

What lies ahead?

A three-year outlook on retirement plans

In August of 2006, Congress passed the most sweeping retirement legislation since ERISA. With dramatic changes to both defined contribution and defined benefit plans, the Pension Protection ACT (PPA) could reform how working Americans save for retirement. As a result, many plan sponsors are wondering what big changes will come next. To help sponsors peek into the future of retirement plan management, T. Rowe Price sat down with leading experts to ask: What's going to happen in the next three years?

We spoke with four industry leaders to answer this question: David L. Wray, President of the Profit Sharing/401(k) Council of America; Daniel Cassidy, President of Cassidy Retirement Group, Jamey Delaplane, a partner at Davis & Harman LLP; and Alan Levenson, T. Rowe Price Chief Economist. These experts revealed many issues affecting retirement plans today along with potential trends that will shape sponsor decision-making in the near future.

David L. Wray

is the president of the Profit Sharing/401(k) Council of America. He was the 2004 Chair of the Department of Labor's ERISA Advisory Council, and author of *Take Control With Your 401(k)*.



Daniel P. Cassidy

is the president of Cassidy Retirement Group, an independent actuarial consulting firm focused on mid-size retirement plan sponsors. He has over 18 years of benefits consulting experience and is the author of *A Manager's Guide to Strategic Retirement Plan Management*.



Jamey Delaplane

is a partner in the law firm Davis & Harman LLP, where he represents financial institutions, employers, and public policy organizations on employee benefits, financial services, and tax matters before the U.S. Congress and the federal executive branch agencies.



Alan Levenson

is a vice president of T. Rowe Price Group, Inc., and of T. Rowe Price Associates. As T. Rowe Price's chief economist, his central role is to contribute to the formulation of investment strategy in the firm's Fixed Income Division.



THE CHANGING VIEW OF RETIREMENT

When Social Security was first established, and along with it the benchmark for retirement, America was facing a surplus of labor, a shortage of jobs, and shorter life spans. According to David Wray, the accepted understanding that our working years should come to an end in our mid-sixties is partially the result of the Depression-era mindset. At that time, Americans were taught to think that at a certain age, they should leave the work force, therefore creating a vacancy for younger workers.

"Today, we're overcoming a limited view of retirement that began in the Depression era. I think we're in the process of changing that view to something much healthier and appropriate to the way people are living now," says Wray.

The idea of sitting in a rocking chair or playing golf as a full-time diversion is fading. Americans retiring today can reasonably expect to live healthy and active lives for 30 years or more. The baby boomers who are now entering early retirement have a dramatically different idea of how they want to live—and work—during this phase of their lives.

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REACHING OUT TO PRERETIREES

As the baby boomers start retiring, there are not as many young people entering the labor force to replace them. And, as Wray explains, these younger workers are not as well educated, or skilled.

"In the next one to three years we'll see a tight labor market," says Wray, "4.4% unemployment is a significant challenge for employers."

He believes employers will reach out to their preretiree population well before their projected retirement to encourage a continued relationship with the company. "There is a significant need for employers to hang on to their mature workers. They have greater tenure, experience, and bring value to their work."

Another facet of this conversation employers will have with their preretiree population involves planning for income in retirement. Wray says, "Some employers are paternalistic and will want to help employees with the distribution phase. They'll want to help employees avoid taking a lump-sum distribution and blowing it. Other employers will be more self-interested, wanting to engage these employees and continue their relationship with the company."

He adds that retirement plans are an attractive method for hanging on to employees.

“Employer contributions into a retirement plan are not subject to FICA, so employees see a dollar-for-dollar benefit. It’s likely that the level of employer contributions will grow in the near future but it’s more likely to grow in the form of profit sharing.”

SHIFTING THE FOCUS FROM ACCUMULATION TO DISTRIBUTION

The retirement planning industry has long focused on helping Americans accumulate savings for retirement. To that end, the Pension Protection Act endorsed automated services for today’s defined contribution plan. These services are proven to be the most effective method of helping the vast majority of employees save and invest for their future. But now that automated services are established and carry the approval of the U.S. Congress and the Department of Labor, industry leaders are turning their attention toward sustaining income in retirement.

“With automated services, the 401(k) is acquiring some of the best features of defined benefit plans. The distribution phase will be the next area for improvement,” says Daniel Cassidy. “There will be a host of options that will emerge in the next few years to assist in the creation of a retirement income stream. Service providers and employers will want to help people maintain income through a potentially lengthy retirement.”

One method to help employees sustain their income through retirement is to automate the withdrawal process. Automated services offer the ability to simplify distribution decisions, reduce lump-sum withdrawals, and provide consistent income.

Jamey Delaplane also sees this issue emerging in Congress. “More attention will be given to establishing a default distribution process. This automated distribution would probably come forward as an opt-out service and may include tax incentives. New legislation may also encourage greater use of annuities.”

Speaking directly about the PPA’s impact on automated services, Delaplane says, “There is a real excitement over default systems and automating the decisions that surround saving and investing. With auto-services, we’ve now constructed a system that is going to work well for the disinterested participant.”

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REDUCING THE NUMBER OF INVESTMENT OPTIONS

Defined contribution plans have struggled with the number of investment options to offer within the plan. At one time it was thought that variety and choice were optimal. Now industry research is showing that fewer options—and therefore less investor confusion—can be more effective.

Several of our experts concur, noting that they foresee investment menus diminishing over time. Many feel that the three safe harbor default investment options—target date funds, balanced funds, and managed accounts—will grow in popularity and eventually replace the traditional investment lineup.

“Automated services will have a big effect on the investment mix that plans offer,” says Delaplane, adding, “The share of the sponsor population for whom an investment menu is relevant will become rather small. In the future, sponsors will spend most of their time choosing default options and setting up brokerage windows for the self-directed minority.”

Cassidy agrees with Delaplane that plan investment lineups will dwindle but doesn’t foresee a need for brokerage windows. “Plans don’t need to be everything to everybody. Sponsors only need to follow their fiduciary responsibilities.”

Delaplane also predicts a significant increase in the use of managed accounts. In addition to a participant’s age, current savings, and other investments, managed accounts take defined benefit assets into consideration. According to Delaplane, “Managed accounts are maturing in the marketplace, their fees are being reduced, and there is a greater openness to them overall.”

According to Wray, another issue affecting investments will be increased scrutiny of investment performance. He believes the average account balance will increase substantially and therefore reduce investor tolerance for underperformance. Wray says, “Performance is going to be critical because the average account balance is going to grow from approximately \$10,000 to \$100,000.”

Wray believes that this will influence the frequency of investment reviews, saying, “Formerly, investment reviews were conducted annually. But now, quarterly reviews will need to take place. There’s going to be a tightening down around the edges.”

INCREASING SCRUTINY AND OVERSIGHT

As the 401(k) becomes America’s main retirement plan, scrutiny will extend beyond investment performance to all aspects of plan management and administration.

“Management is going to face greater scrutiny than they have in the past,” says Wray, “the first evidence of this is being seen with fees.”

Cassidy agrees, “The lawsuits are pushing the entire industry toward greater transparency. Sponsors are going to need to perform due diligence with respect to fees and communicate them well with participants.”

Delaplane adds, “Government oversight of defined contribution plans will become a theme. There will be more congressional oversight of plan management and the initial focus will be on fees.”

For sponsors feeling wary of this increased scrutiny, Cassidy offers some advice, “Sponsors need to have a prudent process in place and really follow it. It’s important to take the review process seriously, get value for every dollar that is spent in the plan, and improve disclosure to participants.”



CONGRESS MAY FOCUS ON THOSE WITHOUT PLANS

As a result of the PPA, Jamey Delaplane foresees a pause in retirement-related legislation, and says that the next two years will lay the groundwork for future legislation by establishing the next set of key issues.

“Given the reality of where we are, and the predominance of the 401(k) as America’s retirement savings vehicle, the new focus will be on communicating messages that bolster a savings and ownership culture,” says Delaplane.

He expects that the Democratic Congress will introduce retirement savings initiatives that attempt to reach all Americans, but particularly those with lower incomes. “I think we’ll see some attention paid to the Saver’s Credit (an income tax credit for lower income savers). Democrats may want to make the Savers’ Credit refundable so people who don’t owe taxes can still benefit from this saving incentive.” To further encourage saving for this population, Delaplane thinks Democrats may also try to expand the Savers’ Credit.

Democrats will also seek opportunities for expanding defined contribution coverage to more Americans. One popular idea is to offer a payroll-deduction individual retirement account at businesses that don’t offer a qualified plan.

“Congress may look at encouraging, or even requiring employers to offer a payroll-deduction IRA if no other retirement plan is made available. This could see bipartisan backing,” Delaplane says.

Additional retirement proposals in the next few years may include extending the auto rollover provision to all rollovers, not just account balances above the \$5,000 threshold.

In addition, health care costs may factor into legislative plans in the near future. Legislators are aware that health care is a major challenge for retirees and that a more integrated approach is needed for managing retirement income and health care costs. According to Delaplane, “Congress may look at opportunities for financing long-term care directly inside of qualified plans or IRAs.”

FORECAST: A SLUGGISH ECONOMY TO PICK UP IN 2008

Understanding the issues that will impact retirement plans in the next three years requires a look at how the economy will take shape during this same period. Alan Levenson says the first issue of concern with most investors today is whether inflation will become a threat. He doesn’t see a reason for alarm with regard to inflation, saying, “The economy has been softening. The housing market is experiencing a hard landing that is creating a soft landing in the larger economy. In addition, the strong labor market is helping to drive down corporate profits. Unemployment has fallen, labor costs have accelerated, and productivity has slowed, thus squeezing profit margins. Therefore, corporate profit growth is likely to moderate in the coming year.”

“During this time frame, inflation is likely to remain moderate at 2.5% to 3%, which is not a reason for concern. Growth in inflation is buffeted by the Federal Reserve, better price discipline, and an open, global economy. It’s no longer the enemy it was in the 1970s and 1980s, and it’s very unlikely that it will get out of control.”

According to Levenson, the prominent issue that shifts this economic outlook from a one-year view to a three-year projection is housing prices. In 2007, the slowdown in the housing sector

will cause the economy to remain sluggish. However, he forecasts that by the end of next year, the market should rebound and, as a result, the broad economy will likely fare well in 2008 and 2009.

“The Federal Reserve has raised its lever for controlling the economy 17 times in two years; however, long-term rates have not risen in accordance,” says Levenson. “The federal funds rate has risen from a low of 1% in 2004 to its current rate of 5.25%. But long-term rates are not likely to go much higher than they are now.”

“While the economy will enter a period of decreased growth in the next year, it is not likely to stop growing or to enter a recession. A period of better growth will emerge in the following two years. Corporate profits have grown at a rate of 20% in the recent past and are projected to grow at only 5% next year.” ❖

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