Revolutionizing DC Plan Design

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Why institutional features are moving to all defined contribution plan markets

Design features once available only to defined contribution plans worth more than $1 billion can now be offered to plans as small as start-ups, and this trend is moving fast thanks to advances in technology at record-keepers and because of more efficient investment lineups.

Much of this change will continue to be aided by the Department of Labor’s (DoL) pending fiduciary rule, as more defined contribution (DC) plan sponsors look to engage in fiduciary arrangements, levelized compensation, and provide the most cost effective investment vehicles.

What has sparked this trend? Certainly, one factor has been the concerted effort of DC plans to incorporate defined benefit (DB) features into their plan design.

The “DB-ification” of DC Plans

Although DC plans supplanted defined benefit (DB) plans years ago as the primary retirement plan for employees, the “DB-ification” of DC plans shift started with institutional features such as auto-enrollment and auto-escalation, which provide a pension-like contribution method for participants, especially if there also is a company match or profit-sharing contribution.

Once participants are auto-enrolled into the plan, they typically are invested in the plan’s qualified default investment alternative (QDIA). Since the QDIA usually is a target-date fund, with a growing movement toward managed accounts, herein are the investment concepts of DB plans that are being used for DC plans.

In what’s commonly referred to as “glide paths,” plan sponsors bring participants’ portfolios to more conservative allocations as they get closer to retirement, and professional asset allocation is provided. This dynamic is enhanced further by the growing availability of custom target-date solutions available.

With a custom target-date fund, one can truly provide similar asset allocation and asset classes that would be common in a DB plan, but are not found in your typical DC plan. This includes a variety of fixed-income asset classes, alternative investments, and other asset classes. In the past, only large-plan record-keepers and their consultants where able to offer customized solutions; but now, many smaller market recordkeeping platforms can take the core menu investment options, and sometimes non-core investment option, to create a custom target-date fund for that specific plan.

If the QDIA is not a target-date fund but a managed account instead, plans would have the ability of creating a custom portfolio tailored specifically to that participant. Not only can they have a custom glide path and more custom investment allocation but also they can form fiduciary engagements with that managed account provider.

Beyond the QDIAs, core menus are evolving as well in order to appear more “institutional” in nature, in terms of consolidation and efficiency. As many institutional consultants are advocating for streamlined menus of eight to 12 options, more plans in the smaller markets are following suit. Part of this consolidation comes from the plans in the mega-market that are gravitating toward “white-label” strategies, whereby multiple asset managers can operate within a single option on the core menu.

Although the white-label concept has not been implemented across the board, there now are certain smaller plan providers that have packaged white-label funds on their platform. As the technology advances, this idea surely will continue to evolve. But whether or not the plan has white-label capabilities, more plans are looking to follow and consolidate their core menu lineups.

In addition to consolidation of the core menu, we also are seeing more and more 3(21) and 3(38) fiduciary programs at both the plan level and the participant level. These programs provide additional fiduciary guidance with the in-depth research process that once was only available through an institutional consulting firm.
Finally, the most universal trend that has spread to smaller markets is the reduction of fees. It has become increasingly common for plans of all sizes to have institutional mutual fund share classes, or “R6” shares. These share classes not only produce the lowest expenses for that fund but they also provide for the transformation of fee levels that has been standard in the institutional market for years. Due to the heightened focus on fees, we also have seen more plans looking to utilize Collective Investment Trusts (CITs). CITs have been utilized in the mega market as a more cost effective vehicle than a fund governed by the Investment Company Act of 1940, and are now commonplace in many smaller-plan lineups, especially as the vehicle of choice for stable-value and target-date solutions.

With the impending DoL fiduciary rule, all these trends should continue. Not only will many smaller-plan sponsors have the look, feel, and cost of an institutional plan but also it is more likely that they will have the benefit of institutional service experience from their advisor and consultant as well. That’s because many advisors who have worked with plan sponsors in the past may no longer prospect these plans due to the additional rules and scrutiny surrounding retirement plans as a result of the fiduciary rule. As the retirement business becomes more specialized, this will provide an environment whereby more plan sponsors will start working with dedicated DC advisors and consultants, and truly have an institutional experience.

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A 401(k) is a qualified plan established by employers to which eligible employees may make salary deferral (salary reduction) contributions on an aftertax and/or pretax basis. Employers offering a 401(k) plan may make matching or non-elective contributions to the plan on behalf of eligible employees and may also add a profit sharing feature to the plan. Earnings accrue on a tax-deferred basis.

Qualified Default Investment Alternative (QDIA). A QDIA is a default option of a retirement benefit plan that provides additional fiduciary protection when chosen by a plan sponsor. As described by the DoL: A QDIA is a product with a mix of investments that takes into account the individual’s age or retirement date (an example of such a product could be a lifecycle or targeted-retirement-date fund). An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual’s age or retirement date (an example of such a service could be a professionally-managed account). A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (an example of such a product could be a balanced fund).

Core menus are individual investment options available to all plan participants and part of the plan’s investment menu.

Non-core investment options are investment options that are not available to individual participants as a standalone allocation and are not part of the plan’s investment menu.

“White-label” strategies refer to custom investment options that usually consist of multiple asset managers and potentially multiple asset classes that are packaged as one choice on a defined contribution plan’s investment menu

3(21) Fiduciary A fiduciary program based on Employee Retirement Income Security Act of 1974 (“ERISA”) Section 3(21)

3(38) Fiduciary A fiduciary program based on Employee Retirement Income Security Act of 1974 (“ERISA”) Section 3(38)

Collective Investment Trusts (CITs) An investment vehicle designed for retirement plans that offers flexible pricing and tend to be less expensive than a fund governed by the Investment Company Act of 1940.