Workforce Management
December 2009
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Disaster-Proofing the DC Plan

Commentary: With many of the fires of 2008-2009 extinguished or at least under control, plan sponsors are now asking: What are the next ticking time bombs to avoid? Or to put it another way: How can we disaster-proof our plans against the next financial upheaval—whatever that may be? Here are some approaches under consideration.

By Lori Lucas

Early in 2009, a plan sponsor blurted out during an investment committee meeting, "I just need to make sure there are no ticking time bombs in my 401(k) plan!"

The plan sponsor was reacting at the time to the onslaught of unexpected 401(k) investment bombshells associated with the 2008-2009 market collapse. These included cratering market-to-book value ratios in stable-value funds, money market funds that were "breaking the buck," and material cash collateral reinvestment losses in securities lending funds. In essence, plan sponsors were finding that even their most staid investment funds were imploding, and that seemingly benign aspects of their plan were in crisis.

With many of the fires of 2008-2009 extinguished or at least under control, plan sponsors are now asking: What are the next ticking time bombs to avoid? Or to put it another way: How can we disaster-proof our plans against the next financial upheaval—whatever that may be? Here are some approaches under consideration:

Breaking out the inflation hedges: According to a recent Callan survey, Real Return/Treasury Inflation-Protected Securities (TIPS) funds are the most likely fund to be added to 401(k) plans' investment fund lineup in 2010. Moreover, the role of inflation-protection vehicles such as TIPS, real estate and commodities is increasing in many target-date funds as well. The reason is simple: Many plan sponsors fear the potential for severe inflation in the longer term, due to the twin Federal Reserve policies of low interest rates and a flood of liquidity, as well as massive federal spending to stimulate the economy. TIPS are particularly attractive to plan sponsors because they also offer additional fixed-income diversification opportunities. The majority of plans have only two fixed-ncome funds: a stable-value and a core bond fund. Some plan sponsors now believe it could be attractive to broaden the array of fixed-income offerings for risk-averse 401(k) investors.

Exploring a better target-date fund solution: Prior to the market crisis, target-date funds were viewed as the ultimate set-it-and-forget-it 401(k) investment vehicles. That perception has changed because of the wide variance in target-date fund performance during the market collapse—especially among funds geared to investors close to retirement—along with recent legislative and regulatory scrutiny. Plan sponsors are now debating whether their target-date funds should be managed with significant equity allocations through retirement to guard against longevity risk, or managed with a goal of being free of equity risk at retirement (assuming that plan participants will annuitize when they reach age 65). Plan sponsors are wondering if their target-date fund series should offer multiple risk levels (e.g., conservative, moderate, aggressive) in order to meet the varying needs of participants. They are even rethinking naming conventions, in some cases shifting to "birth-date funds" or "lifetime funds" and away from the concept of a target retirement date in the fund name.

Downside risk protection and guarantees: Just a couple of years ago, paying for downside protection—whether options strategies or annuities—was viewed as a waste of money. Now, plan sponsors are taking another look at downside-protection vehicles. These run the gamut from products that use options strategies in order to limit downside to products guaranteeing participants a certain stream of income during

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retirement. The buzz is particularly loud when it comes to in-plan annuities, such as deferred fixed annuities and guaranteed minimum withdrawal benefit products. Indeed, in Callan's survey, while only 7 percent of plan sponsors said they are very likely to add a guaranteed-income-for-life solution to their DC plans in 2010, 15 percent said they were "somewhat likely." The idea of attaching a guarantee to the near- or in-retirement portion of the target-date glide path has particularly caught the interest of some plan sponsors.

Rethinking capital preservation vehicles: In 2008-2009, plan sponsors felt particularly vulnerable when it came to their capital-preservation vehicles. Stable-value funds and money market funds were touted as a "safe haven." Yet many of these funds were not immune to the recent credit crisis. Now plan sponsors wonder if it is more prudent to strip away the appearance of stability when it comes to stable-value funds and simply provide a high-quality short-duration bond fund instead. Others are contemplating introducing a government money market fund as their capital preservation bedrock, despite the very low yields such funds offer. At a minimum, there is more care shown today than ever before about the way such funds are communicated to plan participants. For example, there may be more emphasis on stable-value funds' inner workings and less emphasis on their guarantees.

Are such initiatives by plan sponsors reactionary or prudent? Probably a little of both. The reality is that stable-value funds generally made good on their promises, and there certainly was little evidence of participant concern regarding these vehicles. According to the Callan DC Index, 65 percent of all money flowing into the funds of DC plans during the fourth quarter of 2008 was directed to stable-value funds. On the other hand, market-to-book value ratios on many stable-value funds dipped precariously low in late 2008 and early 2009. (The ratio represents the value of the underlying fixed-income portfolio relative to the guaranteed redemption value to participants.) Currently, and probably for some time to come, stable-value yields are coming under increasing pressure due to more stringent credit-quality requirements within the portfolios and higher costs for insurance wrappers. For this reason, it does make sense for plan sponsors to at least examine the efficacy of their capital-preservation and fixed-income alternatives.

Similarly, target-date funds have historically been viewed as somewhat generic investments, when in fact they are highly complex. It is wise for plan sponsors to step back and re-evaluate their goals in offering target-date funds, re-examine whether their current funds fit the demographics of the plan, ask whether their performance has met expectations and determine whether they have been communicated properly.

As for inflation-protection funds and downside-protection or guaranteed funds, plans sponsors should ask themselves whether these are truly a fit for the plan, or merely a case of good marketing by investment providers. TIPS could offer good diversification potential, but the market is relatively thin, and there's little U.S. experience with these funds during times other than those of low inflation. Guaranteed income-for-life funds hold considerable promise conceptually, but are marred by significant issues of counterparty risk, portability and cost.

There is one exciting finding brought to light by the recent Callan survey. Unlike last year, DC plan sponsors are prioritizing strategic initiatives, such as re-evaluating their fund lineup, ahead of tactical initiatives, such as monitoring manager performance. This means that sponsors believe their DC plans are on steady enough ground that they can begin to position them for the future. The concern, however, is that any initiative might be disproportionately affected by recent market events and concerns. Plan sponsors, consultants and other providers to the 401(k) market will all have to be on guard against reacting to events in the past, and instead implement approaches that look to the future.

Workforce Management Online, **December 2009**

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