



## **Automatic Enrollment or Managed Account?**

*A managed account program may be the most realistic solution for sponsors looking to address the long-term retirement income needs of plan participants*

## **Introduction**

Clearly, the issue of retirement income adequacy has come to the forefront of the retirement industry. Over the next several years, as baby boomers begin retiring in bigger and bigger numbers, solving the retirement income gap dilemma in America will remain perhaps our biggest priority as an industry.

In many ways, we are headed toward the right solution. Automatic enrollment and other ancillary automatic features (with significant support through the Pension Protection Act) are clearly steps in the right direction. We are acknowledging the problem and creating potential solutions.

However, before we get too far ahead of ourselves, we need to ask one question: does automatic enrollment (and its associated qualified default investment alternatives) represent the most realistic solution for sponsors looking to truly address the long-term retirement income needs of their plan participants? This position paper posits that the answer to that question is: “no.”

## **Automatic Enrollment: a step in the right direction**

According to a recent joint research report commissioned by the American Savings and Education Council and AARP entitled “Preparing for Their Future: a Look at the Financial State of Gen X and Gen Y,” only 15% of younger working Americans feels very knowledgeable about saving for retirement. In contrast, 40% feel very knowledgeable about their iPods.

The results came from an online survey of 1,752 young people in early 2008. The report includes survey responses from both Gen X (ages 28 to 39 years old -- born 1968 to 1979) and Gen Y (ages 19 to 27 - born 1980 to 1988).

Automatic enrollment (and ancillary elective features such as automatic contribution increases) allows plan sponsors to adopt retirement plan features that force some employees to save for retirement. It can help create new savings opportunities for younger workers. In fact, according to the research report cited above, most young people welcome having employers take a more active role to encourage employees to contribute to employer-sponsored retirement savings plans. Overall, 85% of respondents think it is a good idea for employers to voluntarily enroll workers automatically in a retirement savings plan and set up automatic contributions from workers’ paychecks.

Automatic enrollment can potentially help older workers retire more comfortably when they are ready. In addition, automatic enrollment may also help plan sponsors meet their fiduciary responsibilities. Whatever the reason may be, more and more plan sponsors are adopting automatic features for their retirement plans. Automatic features are becoming more and more popular regardless of the type of business, company size or employee demographics.

Automatic enrollment (also known as automatic deferral or negative election) allows employees to be automatically enrolled in their retirement plan and requires them to “opt out” if they do not wish to participate in the plan. Some plan sponsors require employees to opt out every year if they don’t wish to participate.

## **Ancillary automatic elective features**

In addition to automatic enrollment, **automatic contribution increases** may also be adopted by a plan. The amount employees contribute to the plan is increased up to a pre-determined amount. Here are the two major types:

**Plan-determined increases:** increases are determined at the “plan level.” The plan sponsor determines that everyone’s contribution to the retirement plan is increased by a set amount (usually 1% or 2%) every year. The increase will occur on a set date, such as the first of the year or at merit increase time when one percent won’t have a big impact on take home pay (but can have a positive impact on retirement savings accumulation over time).

**Participant-determined increases:** increases are determined at the “participant level.” Employees choose the amount of the automatic increase and the timing of that increase. The increase will automatically occur on the date the employee selects.

**Automatic investment selection** allows the plan to default employees into Qualified Default Investment Alternatives (QDIAs) with built-in investment selection and ongoing asset allocation management. Some of the most popular investment strategies adopted for automatic investment selection include:

**Age-based target-date retirement funds** (also known as life cycle funds): employees are defaulted to these strategic investment options selected by the employer based on age. The funds offer asset allocation, professional management and ongoing rebalancing.

**Risk-based asset allocation funds** (also known as life style funds): employees are defaulted to these strategic investment options selected by the employer based on investment risk. The funds offer asset allocation, professional management and ongoing rebalancing.

Although the Department of Labor has ruled that a **managed account** may also be utilized as a QDIA, there has been very little adoption so far by plan sponsors. Hewitt’s 2007 “Trends and Experience in 401(k) Plans” report found that only 4% of the 302 surveyed plans with automatic enrollment use managed accounts as the default, compared with 50% for target-date funds and 15% for asset allocation funds. Another 13% chose balanced funds and 18% chose money-market and stable-value funds.

## **However, is automatic enrollment versatile enough for the long run?**

At The Standard, we believe the Pension Protection Act of 2006 was a huge step in the right direction. It encourages employers to enroll their employees automatically in an employer-sponsored 401(k) and provides an ERISA exemption from state laws that prohibit payroll deduction without the employee’s written permission (as long as certain conditions are met).

Although it is a step in the right direction, automatic enrollment may not be versatile enough to adequately meet the long term retirement income needs of a majority of plan participants.

### **Contribution rates are likely too conservative**

One of the requirements of an automatic enrollment feature is that it establishes the deferral rate at which an employee is enrolled in the absence of an affirmative election to the contrary. This default rate of deferral also needs to be communicated to the employee. The IRS has not specified a maximum limit on the automatic reduction percentage. The employer need only establish a reasonable but meaningful rate given their organization's demographics.

However, according to the latest PSCA (Profit Sharing Council of America) Survey on Plan Experience (2006 Plan Year), only 23.6% of all plans have adopted automatic enrollment (although that number is expected to rise significantly in the next few years). About 18.5% of these plans have selected either 1% or 2% as the default percentage. The majority of these plans (58.5%) have selected 3% as the automatic deferral percentage. Only 23% of plans have chosen a default percentage greater than 3%.

At such rather low default rates, how do we know that automatic enrollment in its current form is going to be enough to meet the retirement income needs of participants in retirement – especially if automatic enrollment is added without a companion automatic contribution increase feature? And it's not just daily living expenses in retirement that participants need to think about funding. They also need to think about the strong likelihood of increased medical costs and health insurance as they grow older. The average nursing home stay, for instance, now costs more than \$74,000 a year and could rise to over \$150,000 per year by 2030, assuming an annual inflation rate of 3% (as cited in Yahoo Finance's online guide entitled "How Much Do You Need to Retire?").

In the case of a plan sponsor who has a Qualified Automatic Contribution Arrangement (QACA) -- in effect, a safe harbor automatic enrollment arrangement to avoid nondiscrimination testing -- the initial automatic enrollment amount must be at least 3% (but not more than 10%) of pay. The amount must increase to at least 4% in year 2, 5% in year 3 and 6% in year 4 and beyond. The employer must also fund a "safe harbor" match or non-elective contribution which must be 100% vested after two years of service. Certain other conditions apply as well.

It is too early to tell whether there will be widespread adoption of QACAs, but one thing is sure: adopting a QACA presumably places a significant amount of cost as well as additional administrative burden on the plan sponsor, which may ultimately discourage them from adopting it in the first place.

### **"One size fits all" approach of QDIAs does not recognize individual needs and circumstances**

The PSCA survey notes that 30.6% of plans chose age-based target date funds as the default investment option for automatic deferrals, while 22.8% chose risk-based asset allocation funds and another 14.6% chose balanced funds. How do we know that these popular default investment options are going to be adequate to meet the long-term retirement income needs of the participant in retirement?

Both age-based and risk-based funds are limited in that they address only limited individual circumstances. For example, target-date funds are based on the anticipated retirement age of an individual, and do not factor in other variables that are important and unique to an

individual (such as tolerance for risk and other financial goals). Risk-based funds factor in risk tolerance only, but not years to retirement or other financial goals. And neither age- or risk-based funds factor in other circumstances such as outside assets, spouse or partner assets, or have any built-in flexibility to address whether or not an individual's situation might change dramatically over the course of several years.

### **Lack of benchmarking and comparative analysis**

Target-age and target-risk investment vehicles are still very new. Few if any tools exist for benchmarking the performance of these types of investments. Each has a unique allocation approach and investment components. Standard & Poor's is reportedly working on a target-date fund index, as is investment consulting firm Callan Associates, Inc. Mercer is also developing customized benchmarks that evaluate both asset allocation and performance for each target-date age range. In the mean time, some advisory and consulting firms are already developing their own target-date benchmarking analysis tools. National Retirement Partners (NRP), for example, currently has a system that rates target-date funds with one of four rankings -- superior, favorable, neutral or unfavorable. However, until an accepted industry standard emerges, it will be difficult to judge the adequacy of these target age and risk-based funds.

### **Exploring Managed Accounts as the most versatile long-term solution for retirement plan participants**

Because of the limited versatility of automatic enrollment arrangements, The Standard recommends that sponsors consider a stand-alone, professionally managed account solution to their participants as part of their overall plan design. We believe that a managed account solution is a superior solution and best-suited to meet the long-term retirement income goals of each individual participant -- based on personal goals, tolerance for risk and timeline to retirement.

As of early 2008, we currently administer approximately 350 plans offering Mainspring Managed (our managed account option), with about 12,000 participants who are enrolled in the Mainspring Managed option. We have seen an adoption rate of almost 48% when participants are offered the Mainspring Managed service. In those plans that offer Mainspring Managed as an option, over 58% of participants increased their contributions upon enrollment. And of those that increased their contributions, the average of the increases was 2.26 percent of pay (data is as of 2/29/08).

The increase occurs at least in part because each participant receives a customized Savings and Investment Plan Snapshot in their initial enrollment booklet. The Snapshot serves as a personalized retirement plan gap analysis. The gap analysis is typically an eye-opening experience and has served as a strong motivator for participants to overcome inertia and take action.

### **The Standard's Approach: Up Close and Definitely Personal**

The Standard's Mainspring Managed service goes beyond the traditional managed account/advice solution that is prevalent in the industry today. It is not just an investment plan.

It is a formal, goal-based savings and investment plan which is implemented and actively managed by The Standard. Above all, it's about addressing the needs of individual participants.

The process of building a customized plan for a participant begins with the information included in the initial gap analysis report, which is given to each attendee at the enrollment meeting. From this information, a formal savings and investment plan is produced that focuses on achieving the participant's projected retirement income needs. The managed account solution looks at each participant's unique situation and determines an optimal course for the dependent variables of savings rate and asset allocation. Assets are invested among a series of broadly diversified, institutionally-priced portfolios.

Once a participant's savings and investment plan is implemented, the account is reviewed on a quarterly basis. Outside assets, as well as spouse/partner assets can be included in the plan if the participant wishes. Rebalancing or re-allocations are performed as necessary. Participants receive a progress report each quarter which illustrates progress made toward reaching their goals. In the case of a projected retirement income shortfall, tactical solutions are implemented (such as increasing the savings rate or revising the asset allocation strategy).

The investment plan remains actively managed, and assumes that a participant's personal situation will change and evolve over time. As changes occur, the participant can call an investment adviser representative and have their savings and investment plan updated immediately. For example, a change in marital status usually requires an immediate update of the plan. Changes in a participant's tolerance for risk over time can be incorporated into the plan as well. This asset allocation flexibility is far superior to an age-targeted or risk-based (lifestyle) portfolio approach. Such solutions only incorporate an initial snapshot of risk tolerance, and are not personalized to an individual's unique needs. In addition, such investment solutions do not allow for change over time.

## **Conclusion**

In conclusion, automatic enrollment in its current state offers certain advantages to plan sponsors and their employees. It is a step in the right direction.

However, we at The Standard believe that a professionally managed saving and investment program is a much more holistic and individualized solution for the long term. Such a solution addresses the changing circumstances of the participant in a much more effective way. It should be considered as a part of any plan design.

We see others having success with managed account programs as well. Currently, 60% of Schwab's plan sponsor clients make advice available to employees. The advice can be online, by phone or in-person. Although a relatively low percentage of employees use it (12%), those participants that did use it in 2006 earned a 3% higher return than those who did not (according to Schwab, as cited in the February issue of *PlanSponsor Magazine's* "Riding the Tiger" article). Schwab also sees participant enrollment of 15% to 60% in managed accounts after one year, depending on employee demographics and chosen implementation method.

One thing is certain: as the industry continues to respond to the retirement income gap dilemma in unique and practical ways, plan participants stand to benefit greatly.

## ABOUT THE STANDARD

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The Standard has provided retirement plan services for more than 70 years. Products are available on a full service or recordkeeping-only basis, through both a trust platform (in all states) as well as a group annuity platform (available in all states except New York). The Standard promotes a participant-centric approach with services such as Mainspring Managed, its managed account option for plan participants.

For more information on The Standard’s retirement services, visit [retirement.standard.com](http://retirement.standard.com). Or contact a Pension Consultant at **877-805-1127**.

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## Informational Sources

Profit Sharing/401(k) Council of America’s 50<sup>th</sup> Annual Survey, reflecting 2006 plan experience.

“Riding the Tiger” article appearing in the February 2008 issue of *PlanSponsor Magazine*.

Yahoo Finance “How Much Do You Need to Retire” Guide.

*The ASPPA Journal* (winter of 2008).

The Standard’s plan experience.

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