

THE CURRENT STATE OF NEXT GENERATION PLAN DESIGN

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The 2006 Pension Protection Act (PPA) created some of the most sweeping changes in pension legislation since the original Employee Retirement Income Security Act (ERISA) of 1974. Five years later, the PPA continues to redefine the defined contribution

(DC) plan landscape, offering the opportunity for continued and important innovation in retirement plan design.

Today, the focus of much thought and debate is on how to produce better retirement outcomes—

ideally transforming an industry centered on savings to one focused on providing retirement income. That means innovation should address some of the structural flaws found in widely used default investments—qualified default investment

alternatives (QDIAs)—which are typically asset allocation funds such as target-date funds. Unfortunately, almost all widely used QDIAs do not properly address the income needs of current or future retirees.

On the positive side, the current state of plan design is a marked improvement over the previous paradigm. Coupled with the PPA's allowance for automatic enrollment and automatic escalation of participant deferrals, target-date funds do take into account the failure of plan participants to proactively manage their retirement savings and they do offer adequate risk diversification. Just as balanced funds were an improvement over investing in a single stand-alone fund, target-date funds combine the basics of behavioral economics and offer a pre-set asset allocation glide path. However, much more can be done.

By focusing solely on asset allocation, target-date funds fail to take into account participants' unique demographic differences (including human capital, gender, income levels, supplemental savings, and spousal demographics) as well as the fundamental issue facing all retirees: how much money can be used on a monthly basis to cover spending needs. Bottom line: Today's QDIAs don't offer what participants need the most—monthly income in retirement.

Here, Zvi Bodie, PhD, professor of finance and economics at Boston University School of Management, discusses the challenges facing today's plan sponsors as they struggle to provide complete benefits packages that not only satisfy current regulations, but also help to better prepare retirees for the challenges of retirement.

DC Dimensions: What are the top risks facing both individuals and plan sponsors in the current retirement landscape?

Zvi Bodie: For plan participants, it's risks to their standard of living or income throughout life. The resulting investment challenge is to transfer income or resources from the period in life when one earns the most to the period in life when one earns a lot less. A risk under the DC system is any disability that could affect a participant's ability to work and therefore save. This is not only true for the participant but also for a participant's spouse. There are a lot of people in their 50s with no desire to retire who are finding out that they're having to retire a lot earlier than they thought they would have due to family disability.

With respect to plan sponsors, the major impediment and the major defect in a lot of plans is relying on the fallacious idea that stocks are going to do the heavy lifting, that as long as the participant's money is invested—a large fraction of

it in the stock market—then you can count on a high rate of return. Stocks are risky in the short run, and they're risky in the long run.

DC Dimensions: What can plan sponsors do now to better prepare their workforce for retirement?

Bodie: There are a lot of things plan sponsors can do. It starts with basic education about financial fitness and the importance of getting out of debt. For a lot of people, that is one of the biggest challenges to saving. In terms of building up a nest egg, I just finished a book with Rachelle Taquu called *Risk Less and Prosper: Your Guide to Safer Investing*. The basic idea, contrary to what a lot of the conventional wisdom says about saving for retirement, is that you have to first and foremost worry about your basic needs. You need to target a minimum income level in retirement. Once participants have covered their minimum income levels, they can take on more risk in order to achieve a potentially higher income stream. This message needs to be delivered to plan participants through plan sponsor communication and education programs, and/or be incorporated by next generation defaults.

DC Dimensions: Speaking of defaults, what aspects should a default option have in order to better prepare plan participants for retirement?

Bodie: A good default option is tailored to an individual plan participant and his or her particular circumstances. We need defaults that combine the best features of both defined benefit and defined contribution programs. In other words, the default should offer defined benefit-like protection on the downside, offer a minimum guarantee, and be professionally managed. Combining the best of DC, the solution should allow customization, portability, and upside potential.

DC Dimensions: It seems like target-date funds have filled the “QDIA of choice” default since 2006 as the dominant savings vehicle for participants. What is the biggest shortcoming of today’s target-date funds?

Bodie: The biggest shortcoming is that there’s no income level being targeted. The target-date fund simply promises a certain mix of inputs of the portfolio composition. Plan participants don’t care about the inputs; they care about the outcomes. The term that’s used in connection with a target-date fund is a “glide path,” which actually is an apt analogy that brings to mind a flight plan. How are you going to get from where you are now to where you want to be at retirement? The current generation of target-date funds just tells you an expected time of arrival. It just doesn’t say where you’re going—that’s one hell of a flight plan! Participants need

a certain destination—at least a certain minimum level of standard of living in retirement.

As I think of what happened during 2008, when many target-date funds lost 30–40% of their value for plan participants who were about to retire, I am encouraged to know that many

can help close the retirement income gap. We used to think that this was in large part the government’s role, but we’re now seeing that people are being asked to do it on their own. An employer can provide a very valuable gatekeeping function in this new retirement paradigm.

“Participants in defined contribution plans don’t care about the inputs; they care about the outcomes.”

— Zvi Bodie, Professor of Finance at Boston University

retirement plan sponsors are now rethinking their approach to their current default options. Next generation default options need to offer a safe landing at plan participants’ target date, minimum income levels, and fundamentals of both DB and DC, and they need to accomplish this at a reasonable cost.

DC Dimensions: You said, “The plan participant really can’t do it alone.” Who else has a role in helping participants achieve their retirement targets?

Bodie: The employee benefits department can have a tremendous impact on participant outcomes in the US. Through basic plan design, the employer

DC Dimensions: Looking to retirement systems outside the US, are there any lessons to be learned that may help inform our readers?

Bodie: The Dutch have one of the best retirement systems in the world. However, it’s also not sustainable in its current form because it has promised too much. The Dutch have to find ways of lowering the level of guaranteed benefits (or quasi-guaranteed benefits) and shift more of the risk to the participants. I imagine their system will look more like ours in the future.

Australia and New Zealand have done the best job so far in providing free, objective online education to participants, but

that type of education only takes you so far. Even if you get people to pay attention, there's still the problem of getting them to implement. Education alone, no matter how well it's done, is never the complete solution. ■

READ MORE ONLINE

Find out more about the Dutch system in a recent paper by Zvi Bodie and Henriette Prast, titled "Rational Pensions for Irrational People: Behavioral Science Lessons for the Netherlands," on the Dimensional DC Services website:
<http://dfaus.com/dutch>



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