

# Megatrends in Retirement Planning

*Dan Cassidy*

Since 2001, the world of retirement planning has been buffeted by storms and upheavals that, as a result, have begun to transform the state of the industry. As such, a number of megatrends have begun to emerge. Human resources practitioners are already feeling the effects of these. Thus, understanding what is going on, coupled with implications for new ways of dealing with the megatrends, will go a long way toward successful HR implementations of retirement plans. This article explores these megatrends in detail. With this information, HR managers will find themselves better prepared to cope with these radical new changes.

Six major megatrends need to be addressed above any others. All of these are literally driving the retirement industry. The six megatrends are:

1. Asset-based solutions—including “portable alpha” strategies
2. Globalization
3. Death of defined-benefit (DB) plans, followed by DB-ification of 401(k) plans
4. Bundling of service providers
5. Enterprise risk management
6. Demographics

Let's take a brief look at each.

## ASSET-BASED SOLUTIONS

For DB plan sponsors, the trend over the past 20 years has been to look to the liability side of the balance sheet for solutions. If the plan was “too expensive,” a plan sponsor would begin a design study rather than look to the asset side to solve the problem. Combine this with the seemingly constant regulations coming out of Washington calling for required plan-design changes. The major consulting firms, such as Hewitt, Towers Perrin, and Mercer, blossomed during this period to help their clients manage this process. The primary example of the significance of liability-side management has been the conversion of many DB plans to cash-balance plans—a hybrid DB plan design. Various surveys highlight the prevalence of these new designs. One-third of the Fortune 100 and 19 percent of employers with more than 1,000 employees have now converted their plans to cash-balance plans.

The U.S. government and courts have struggled with the issues surrounding the cash-balance conversions. This uncertainty has put a stop to the conversions for the most part. Besides this uncertainty, some employers froze their plans altogether. Watson Wyatt's 2005 survey of the Fortune 1000

showed that 116 froze or terminated their DB plans since 2001. All of these attempts—cash-balance conversions or plan freezes—are liability-side methods to manage retirement-plan costs. For those employers who remain committed to DB plans, the only realistic area to manage costs is on the asset side.

Portable alpha strategy is among the plans that sponsors are looking at to extend the duration of the fixed-income portfolio to better match that of liabilities. It requires derivatives and other investment vehicles that some plan sponsors may not be comfortable with. However, we see this trend continuing and would recommend that all plan sponsors get comfortable with derivatives to help control pension-plan risks.

## Understanding the Basics

To understand portable alpha strategies, you need to get comfortable with some basic con-

*Historically, pension funds have attempted to find alpha-generating managers through traditional investment management searches in various asset classes.*

cepts from modern portfolio theory. Investment return from any actively managed portfolio can be broken into alpha and beta. Beta is defined as the investment return generated from market exposure and is essentially the return earned for bearing the risk of market investing. Alpha is the excess return—either positive or negative—that a fund manager generates from the active management of the portfolio.

Historically, pension funds have attempted to find alpha-generating managers through traditional investment management searches in various asset classes. So, for example, a pension fund would determine its asset allocation—say, 15 percent or \$15 million—targeted

to the U.S. long-bond asset class. The fiduciaries would then hire an investment consultant to help them find the best manager in that particular asset class. After a search, the fund would give the entire \$15 million to the investment manager, who would then deploy the dollars according to the manager's strategy. The investment manager would be compensated at a level—say, 50 basis points—on the entire \$15 million, or \$75,000. The fiduciaries would sit around and hope that this manager could replicate his or her past performance and, in fact, produce positive alpha while being exposed to the asset class's beta.

## Portable Alpha Process

Compared with the traditional investment model described above, portable alpha strategies divorce the search for alpha from beta. The following example provides more detail on how strategy is deployed. Using the same example above with a \$15 million desired allocation to U.S. long bonds, the fiduciaries have confidence in a European equity manager and believe they will produce significant alpha in the near term. In addition, the expected alpha of the European equity manager is significantly higher than the expected alpha of the current U.S. long-bond manager. The fiduciaries, however, do not want to be exposed to the European equity market, so they adopt a portable alpha strategy as follows:

1. Allocate fund to the European equity manager seeking high alpha.
2. Use derivatives to "short" the European equity market (i.e., sell futures of the Japanese market).
3. Use derivatives to "long" the U.S. long bond market (i.e., buy futures of the U.S. long bond market).

A portable alpha strategy includes some key benefits, such as:

- ❑ Separates the search of alpha from the search of beta (asset-allocation exposures),
- ❑ Targets investment management fees to alpha sources and reduces investment management fees for beta sources, and
- ❑ Can diversify across multiple, uncorrelated alpha sources while maintaining pension plan's asset-allocation exposures.

Some challenges of executing a portable alpha strategy include:

- ❑ Plan sponsor must find alpha sources on a consistent basis.
- ❑ Successful coordination between alpha generators and the porting process is critical.
- ❑ Plan sponsor must be comfortable with entering into the derivative marketplace. Many pension-plan investment-policy statements specifically exclude derivatives from allowable assets.

Overall, portable alpha strategies can be appealing to pension-plan sponsors looking for ways to control risks. And, more important, we see a trend of plan sponsors being more accepting of entering the derivative market. By allowing the full spectrum of investments available today in the global marketplace, plan sponsors can dial in the risk level they want.

## GLOBALIZATION

By globalization, we include all types of changes to our world from the financial service industry to accounting requirements to employment to government barriers. Many of

these changes may only apply to multinational corporations; however, all employers, regardless of size, should consider the ramifications for their organizations.

## Financial Service Industry

The world is getting smaller, and the ability for global capital to flow between countries has never been greater. Retirement plans can now get exposure to emerging markets in an efficient manner. Investment managers now compete on a worldwide basis, and investment firms compete to attract their talent anywhere in the world. Hedge funds have exploded in numbers as investment managers attempt to exploit inefficiencies in the global marketplace. Operating costs will continue to drop, putting more sophisticated vehicles in

*The world is getting smaller, and the ability for global capital to flow between countries has never been greater.*

the hands of the average investors. This will require significant investment in education and dissemination of knowledge to allow investors throughout the world to assess the risk/return trade-off of the particular vehicle.

## Accounting Requirements

In the past, each developed country had its specific accounting standards that would apply to any publicly traded company. The British, Canadian, French, German, and Japanese financial industries each developed their own standards. In the past several years, however, the push has been to establish common international accounting standards. Two major benefits of robust international standards include:

- ❑ Companies need to comply with only one standard for each country where their stock is traded.
- ❑ Investors can more effectively compare financial records based on a single method. Currently, adjustments are required to compare companies traded in the United States versus Germany, for example.

While the benefits are clear, the speed by which individual countries adopt the international standards will be incremental and take 10 to 20 years.

## Employment

No matter whether it is companies operating globally, outsourcing operations to lower-cost countries, or smaller companies attracting talent regardless of location, employment opportunities and their complexities will con-

*The slow decline of DB plans has been well documented and is quickly accelerating.*

tinue to increase over time. Retirement-plan solutions will continue to include offshore pension arrangements that move beyond national borders.

## DEATH OF DEFINED-BENEFIT PLANS

The slow decline of DB plans has been well documented and is quickly accelerating. We predict that the DB marketplace will continue its path and eventually be dumbbell-shaped. The only companies that will have DB plans will be either small, closely held firms using DB plans for tax avoidance or jumbo companies that will never close. (We include large

public plans in the jumbo definition.) Midsized organizations will continue to freeze and terminate their plans.

Small organizations that initially adopt a 401(k) will not adopt DB plans when they grow in size for fear of the financial uncertainties. This slow death of DB plans will be accelerated by two things:

1. Rise in interest rates that will reduce the cash required to terminate any DB plan—whether it is frozen already or not. We predict that if interest rates rise by 200 basis points, you will see a flood of DB plans terminate. This will reduce the number of plans from today's 30,000 to fewer than 10,000. This reduction will exacerbate the current problems with the entire pension system, since the insurance system guaranteeing DB plans is self-funded.
2. The government's inability to control the skyrocketing liabilities being pushed onto the Pension Benefit Guaranty Corporation (PBGC)—the quasi-government agency responsible for insuring DB plans—will also force plan sponsors to terminate their DB plans. The PBGC insurance program is seriously flawed and promotes bad behavior on financially distressed organizations. Because healthy DB plans pay for the unhealthy ones, if the number of DB plans continues to fall, the PBGC premium income will spiral down and the system will crash.

## 401(k) Plans Filling the Gap

From the ashes of the demise of DB plans, we now see 401(k) plans adopting many of the best features of DB plans. These changes that we see now in 401(k) plans are being

made to fix many of the problems the 401(k) plans have in actual operation. The following runs through some of these changes that have happened and some that we predict.

### Participation

The problem is that many 401(k) plans have very low participation rates, especially among the employees who most need assistance saving for retirement. The fix is automatic enrollment and/or negative elections. These two features both work to force employees into the plan immediately upon hire. It works by automatically enrolling employees at a set rate—say, 3 percent—on employment. If an employee does not want to participate, he or she can elect not to; however, research shows that is unlikely. DB plans always had automatic enrollment and this problem was never an issue. The recently passed Pension Protection Act of 2006 included specific provisions that further spur plan sponsors to adopt these features.

### Investment Elections

Many participants do not make any investment elections after they join the 401(k) plan. The plan invests their accounts in the default fund—which was typically a money-market fund. Now, plan sponsors are looking more closely at this default-fund choice because they see that participants never shift out of the money-market fund—which will not keep pace with inflation. Today, plan sponsors are selecting balanced funds that may change a participant's risk profile based on his or her age.

### Distribution Options

Most 401(k) plans provide for lump-sum distribution of the account on retirement. Many

participants are troubled when faced with making an investment that will affect all of their retirement years. Many 401(k) plans are now exploring annuities and other payout options that give the participants additional choice that will guarantee monthly income throughout their remaining lifetime, as shown in a recent (2005) Hewitt survey. Hewitt found that 20 percent of companies now offer annuities as a form of payment for final distributions, which is up from 17 percent in 2003. When available, 6 percent elected an annuity, which is up from 2 percent in 2003.

### Disability

Since the driving force in 401(k) plans is the employee's own salary deferrals, if an individual is not employed due to a disability, his

*Today, plan sponsors are selecting balanced funds that may change a participant's risk profile based on his or her age.*

or her retirement savings can be significantly affected. Most long-term disability plans do not contemplate these lost contributions and/or provide insufficient income to employees to continue to make 401(k) plan contributions during a time of high medical costs.

Progressive plan sponsors are looking to add disability coverage directly within the 401(k) plan. Participants can select an option, just as with other investments, that provides for continuation of 401(k) contributions in the event of a participant's disability. This insurance option, though not commonplace today, will grow in popularity as 401(k) plans become the only plan for most employees. IBM has begun to offer this insurance and major insurance companies (UnumProvident,

MetLife, AIG) are working to include their offerings. DB plans typically included disability provisions that provided for continued accrual of benefits as well as early commencement of benefits.

### Deferred Annuity Options

The problem here is that greater investment risk is being shifted to employees with 401(k) plans. Many employees are not suited either by education or desire to make investment choices. This indecision shows up in many studies in the form of poor asset allocation, no investment choice being used, and other inactivity. The fix is to provide an option within the 401(k) plan that purchases units of deferred annuity with each salary-deferral contribution. This "new" concept was developed decades ago when insurance companies dominated the retirement-plan package. Today, we see this option when insurance

*Overall, we applaud the changes that 401(k) plans are adopting to solve real problems with the actual operation of their plans.*

companies provide the bundled administration and investments for a plan. New York-based MetLife has introduced a deferred fixed annuity that converts into an immediate fixed annuity upon retirement. It works like this: An investor can put money into the annuity in increments, locking in an interest rate. When the investor retires and the deferred annuity converts to an immediate one, the payouts are based on the rates at the time of investments. With a traditional fixed annuity, the return would be based on the rate at the time of conversion. We see it moving beyond insurance company-based models and into all 401(k) plans, even those managed

by mutual fund companies. DB plans always focused on the ultimate benefit paid to participants, so it would not expose them to investment risk.

Overall, we applaud the changes that 401(k) plans are adopting to solve real problems with the actual operation of their plans. These changes address many of the shortcomings in 401(k) plans. However, participants still bear the associated investment risk. We believe the financial services industry will continue to bring cost-effective solutions that will help participants shift risk to organizations more suited to handle these risks.

### BUNDLED SERVICE PROVIDERS

In the small and midsize marketplace, providers are pulling together all functions associated with retirement-plan management. And in many cases, they are also providing bundled services for both defined contribution and DB services. These changes are being driven by both plan sponsor demand and technological developments. We see this trend accelerating with service centers moving offshore to lower-cost countries. The advantages to employers are significant, with cost reductions paramount. In addition to the continued dominance of bundled providers, we predict that you will see an increase in the use of independent fiduciaries and retirement advisers.

With all the retirement-plan services bundled with one company, fiduciaries are exposed to increases from the concentration with a single source. Although many of these bundled providers include additional services such as performance monitoring, access to legal counsel, and actuarial consultants to help plan sponsors manage their fiduciary duty, we see an increased demand for inde-

pendent advice. We predict a substantial increase in the use of independent fiduciaries and investment consultants as a result of the move to total retirement outsourcing.

## ENTERPRISE RISK MANAGEMENT

Our clients are now looking at their retirement plans in relation to their entire business. Other employee-benefit programs are also scrutinized to see how they affect the overall risk of the employer. Medical programs—both for active employees and retirees—top the list of companies' focus points. Companies are starting to talk about what risk they want to hold and what risk they can transfer to employees or onto other financial markets. Enterprise risk management (ERM) is defined by the Casualty Actuarial Society as "the discipline, by which an organization in any industry assesses, controls, exploits, finances, and monitors risk from all sources for the purpose of increasing the organization's short- and long-term value to its stakeholders" (see <http://www.casact.org/research/erm/overview.pdf>).

Enterprise risk management should force companies to be more educated about where they can provide a competitive advantage and, therefore, should keep the risk or transfer it to reserve "risk capital" for other projects. This ERM trend has been spurred on with the passage of the Sarbanes-Oxley Act, which forces companies to take a risk-control perspective throughout their organizations. Executives need to put in place controls that will catch any problems before they happen.

For retirement plans, ERM means that employers will no longer look at their retirement plans as silos, but as part of the broader organization. Managers will consider the impact of the business's life cycle—whether they are in a growth phase, maturity, decline,

and so on—and how that intersects with the life cycle of the retirement plan. This disconnect is apparent when one considers the automobile industry, where some manufacturers have three retirees for every one worker. Combine the business life-cycle concerns with strategic concerns such as competitiveness within an industry such as we have seen with the airline industry recently. The new lower-cost carriers do not have high-cost DB plans; therefore, they have lower operating expenses. For all of these reasons, we predict that com-

*For retirement plans, ERM means that employers will no longer look at their retirement plans as silos, but as part of the broader organization.*

panies will continue to use ERM techniques to manage their retirement plans in the future.

## DEMOGRAPHICS

The demographics facing the United States are well documented in the media. The aging of our population, the baby boomers starting to enter their retirement years, and a reduction in the birth rate will all have a tremendous impact on our society. The never-ending debates about how to solve the Social Security problem seem to flare up with each new presidential administration. For our purposes, we would like to highlight three areas that employers can focus on now that will help them navigate their organizations through these huge demographic changes.

### Employees Working Longer

The image of people taking early retirement will not be and probably was not reality. Employees, for better or worse, understand that they can probably expect to work longer

than their parents did. Whether it is because of financial needs or the desire for social interaction, employees today do not expect to retire at 65. Other societal changes also impact this—such as people getting married later in life, having children later in life, having second or third marriages (some combined with new children)—and all contribute to the understanding that employees will have to work longer. Medical advancements have enabled many people to be productive after the initial onset of once-dreaded diseases.

### Phased Retirement

Combined with the expectation of people working longer, older workers are exploring ways to work that are outside the normal full-time commitment. Our government still puts up certain roadblocks for retirement plans to fully support this phased retirement, but many special interest groups are actively pursuing these changes. Probably one of the biggest factors for employees looking to continue working in some fashion is access to medical care.

With the medical system in the United States tied to employment, we see this tension continuing. We do not believe the medical system in the United States will change if left alone. Only through government intervention will any major structural changes occur. Given the current environment in Washington, we do not believe there is enough willpower to make the tough choices to change this.

### Generational Differences in Outlook

Employers need to recognize that the multiple generations within their workforce look at retirement planning significantly differently. Younger people do not believe that Social Security will be there when they reach retirement age. This is a troubling thought, because one of the key tenets of Social Security is that it should cover every worker in the U.S. economy. This tenet of universal coverage was crucial when President Franklin D. Roosevelt proposed the program so that Social Security was not viewed as welfare. If the poor were the only ones to receive Social Security benefits, then the remaining people would view it as another welfare payment.

If the younger population loses confidence in the system, overall support for Social Security will be reduced. If this trend continues, the confidence and expectation of Social Security will be so low that our society will stop supporting it and we will revert back to a system based on personal employment-based savings only. Demographically, as the baby boomers continue to retire, this bugle of Social Security beneficiaries will move through the system like a pig in a python. If Social Security does not maintain the confidence and commitment of the remaining population, it may quickly dwindle and be eliminated. We would then be back to a welfare system supported by general tax revenues. That is certainly not what FDR envisioned in the 1930s.

*Dan Cassidy is president of Argus Consulting Ltd. of Concord, Massachusetts, providing retirement-plan consulting services for qualified and nonqualified benefit plans of clients in the United States, United Kingdom, and Canada. This article is based on Chapter 8 of his new book, A Manager's Guide to Strategic Retirement Plan Management (2006, John Wiley & Sons). He may be reached via e-mail at [danc@arguscl.com](mailto:danc@arguscl.com).*