New Research on 401K Plans, from Top Researchers

By Kerry Pechter *Fri, Apr 19, 2019*

Boston College, DCIIA and Morningstar provide new research on Britain's 'NEST' experience with auto-enrollment, custom TDFs and why replacing bad 401k investment options is a good idea.

Most 401(k) participants barely notice, but the products and services in their plans undergo constant tinkering. The updates might be small or huge. At a big corporation, subtle fee reductions might occur. At a small shop, employees might punch in one morning and discover that they can save at work for the very first time.

Changes at a single plan are often inspired by innovations that are rippling through the whole defined contribution (DC) industry, and those innovations are sometimes the subject of scholarly investigation. Three recent studies shed light on three of the latest trends.

In one study, the Defined Contribution Institutional Investment Association (DCIIA) publishes, for the first time anywhere, data on the use of custom target date funds (TDFs). Another study, by the Center for Retirement Research at Boston College, looks at the results of the UK's experiment with nationwide auto-enrollment in plans, known as NEST. A third study, by Morningstar, offers evidence that plan advisors should invest time and effort in identifying and replacing unsatisfactory funds.

DCIIA's custom TDF survey

TDFs are funds-of-funds into which the contributions of auto-enrolled participants can be automatically deferred. A company might offer 10 TDFs, each assigned to a different retirement date (e.g., 2020, 2025, 2030), whose exposures to equities gradually and automatically shrink (following a common "glide path") as their retirement dates (maturities) approach.

Just as senior executives at large corporations might wear bespoke suits, a giant company might create a uniquely tailored TDF as its plan's qualified default investment options (QDIAs) instead of using an off-the-rack TDF from one of the major vendors.

But apparently nobody was measuring this phenomenon until DCIIA, an association of asset managers that distribute mutual funds and other investments through DC plans, decided in 2017 to gather data from nine custom TDF designers on 673 unique funds at 65 retirement plans with some $990 billion in assets.

Overall, DCIIA estimated that about a third ($340 billion) of that $990 billion was in custom TDFs as of the end of 2017. That $340 billion represented 16% of total industry-wide TDF assets and 80% of custom TDF assets. Overall, DCIIA found an estimated total of $2.1 trillion in TDF assets at year-end 2017. The main components were:

- 51% mutual funds, with a market value of $1.1 trillion
- 29% collective investment trusts (CITs), with a value of $622 billion
- 20% custom TDFs, with a value of $430 billion

The $2.1 trillion represents a 61.5% increase over the $1.3 trillion estimated for 2015. "Improved reporting, auto-enrollment, and a bull market over the period contribute to the significant increase over the three-year period," said the DCIIA Research Center in its March 2019 ***Custom Target Date Fund (cTDF) Survey***.

"The fact that [DCIIA] could gather this information at all is significant," said Stacy L. Schaus, author of Designing Successful Target-Date Strategies for Defined Contribution Plans (Wiley Finance, 2010), in an interview. "There's been very little research that showed the size of the market, and now it's over $400 billion."

The study didn't provide details on individual custom TDFs. Instead, it showed the range among custom TDFs in their allocations to equities, fixed income, "inflation-sensitive" assets (TIPs, commodities, etc.) and "diversifiers" (bank loans, hedge funds, etc.). The custom TDFs appeared to differ most in their final allocations, at the retirement date.

For equities, the final allocations ranged from 12% to 39%; for fixed income, they ranged from 32% to 67%; for inflation-sensitive investments, they ranged from 5% to 46%; for diversifiers, they ranged from 1% to 30%.

"Custom TDFs allow investment options that packaged TDFs don't provide for," Schaus told *RIJ*. "A packaged TDF wouldn't have CITs or private equity. A custom TDF gives you more exposure to high diversifiers, like commodities and REITs [real estate investment trusts]. Any packaged TDF can give you access to institutional pricing, but at the custom level the pricing is even lower, assuming you have enough size to meet the investment minimums" required by asset managers.

One flew over the 401(k) NEST

California, Oregon and other Democratic Party-controlled ("blue") states are initiating statewide auto-enrolled salary-deferral IRA plans for workers whose employers don't offer retirement savings plans. The experience of NEST (National Employee Savings Trust), the UK's public-option savings vehicle, has helped guide the US states in designing, establishing and evaluating their own fledgling plans.

As reported in a recent ***Issue Brief*** from the Center for Retirement Research at Boston College (CRR), auto-enrollment in the UK under NEST has gradually increased private sector retirement plan participation rates to 67% in 2017 from 32% in 2012. That breaks down to around 90% for workers at medium and large employers and 70% at small employers.

The CRR reported these lessons from the NEST experience:

- Re-enrollment efforts don't seem to have boosted participation any further. Most workers who chose to opt out when first enrolled also chose to opt out when re-enrolled three years later.
- For employers with fewer than 500 workers, the UK participation rate flipped from being much lower than the US rate to significantly higher.
- Employers with 50-57 and 30-49 workers saw substantial increases in participation, with participation rates reaching 74% and 67%, respectively.
- Most new enrollees are making minimum default contributions, but the share of employees contributing at higher rates has also risen significantly.

The NEST experience "suggests that an equivalent reform in the United States could generate a sizeable increase in retirement plan participation, primarily among employers with fewer than 500 workers," the CRR said.

Replace those burnt-out funds!

In a new report, "**Change Is a Great Thing**," David Blanchett, head of retirement research at Morningstar, Michael Finke, chief academic officer at The American College, and Jim Licato, vice president, product management, Morningstar Investment Management LLC, questioned the conventional wisdom that plan sponsors are wasting their time in monitoring their investment menus (even though, in these litigious times, they risk accusations of a lapse in fiduciary duty if they don't).

The three authors used "a unique longitudinal data set of plan menus from January 2010 to

November 2018 that includes 3,478 fund replacements" in the plans of three retirement plan recordkeepers that use Morningstar's managed account services. They found evidence that the conventional wisdom isn't true.

"We find significant evidence that the replacement fund outperforms the replaced fund over both future one-year and three-year periods. The outperformance remains even after controlling for various fund attributes and risk factors. This analysis suggests that monitoring fund menus can improve performance, although more research on why this effect occurs is warranted," they write.

"Large-blend was the investment style with the most replacements, averaging 42.7 funds per year, which was 10.8% of the total funds replaced," the report said. "Equity was the most common broad style group, averaging 67.7% of replacements. Replacement funds tended to have lower expense ratios, averaging 5, 4, and 14 basis points for equity, bond, and allocation funds, respectively. Replacement funds tended to have higher historical returns, most notably at the five-year period, averaging 164, 41, and 70 basis points for equity, bond, and allocation funds, respectively."

Social Security reckoning point

With the exhaustion of the Social Security reserves ("trust fund") only 15 years away, Americans face a reckoning. They can ask the government to prevent Social Security benefits from dropping about 25%, but that would probably require taxes on high earners.

Alternately, they can choose to let benefits drop and possibly offset the lost purchasing power through contributions to some new form of universal DC plan.

Either solution would create new winners and losers, and therefore provoke opposition. The experience of other countries teaches that the less radical the change, the easier it would be to make.