealth over time, but fewer tools exist that help investors draw down wealth throughout retirement in an optimal and tax-efficient way. In addition to providing robust drawdown strategies for investors, managed accounts are arguably the best avenue through which to gain appropriate exposure to specialized retirement income products that may be components of a retirement plan investment menu. In most cases, and depending on the needs of the individual, managed account providers are able to incorporate guaranteed income (i.e. annuity) products into participants' asset allocations to provide a guaranteed income source in retirement. Annuity purchases are highly individualized decisions that are incredibly difficult to implement through target date funds in a suitable way. Managed account providers can also utilize non-guaranteed income funds (such as dividend-oriented equity funds and multi-sector bond funds) to design portfolios that are optimized toward generating income in retirement.

POTENTIAL FIDUCIARY CONCERNS

Certain fiduciary concerns have been raised relating to managed accounts, and they tend to center around fees or lack of participant engagement.

Fees

Although the concept of offering participants personalized retirement strategies is attractive, managed accounts can also raise concerns for plan sponsors. One common concern is fees. Given the countless lawsuits and ongoing scrutiny over retirement plan fees, ensuring that all costs are appropriate is often top of mind. Managed accounts usually entail higher costs than a typical target date or balanced allocation fund. Most managed account providers charge an asset based fee that the participant pays in addition to the cost of the underlying mutual funds. Over time, a small increase in fees can have a substantial impact on long-term results. Understandably, adding this extra layer of fees can make plan sponsors uneasy.

The Department of Labor requires plan sponsors to determine that fees charged to the plan are reasonable for the services provided, and that the services are necessary or valuable.[6] Consequently, in addition to determining whether a managed account service would be necessary or valuable for a plan, sponsors should also evaluate a managed account provider and the range of services that they offer to participants to determine if the provider's fees are reasonable.

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[5] David Blanchett, "The Impact of Expert Guidance on Participant Savings and Investment Behaviors", 20 August 2014, pg. 8-9.
[6] [1] ERISA § 408(b)(2).

Lack of Participant Engagement

Another potential concern with managed accounts is the level of participant interaction necessary for the provider to offer highly customized advice. As discussed above, the benefit of managed accounts is the potential for better retirement outcomes based on the personalized recommendations provided. However, the managed account provider needs access to personal data to create a customized strategy. Ideally, participants would log into the portal and provide information on all financial assets, including assets held outside of the plan, as well as retirement goals and risk preferences. In reality, many investors won't take action, due to lack of time, interest, or knowledge of how the program works. A common concern is that if the participant does not interact, the managed account provider will use default assumptions similar to a target date fund or other off-the-shelf product, resulting in the equivalent of a higher cost off-the-shelf product. In most cases, however, the managed account program will receive at least some important investor-specific data points (such as compensation level, savings rate and plan account balance), giving it a relative edge over an off-the-shelf product. Without requiring any participant interaction, the manger can create a more customized strategy using the data available from the record keeper. Nevertheless, it is important to evaluate what inputs the manager uses in its portfolio construction process and how it acquires the information.

EVALUATING THE COST / BENEFIT OF A MANAGED ACCOUNT SOLUTION

With all of these considerations in mind, how should a plan sponsor or fiduciary determine whether a managed account program is right for their plan? There are a few characteristics that make certain plans more likely to benefit from a managed account solution, each of which are discussed below.

Participant Demographics that Differ Significantly from Industry Averages

One of the biggest factors that distinguishes a managed account from a target date fund has to do with the inputs used by the provider in the portfolio construction process. Target date funds are not managed with one specific investor in mind, but rather as a simple solution that could fit many investors. As such, the inputs used by target date fund managers in their modeling typically include the average US investor's demographics. For example, a 2040 target date fund would look at the average salary, savings rate, and account balance of all defined contribution investors around ages 40-45 and construct a portfolio that is likely to achieve a successful retirement for that average investor. All participants who plan to retire around 2040 would receive the same portfolio, regardless of their individual financial statuses or risk preferences. Conversely, a basic managed account provider uses the participant's actual salary, savings rate, and account balance, and creates a solution based on personal inputs rather than national averages. As a result, participants whose demographics differ substantially from the national averages will likely end up with portfolios that look very different from the target date portfolio, and should theoretically be more appropriate for them. A plan in a high-paying industry, for example, or one that has materially higher-than-average savings rates, may benefit from a customized solution that reflects the participants' actual financial status. The same would be true for a plan with generally lower than average salaries and savings rates.

A Diverse Participant Population

Aside from an employee population that differs from the national average, a population that has highly divergent underlying demographics also argues for a managed account solution. The more diverse the population is, the harder it will be to find a single suite of target date funds that fits the majority of the group. Take Apple Corporation for example; it is usually seen as a technology company, but the employee base covers a wide range of occupations, from engineering, to manufacturing, to retail. The salary levels, account balances, and overall financial profiles among this population vary dramatically. In addition, the group also includes varying levels of financial knowledge and risk aversion. Retirement plans with a diverse participant population may want to consider offering a managed account solution to accommodate the variety of underlying demographics.

The Presence of Unique Plan Features

The presence of certain features within a company's retirement program, such as company stock, self-directed brokerage accounts, or the ability to participate in a defined benefit plan, may also argue for a managed account solution. Such assets are typically not included in most target date funds' modeling, so if a large percentage of the employee population has them, it may call for a more customized solution. This could take the form of a custom target date product that is deemed to be suited to the plan's unique demographics, or a managed account that is built around each participant's needs.

Investors with defined benefit assets will have a future income source separate from their defined contribution assets, which changes their income replacement need. A managed account will take this factor into consideration when implementing an appropriate allocation. Company stock is another example. When a participant has assets that are concentrated into a single stock, their risk profiles are likely to be higher than the average participant. Assets in self-directed brokerage accounts may also have varying exposures to equity risk compared to the typical investor. In these cases, a managed account which provides a customized allocation that is built around these unique investments and risk profiles may be warranted.

A plan sponsor should consider what features are offered and utilized within the plan to help determine the potential effectiveness of a managed account program. In general, more complex financial situations call for more robust portfolio solutions, and in these cases, a managed account may be a better fit for those investors than an off-the-shelf product.

OPTIONS FOR IMPLEMENTING A MANAGED ACCOUNT PROGRAM

Of the plan sponsors who have chosen to offer a managed account solution, few have elected it as the Qualified Default Investment Alternative (QDIA) within the plan.[7] This is likely due to the fact that employees would be defaulted into a higher cost solution regardless of their financial position and their intent to interact. Because of this, most plan sponsors are choosing to offer managed accounts on an opt-in basis, where only participants who choose to enroll in the service will be part of it. If an investor takes the steps to enroll and agrees to the fee policy, they may be more likely to engage in the service versus someone who is defaulted into the program. This could be one way to ensure that only participants who actively choose to participate will be charged the fee for this program, and may be more likely to benefit from the additional services.

More recently, a few large record keepers such as Fidelity and Empower have introduced a new solution which allows for multiple QDIA options within a plan. This new service, called Smart QDIA or Dynamic QDIA, respectively, allows plan sponsors or advisors to set the criteria for determining which product the participant is defaulted into, such as age, account balance, presence of company stock, and/or deferral rate. For example, the employer may dictate that any participant who is younger than 40 would default into a target date fund, while any participant who is 40 years or older (and is therefore assumed to be closer to retirement) would default into a managed account. Once a younger participant turns 40, they would automatically convert from a target date fund to a managed account solution. This way, only employees who are closer to retirement or who have more complex financial situations will default into the managed account, since their likely larger balances and shorter time horizons make asset allocation even more crucial. The plan sponsor can determine what those factors are that make one product more suitable for particular investors than the other. This dynamic solution could be a way to ensure that the participants enrolled are receiving the maximum potential benefit for the expenses paid. In today's competitive environment, it is possible that other record keepers will launch similar QDIA services in the near future.

CONCLUSION

Managed accounts are becoming more popular in defined contribution plans.[8] Although these arrangements can add cost and complexity to a traditional fund lineup, they can also provide a unique solution for retirement savers that is significantly more customized than an off-the-shelf balanced or target date fund. By considering an investor's entire financial picture, as well as their personal goals and risk tolerance, a managed account has the potential to increase the probability for a successful retirement, and can help retirees to navigate through this phase of their lives with different withdrawal strategies.

When considering whether or not to offer a managed account in a defined contribution plan, sponsors need to conduct a robust due diligence process. This includes evaluating employee demographics to determine whether a managed account is likely to add significant value to the group. If employee demographics differ substantially from the national average or include a wide range of underlying sub-populations, the plan is more likely to benefit from a managed account program. Participants with defined benefit assets, company stock, or other outside assets may also benefit from a managed account versus an off-the-shelf product due to their more complex asset base. The selection of a managed account provider is a fiduciary act and if it is determined that a managed account program would be beneficial, sponsors should then thoroughly evaluate the managed account provider itself, including its methodologies for risk and asset allocation, and the level of services that it provides, to ensure that it is a good fit. The details of such process are beyond the scope of this article, and we would recommend that plan sponsors seek the guidance of an investment consultant to help with this task. Ultimately the plan sponsor should have a solid rationale and documentation for the decision that they made. While managed accounts are a complex solution that may not be a good fit for all plan sponsors, they offer some unique benefits that we feel are worth considering.

[7] "2018 Defined Contribution Trends", Callan, pg.24.
[8] "Defined Contribution Benchmarking Survey", Deloitte, 2017, pg.18.