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JULY 2011

Next Generation **Retirement Planning**

Nobel laureate Robert C. Merton on a revolutionary new managed DC solution

Dimensional

DC DIMENSIONS JULY 2011

Photo by Roy Niswanger.

ON THE COVER: Dimensional Fund Advisors' corporate headquarters, Austin, TX. Photo by Rob Amoroso.

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LETTER FROM THE EDITOR

Dimensional Fund Advisors is proud to introduce *DC Dimensions*, a semiannual magazine focused on new and developing trends in the defined contribution industry.

Readers of *DC Dimensions* will be exposed to some of the best thinking and ideas from DC practitioners, legal and regulatory experts, and leading academics. With each issue, we look forward to bringing you insightful interviews, papers, and cutting-edge research to help you stay in front of the changes affecting our industry.

In this introductory issue, we feature an interview with Nobel laureate Robert C. Merton, Dimensional's Resident Scientist, in which he offers his perspective on the retirement industry and explains the motivation and financial science behind his groundbreaking work developing a new managed DC solution. We also offer a summary of the findings from new research performed by Dimensional Fund Advisors and the Boston Research Group examining the behaviors, attitudes, and investment trends of plan participants and sponsors.

Two features will especially interest financial advisors. The first outlines important regulatory changes that will bring increased transparency and disclosure requirements to the 401(k) industry, as well as the steps advisors should take to better position themselves for the regulatory changes. The second focuses on TAMPs and how advisors may benefit from the services they provide.

For the legal and regulatory updates, we feature two of the industry's leading experts. We conclude the issue with a more detailed overview of Dimensional's Managed DC solution.

We look forward to bringing you future issues and hope *DC Dimensions* becomes a trusted resource.

Sincerely,

TIM KOHN
Head of DC and Vice President
Dimensional Fund Advisors

Next Generation **Retirement Planning**

Interview with Robert C. Merton

Employers around the world have discovered how expensive it is to offer defined benefit plans and are converting to defined contribution plans. But DC plans in their current form are ineffective because most people aren't comfortable deciding how to invest their retirement savings. Employees need new and better ways to manage the risks they face when planning for retirement.

Motivated to come up with a solution that works better for both companies and their employees, Dimensional launched Dimensional Retirement, a business unit dedicated to providing leading-edge retirement products and services to plan sponsors and financial advisors. Dimensional Retirement's first offering is a low-cost managed account solution for DC plans that aims to help employees achieve inflation-protected retirement income.

The managed DC concept was developed by Nobel laureate Robert C. Merton. We interviewed Professor Merton to hear his perspective on the retirement industry and to learn more about the financial science that has gone into Dimensional's Managed DC solution.

Professor Merton, how did you get interested in retirement savings issues?

I've been working on household lifecycle finance for my entire professional career. Through my work, I learned that most people would like to have an income in retirement that enables them to sustain the standard of living they enjoy in the latter part of their work life. They also need that income to be protected from inflation.

Unfortunately, it appears that fewer and fewer people are likely to have enough income for a good retirement. Defined benefit plan participants used to be confident that their employers would provide them with an adequate retirement paycheck, but that confidence has been shaken as their plans have been frozen or closed. DC plan participants, too, are at greater risk than was previously expected. The more I looked at this problem, the more inspired I was to find a way to solve it.

What do you see as the beginning of the end for defined benefit plans?

In my view, most DB plans were vulnerable from the outset because their accounting treatment systematically underpriced the cost of the benefits and understated the risk to the plan sponsor that guaranteed those benefits. That mispricing ultimately makes the plans unsustainable, but rising stock markets throughout the 1990s masked that vulnerability until the period between 2000 and 2002. In those years, the combined effects of an extensive stock market decline and a steep decline in interest rates caused DB plan assets to fall substantially and DB plan liabilities to increase substantially, putting the plans under intense financial pressure. Companies in weak industries, such as airlines and steel, were forced to close their plans,

Professor Merton is the School of Management Distinguished Professor of Finance at the Massachusetts Institute of Technology and University Professor Emeritus at Harvard University. He also serves as Resident Scientist at Dimensional.

and some were driven to bankruptcy. Strong companies came to realize how large a risk exposure their DB plans created and began reexamining the viability of continuing to provide these benefits.

So plan sponsors turned to defined contribution plans?

Sponsors adopted DC plans to replace closed or capped DB plans by default. However, DC plans were never designed to provide core retirement benefits. In the beginning they were largely supplemental for higher paid workers to increase their retirement benefits beyond their DB. With more widespread adoption of DC plans, participants—from brain surgeons to assembly line workers—are being called on to make complex financial management decisions that they have not had to make in the past, they aren't equipped to make now, and, even with education, they will not be capable of making in the future. Their situation is like being a surgical patient who, while being wheeled into the operating room, has the surgeon lean down and say, "I can use anywhere from 7 to 17 sutures to close you up. Tell me what number you think is best." That is not only a frightening decision for a patient to be faced with, but it is one that most people are poorly qualified to make. All of this points to the need for a next-generation retirement solution.

How did you get started?

We started by examining the needs of the people who have the largest stake in retirement planning: plan participants. Their need is to be able to sustain their lifestyle after they retire. To achieve that goal, they will need retirement income that is protected against inflation. They also need to make sure that this income is available no matter how long they live.

Our understanding of participants' needs was our core design element—the foundation on which we built. The solution is designed to ensure that plan participants will have a reasonably high probability of achieving the income they need, even if they never actively participate in their retirement planning.

The solution is designed to ensure that plan participants will have a reasonably high probability of achieving the income they need even if they never participate in their retirement planning.

Don't they have to manage their own plan?

This is a managed account, so they don't make investment choices. And although the solution is capable of handling large numbers of employees at low cost, it is highly customized for each individual in important ways.

We achieve this customization by taking an integrated approach. Some information about the participant—such as gender, marital status, age, and salary—is provided to us by the recordkeeper. These data are used by the employer to create default settings for retirement age, contribution rate, desired target retirement income protected for inflation and minimum risk income level. The model also incorporates each individual's expected Social Security payments, existing DB plan rights, existing DC plan balances, and expected future DC plan contributions. Our algorithm uses all of this, plus simulations for equity prices, interest rates, and annuity prices, to create an optimized asset allocation strategy for each person. The participant's investment allocation

THE SOLUTION IS FULLY INTEGRATED TO INCLUDE:

- Implementation support
- Robust, easily configurable reporting tools
- Educational materials for plan participants
- An engaging online retirement planner
- Asset allocation strategies that are customized for each individual
- Professional investment management
- Access to a range of payout options

is revised dynamically in response to changes in income, accumulations, contributions, and market conditions.

Our goal is to maximize the probability that the participant will be able to purchase a specific life annuity, protected from inflation, at his or her targeted retirement date. Of course, participants can choose alternative options at retirement if it's in their best interest to do so.

You mentioned that participants are able to further personalize their accounts. How do they do that?

All of this dynamic asset management optimization takes place without requiring the participant to be involved in the process at all. If, however, the participant chooses to become engaged and actively provide input into the process, then he can further customize his program by changing the income goal, contribution rate, retirement age, and minimum risk income level to better fit his needs.

When participants log in to their accounts for the first time, they see a preset target for their retirement income. They also see feedback from us about the probability that they will achieve this target. If they don't like what that feedback says—if the probability of success is too low—we offer ways to improve it. There are only three things they can do: save more, work longer, or take more risk. That's it.

We don't talk with the participant about rates of return, asset allocation, or rebalancing. That isn't meaningful to him. What is meaningful is how much income he'll have to live on in retirement. Once the participant tells us what he wants, and what he's willing to do to get there, we take care of investing.

What about employers? What's in the Managed DC solution for them?

Employers want plan participants to be able to retire with adequate income. This solution gives them a very simple but effective way to help their employees aim for that benefit, without the risks that come with DB plans.

Is the Managed DC solution available now?

The Managed DC solution has been in place in Europe with a global electronics company and a global semiconductors company for about six years. It's now being implemented with a multi-employer pension provider in the United Kingdom. Implementations in the United States will begin in the fall of 2011.

So is your work done?

That's an easy question to answer: No, our work will never be done. We plan to make continuous improvements to the Managed DC solution to ensure that it always incorporates the best that financial science has to offer. We intend to provide plan sponsors with a solution that they will never have to replace. ■

Dimensional Retirement (an affiliate of Dimensional Fund Advisors LP) is an investment advisor registered with the Securities and Exchange Commission. Dimensional Managed DC is available through Dimensional Retirement.

FROM MY CORNER

PSCA president David Wray speaks out on legislation, oversight, and the employer's changing role

By AARON BORDERS, regional director, Dimensional Fund Advisors

DC Dimensions: You've talked about the need for simplifying the investment choices in a DC plan. We're seeing a movement in the marketplace toward more of a "managed" structure for participant investment choices. Where is the DC investment menu ultimately headed?

David Wray: The simplification will come about in two ways. At some point, every plan will have an option that allows the employee to delegate the allocation decision. Whether it's a target date fund, a managed account, or an employer-managed default balance fund of some kind, the employee is going to be able to delegate the allocation. If the employee doesn't make the choice to delegate, the plan sponsor will default the employee into an employer-selected managed solution.

The second simplification is the way in which employers are looking at their investment lineups. I think there is a recognition that proper diversification can clearly be achieved with fewer choices than plans had in the past. A lot of the momentum for all those choices came out of the 1990s, when employees were aggressively pushing for as many options as they could get so they could actively manage their 401(k) plans. Participants have moved in a different direction. They are really looking for simplification and for employer support and help.

DC Dimensions: How will the recent "Encouraging Better Retirement Decisions" hearings impact future legislation? What is the PSCA's view of or role in this potential legislation?

David Wray: The plan sponsor community is pretty much united

David L. Wray is the president of the Profit Sharing/401(k) Council of America (PSCA), a national, nonprofit association of companies that sponsor profit sharing and 401(k) plans for over 6 million employees. He is a nationally recognized authority on 401(k) and other defined contribution plan issues and has testified before congressional committees and at hearings of the US Department of Labor, US Department of Treasury, and the Internal Revenue Service.

in its opposition to anything that would require a tilt toward a mandated distribution solution. I think what they want is the ability of participants to make that decision when they retire. Trying to force them into one particular solution or another is not perceived as a wise course of action.

the government should mandate. But if people are going to work at eight different employers, who makes the assumptions? What does that gap calculator really say to a 50-year-old who has been working at a company for four years and has four IRAs or previous account balances somewhere?

The employer role is increasing because there is so much more money, and when you have responsibility for great amounts of money, the oversight and management of that money takes more commitment.

When an individual retires, there are many factors in play. These include a person's age, marital status, health concerns, older children in college, other assets, or expected inheritances. It's a very, very complex financial situation, and people should be left to figure it out among the competing products and services that are out there. The employer community, and certainly PSCA, is opposed to the government looking at retirees as a single entity with a common need. The needs are so diverse, and we need to keep the system as open as possible and let individual participants decide.

One of the things that people suggest is gap calculators that

We recognize this is an important transition period, but we would prefer to let the marketplace work that out.

One thing we do encourage is for employers to be as aggressive as possible in helping with the education process for retiring participants. Employees are looking for help with this process, which is quite complex. They need people they can trust. If the employer can help with the selection of that expertise, that would be a very useful thing. We want to make sure that the government in no way discourages employers from doing that. There's no question that the Department of Labor will probably clarify the educational letter it wrote back in 1996. Hopefully, the Labor Department will clarify that helping employees with information about retirement decisions is certainly appropriate and does not bring additional liability to employers.

DC Dimensions: Looking outside the US, we see retirement plan schemes in other parts of the world (e.g., Australia, Chile, etc.) that have adopted a mandatory participant contribution. Is this where DC is headed globally? Do you see this happening in the US?

David Wray: At this point, it does not look likely that the US will transition its mandatory government program to a defined contribution system. I think that Social Security will remain a defined benefit system. There was a time when a transition could have been made, but now I just don't see how they can unwind it. The baby boomers are too close to retirement or entering retirement and have planned on this promise. Considering how large a constituency they represent and their voting patterns, I think it's just not likely. There are other countries that are trying to transition from their defined benefit retirement programs. It will be interesting to see how they do that.

DC Dimensions: How do you feel about the employer-employee partnership in DC plans today? Do you see the employer's role increasing or decreasing as DC plans become more important for the security of America's workforce?

David Wray: The employer role is increasing because there is so much more money, and when you have responsibility for great amounts of money, the oversight and management of that money takes more commitment. The government has also raised the bar with a lot more oversight of plan sponsors. The Department of Labor and the IRS have hired more people, and there will be many more plan audits, for example.

The government is expecting extremely high performance by employers in the management of their 401(k) plans. So far, we haven't had a lot of litigation, but people are looking for ways to sue employers over their plans as the money increasingly grows.

Participants are looking more to the employer than they did in the past. Employees are saying, "I don't want to make this investment decision. I want you to make it for me." The employer doesn't make it, but they hire somebody, and they're responsible. The great gift of employers to employees in 401(k) plans is that the employers are willing to take responsibility for making the system work right. That's a significant thing, and there's more intensity around holding them accountable. It's important that we don't overwhelm employers with increasing regulatory oversight and potential liability.

Employers are working to sell products or provide services in a very competitive marketplace. 401(k) plans are not their core business, and some people are expecting them to run a 401(k) like it is their core business. We have to recognize what a great thing it is that employers are willing to step up, make decisions, and accept liability for their plans. Employers are expected to do that more than ever, and the regulators and others are scrutinizing them more than ever to make sure they manange their plans well. We just don't want to overwhelm them. ■

THE BEST DEFENSE IS A GOOD OFFENSE

Plan sponsors can minimize fiduciary liability with adequate fiduciary education and certification

By IAN KOPELMAN, partner at DLA Piper LLP (US) and PSCA's legal counsel

As pointed out in a recent column published by the PSCA, an in-house or named fiduciary of an ERISA plan is never completely free from fiduciary responsibility for the plan—and the potential personal liability that comes with it. The smart fiduciary takes steps to minimize that liability. As the old saying goes, the best defense is a good offense. In this case, that means the in-house/named fiduciary of the plan has a full understanding not only of the fiduciary responsibility rules, but also the rules of ERISA and the Internal Revenue Code that govern the operation of qualified retirement plans and the investment of plan assets. The fiduciary that fully understands the plan rules is in the best position to fulfill its fiduciary responsibilities and minimize its liability.

As previously explained, a plan's in-house/named fiduciary can delegate some or all of the day-to-day responsibility for a retirement plan, but it always retains responsibility for the following:

- Appointing the trustee
- Appointing investment managers
- Investing plan assets
- Selecting plan service providers
- Monitoring the performance of all of the above on an ongoing basis

Under ERISA, the in-house/named fiduciary's actions in fulfilling these responsibilities must be:

- For the exclusive benefit of plan participants and their beneficiaries, and for the purpose of defraying expenses of admin-istering the plan.
- Prudent, which means they must be done with the care, skill, and diligence that would be exercised by a reasonably prudent person who is familiar with such matters.
- In accordance with the plan documents, unless the documents themselves are not in compliance with the terms of ERISA.

Meeting these responsibilities with respect to the selection of plan service providers and other plan fiduciaries may seem fairly straightforward, but a plan's in-house/named fiduciary is also responsible for monitoring the performance of the service providers and fiduciaries it selects. This means that even if the selection was prudent, the in-house/named fiduciary will have breached its ERISA fiduciary responsibility if it does not terminate the relationship with a service provider or fiduciary when a failure to perform makes continuing the relationship imprudent. Further, under ERISA's co-fiduciary liability rules, an in-house/named fiduciary that acts in good faith and complies with all ERISA requirements still may be liable for the acts or omissions of a co-fiduciary if:

- It knows the person committing the act or omission is a fiduciary with respect to the same plan, participates knowingly in the act or omission, and knows the act or omission is a breach of fiduciary duty.
- Its breach of ERISA's rules enabled the subsequent breach by a co-fiduciary.
- It knows of a breach by a co-fiduciary and fails to make reasonable efforts under the circumstances to remedy the breach.

It is generally agreed that, in order to manage its potential liability, a plan fiduciary needs a paper trail demonstrating it acted prudently. However, it is difficult, if not impossible, for an in-house/named fiduciary to satisfy the responsibilities described above, meet ERISA's fiduciary standard, and avoid liability if it doesn't understand the rules of ERISA and the Internal Revenue Code governing qualified retirement plans.

Once an in-house/named fiduciary understands the rules that apply to plans, it can avoid fiduciary breaches by:

- Formulating (and periodically reviewing) a formal written investment policy statement.
- Performing adequate due diligence in selecting plan fiduciaries and other service providers.
- Periodically auditing the performance of those service providers.
- Reviewing the performance and relative expenses of plan investments.
- Terminating other plan fiduciaries and service providers when their performance makes it imprudent to continue the relationship.
- Understanding and complying with ERISA's reporting requirements.

Fortunately, understanding the rules governing qualified retirement plans does not mean the in-house/named fiduciary needs to become a compliance expert. That can take years. However, an understanding requires more than reading the statute or a couple of articles. The best and most efficient way for the in-house/named fiduciary to gain the knowledge it needs is to get help from compliance experts by taking advantage of educational programs, such as those offered by the Profit Sharing/401k Council of America (PSCA).

The in-house/named fiduciary of an ERISA plan faces a difficult problem. It has significant fiduciary responsibility under ERISA, which can't be completely relieved by delegation to another fiduciary. If the actions of the in-house/named fiduciary don't meet ERISA's fiduciary standards, it faces significant liability. However, it can't be confident that its actions meet ERISA's standards without understanding the applicable rules.

Further, the in-house/named fiduciary needs to be able to demonstrate that it took steps to make sure its actions and decisions meet ERISA's fiduciary standards.

Conclusion

Fortunately, this problem can be addressed. A fiduciary education program can provide the in-house/named fiduciary with a basic knowledge of the rules of ERISA and the Internal Revenue Code with only a small time investment. That basic knowledge minimizes the potential for failure to meet ERISA's fiduciary standard. Completing a formal education program offers an additional advantage beyond gaining the necessary understanding of the rules. If the program offers a certificate of completion, it provides hard evidence that an in-house/named fiduciary who participates in the program has taken action to fulfill fiduciary obligations under ERISA, and it minimizes potential fiduciary liability. ■

Reprinted from the PSCA's Jan/Feb 2011 Defined Contributions Insights *magazine.*

UNSAFE AT ANY SPEED? THE DESIGNED-IN RISKS OF TARGET-DATE GLIDE PATHS

By ZVI BODIE, PhD; RICHARD K. FULLMER, CFA; and JONATHAN TREUSSARD, PhD

Given the poor investment performance that so many defined contribution plan participants experienced by investing in target date funds (TDFs) in 2008 and early 2009, it is not surprising that the US Department of Labor started reviewing their suitability as a "safe harbor" qualified default investment alternative (QDIA) in early 2010. These funds are marketed as simple solutions for plan participants who find it too difficult, unpleasant, or time consuming to choose among investment alternatives. Their objective is to provide individual investors who plan to retire at a specific date with a prudent strategy for managing their etirement assets. This does not mean the funds are without risk. Many carry a substantial amount of risk, as evidenced by their recent performance.

Lawmakers, regulators, and plan sponsors have expressed concern with TDF safety. The level of investment risk in these funds is primarily a function of their asset allocation glide paths. The term "glide path" refers to the (usually predetermined) schedule for changing the proportion of assets invested in stocks, bonds, or cash over time. It can also refer to the changing duration of the bonds. Thus, the shape of the glide path has a significant effect on the risk and return characteristics of a fund and varies substantially among fund manufacturers.

Whatever their differences, the objectives of every TDF that enjoys QDIA status should align closely with those of the defined contribution system itself. Defined contribution (DC) plans are meant to provide a supplemental source of funding for the post-retirement consumption needs of people in the workforce. The idea is that the stream of cash from the DC plan plus Social Security (and possibly other defined benefit plans that may be available) should replace a specified portion of participants' labor income, enabling them to maintain the same standard of living. That funding needs to be in place when a participant retires—at the target date. What happens after the target date has no bearing on a participant's balance at the target date. Either the necessary amount of post-retirement funding will be there or it will not.

Traps, Fallacies, and Worst Practices

It is incumbent on TDF manufacturers and their glide path engineers to understand the nature of risk in the capital markets. The academic literature on this topic is rich. A few of the traps that lie in wait for unsuspecting engineers include the false notion that stocks are an effective hedge against inflation, the fallacy of time diversification of risk, and reliance on probability statistics as a measure of risk. We are also concerned that investors today must make decisions without a standardized means of evaluating the risk/reward tradeoff of the many choices available to them.

What Can Be Done?

These issues make the evaluation of TDF suitability difficult for policymakers and financial advisors. We offer the following perspectives on the subject.

FUND OBJECTIVES

Fund objectives should be fully disclosed to investors, and these disclosures should use a common base for measurement. The logical base measure is that of a deferred real life annuity contract starting at the target date. This way, plan sponsors, participants, and their advisors could readily compare the objective of the various TDFs available to them to assess their suitability. In addition, the important assumptions used in creating the glide path, such as the contribution rate expected of the participant, should be disclosed.

RISK MANAGEMENT

Currently, there is no generally accepted standard for measuring target date fund risk. This has led to much uncertainty over just how risky they are. Fundamentally sound standards must be established to measure the investment objective and the underlying risk in order to provide plan sponsors, participants, and their advisors with the means to evaluate their options and make informed decisions. Depending on their risk aversion, some will prefer safe TDFs, while others will prefer riskier TDFs.

In the same way that standards exist for food safety and labeling, so too can standards be developed for QDIA safety and labeling. The former standards aid society by promoting better dietary decision making, leading to better physical health. The latter standards aid society by promoting better investment decision making, leading to better financial health. ■

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As Dimensional Fund Advisors seeks to provide the latest trends in both academia as well as in commercially developed investment solutions, we are proud to add Zvi Bodie to our academic lineup. We plan to work closely with Zvi over the next few years in order to bring his vast experience in lifecycle investing and pension finance to help us evaluate and address best-in-class defined contribution solutions.

Look for a detailed curriculum in 2012 as we develop an educational series designed for plan sponsors, consultants, and advisors.

To learn more about the authors' analysis and to read the complete article, please visit the *Journal of Financial Planning* at: http://www.fpanet.org/journal/CurrentIssue/TableofContents/UnsafeatAnySpeed/.

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WAYS TO IMPROVE THE DEFINED CONTRIBUTION PARTICIPANT EXPERIENCE

With WARREN CORMIER, founder and president of Boston Research Group (BRG)

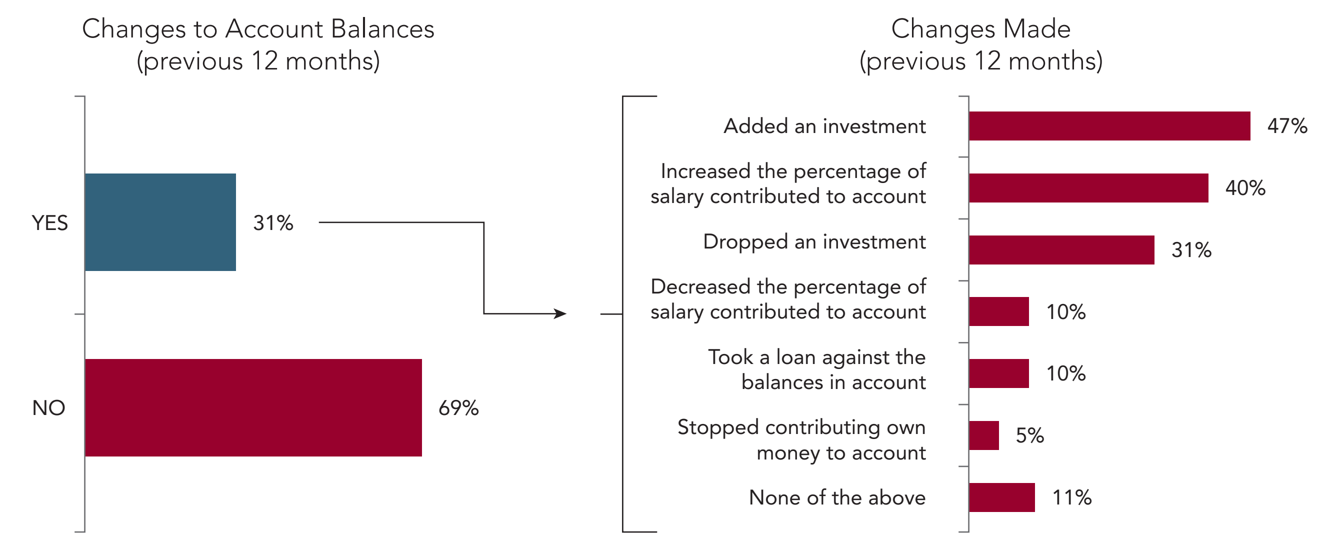
The defined contribution plan participant has been the subject of twenty-plus years of study and debate between corporations and policymakers. At stake has been how the traditional "three-legged stool" retirement paradigm should be redesigned. To this end, Dimensional Fund Advisors wanted to examine the behaviors, attitudes, and investment trends of active DC participants and their plan sponsors in order to determine: 1) current investor sentiment in light of the 2008–2009 bear market, 2) receptivity and concerns surrounding qualified default investment alternatives (QDIAs), and 3) possible actions for plan sponsors to consider to improve the participant experience.

Dimensional Fund Advisors engaged the Boston Research Group to conduct an online quantitative study with 1,000 DC participants who actively participate in a DC plan. A subsequent phone-based, computer-assisted telephone interview (CATI) was conducted with 200 plan sponsors, with data being collected from January 11–13, 2011.

CURRENT PARTICIPANT SENTIMENT

Traditionally, participants are inactive investors, exhibiting extreme inertia as defined by reallocation of one's investment portfolio. Studies by the

FIGURE 1 CHANGES TO ACCOUNT BALANCES AND FUTURE PLANNED CHANGES



Corporate Executive Board and the Boston Research Group indicate that as many as 80% of participants never reallocate their investment portfolios—which means a majority of participants will begin employment with a company and never make changes to their initial investment instructions. Our findings (see Figure 1) indicate that last year, however, about one-third (31%) of participants made some change to their allocations—indicating a relatively high level of activity. The top changes made were adding a new investment, increasing salary deferral, and removing an investment from the fund lineup. This increased level of activity indicates that participants are looking at their balances, salary deferrals, investments—and making active decisions. Looking forward, we see that just over one-third (37%) of participants plan to increase their future salary deferral, and just under half (44%) don't plan to make additional changes in 2011.

As we look at future decisions, it is important to note that behavioral experts have commented on a participant's forward-looking sentiments, stating that, in essence, tough decisions, such as increasing one's contribution to retirement, are easier when the action is separated by time. According to Warren Cormier, "participants will again and again sign up for tough decisions when the decision and action are separated by time; thus, we often see a disconnect between what is actually done and what optimally should be done. This form of investment procrastination is not new and spans both good and bad economic times." The realization of this behavior is one of the reasons for the creation of automatic investment features, such as automatic enrollment and escalation of salary deferrals. The recent uptick in adoption of these features is greatly attributable to the passage of the 2006 Pension Protection Act (PPA).

This increased level of activity indicates that participants are looking at their balances, salary deferrals, investments—and making active decisions.

The PPA created safe harbor protection for plan sponsors who implemented automatic enrollment as long as the defaulted investment was a QDIA. As we examine QDIAs, one approved solution, the target date fund (TDF), has become "the QDIA of choice" with respect to plan sponsor usage. TDF growth has been spectacular, growing from relative obscurity since their introduction in the early 1990s to over $340 billion today. Before we dive into TDFs, let's finalize our analysis of participant sentiments.

When we asked participants about their desire to "swing for the fences" or if they would rather stay more conservative with their retirement savings, we saw a trend toward risk-averse decision making. We phrased the risk-averse versus risk-seeking decision making question by setting up two scenarios. One scenario asked if participants would like to improve their retirement by taking on risk, and the other scenario asked participants if they would rather maximize their retirement wealth at the risk of impacting their minimum desired income levels in retirement. The findings indicate that participants, by a healthy majority, tend not to be risk seeking with their retirement assets.

Finally, we examined overall retirement confidence by asking participants six questions, ranging from their ability to make good investment decisions (in support of their retirement goals) to confidence in their ability to manage and spend down their retirement nest egg throughout retirement. The results speak volumes and indicate that a vast majority of participants do not feel confident about their retirement prospects. When we look at each of the retirement confidence questions, we find that those who are "very confident" range from a high of 29% of respondents to a low of 12% (Figure 2). Not surprisingly, the lowest numbers indicate that participants do not know how much money they will need in retirement to support their desired lifestyle. Logically, if participants do not know how much money they need in retirement, it makes sense that subsequent savings and investment decisions become increasingly hard for participants to grasp, thus reducing confidence and increasing participant confusion.

RECEPTIVITY/CONCERNS SURROUNDING QDIAs

With the passage of the PPA in 2006, the first and most dramatic change to America's retirement system since the Employee Retirement Income Security Act of 1974, we have seen the creation of QDIAs and corresponding "safe harbor" protections for employers. Not surprisingly, the years after 2006 saw numerous employers seeking to redesign their DC plans, adding QDIAs along with automatic investing and escalation programs. The biggest asset-gathering QDIA to date has been the TDF. By some estimates, as many as 60% of QDIAs are TDFs, with managed accounts and balanced funds splitting the remaining 40% of mandates. Based on the relatively new and untested TDFs and their gaining popularity, we wanted to examine current sentiments around TDFs, especially in light of the recent bear market, which saw the average 2010 TDF lose 30%. Most notably, we found that only 22% of participants are "very satisfied" with TDF returns (See Figure 3). When examining the top reasons for participants being neutral or dissatisfied with TDFs, we found that almost half (49%) were dissatisfied with the returns of TDFs when compared with other standalone investment options. Most telling, only one in ten participants who currently invest in a TDF would be "very likely" to recommend a TDF to a friend, colleague, or family member. Most participants (four in ten) remain mostly neutral with respect to a TDF recommendation.

Where Do We Go from Here?

The potential retirement outcome for participants spans a wide range—depending on participant investment elections, salary deferrals, available fund options, plan design, communication and education, and the impact of rules and regulations. In order to maximize outcomes for participants, and in light of this recent study, we believe the following actions should be considered to improve the participant experience:

FIGURE 2 RETIREMENT CONFIDENCE FINDINGS AND THE IMPACT OF AGE

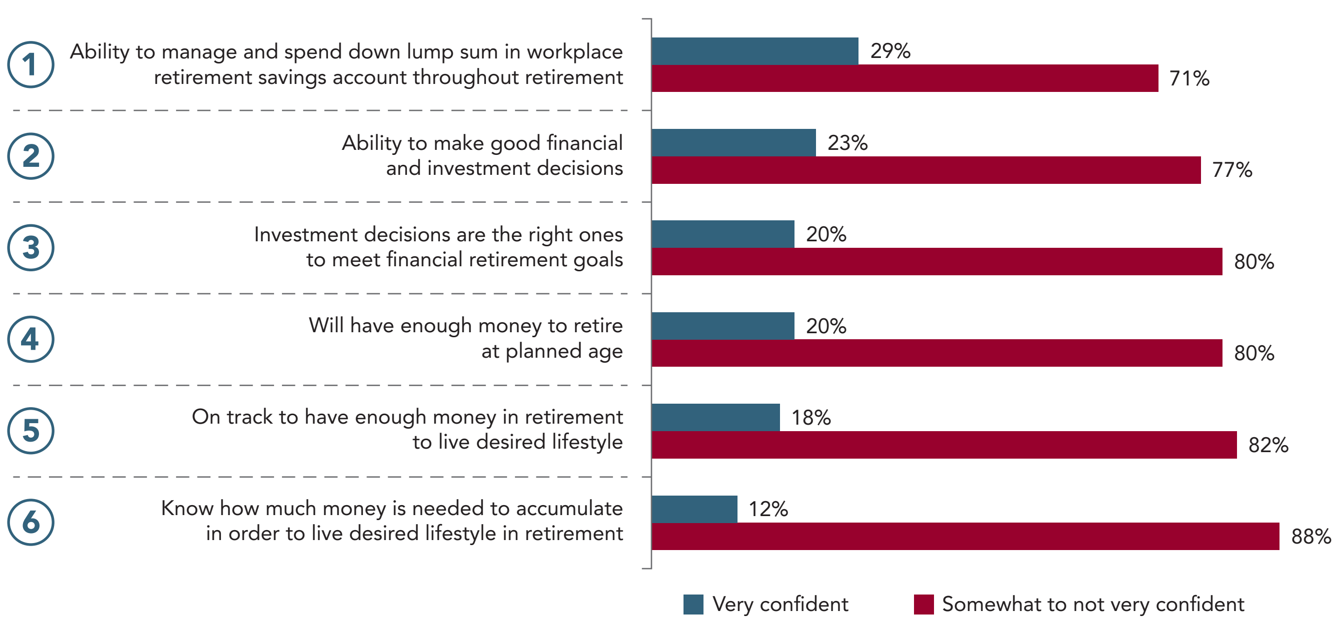
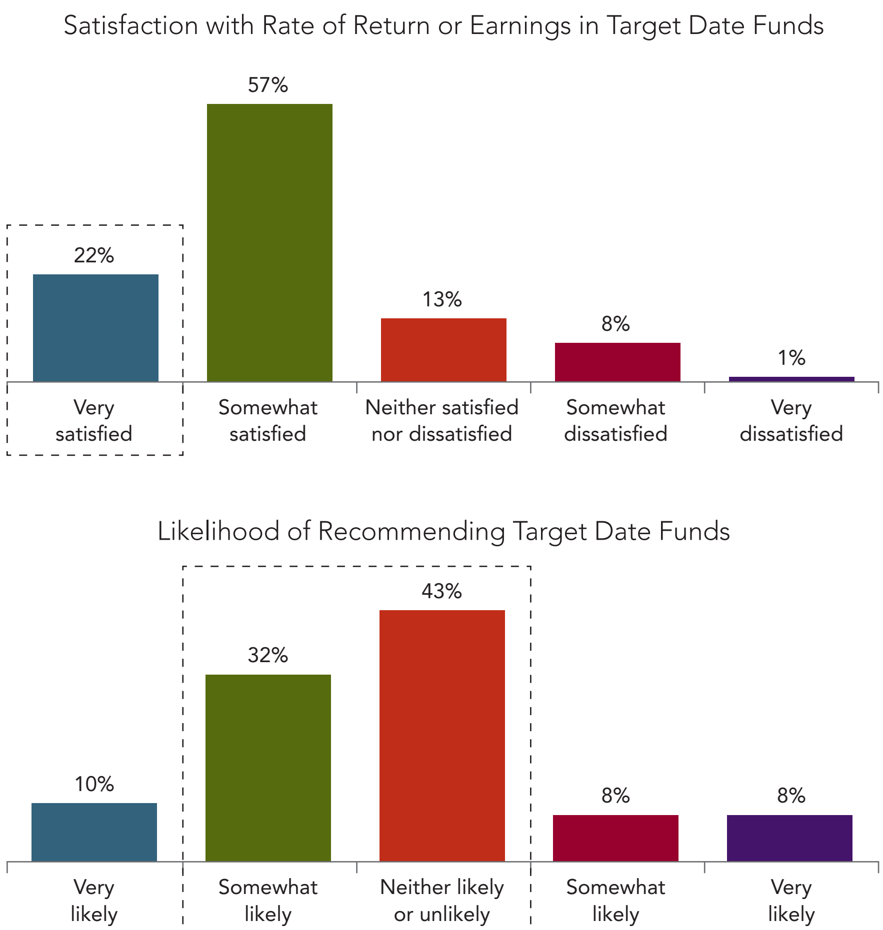


FIGURE 3 TARGET DATE FUND SATISFACTION WITH RETURNS AND LIKELIHOOD OF RECOMMENDATION



(1) Re-frame the discussion to focus on income. Today, most participants see retirement in the form of a lump sum—they spend their working years acquiring a lump sum and then transition from accumulation to spending with little guidance. Showing a participant's current holdings in terms of retirement income (as opposed to a lump sum) may help participants see their account balances through an "income lens" and start the conversation on retirement income today.

(2) Automate, automate, automate. Taking lessons from how participants make decisions (or choose not to), every plan should tackle participant inertia by considering automatic enrollment, deferral escalation, and rebalancing programs. When implementing automatic enrollment, each plan sponsor should consider the pluses and minuses of each QDIA category and our recent findings on TDF acceptance among participants, especially those closest to retirement.

(3) Next-generation solutions are designed to provide more customized solutions than previous offerings. Typically, these newer solutions are offered in the form of a managed account and combine the lessons learned from behavioral finance (i.e., provide easy participant intake and decision making) with the lessons from modern portfolio theory and defined benefit plan management. These newer solutions include automation and customization, and they offer a defined benefit-like experience—providing both longevity and inflation protection.

(4) Get professional-grade help for your participants. Our research findings point to a new set of retirement products, and with the help of an advisor, participants may be able to create a better retirement that is focused on "income outcomes" as opposed to "lump sum outcomes." Plan sponsors can take meaningful action to help guide participants through their investment and spending glidepaths. Advisors can help mitigate the effects of longevity and inflation, reducing fears around annuitization while providing custom, professional-grade income solutions. ■

For a copy of the complete research study, please contact Tim Kohn at tim.kohn@dimensional.com or visit dfaus.com/service/dc-professionals.html

NEW FIDUCIARY CONSIDERATIONS IN A CHANGING ENVIRONMENT

Three steps advisors need to start taking now

By APOLLO D. LUPESCU, vice president and head of 401(k) advisor efforts, Dimensional Fund Advisors

Recent regulations released by the Department of Labor (DOL) aim to provide plan sponsors and plan participants with information that would enable them to make better decisions. Scott Simon, principal at Prudent Investor Advisors, says that "under ERISA section 404(a)(1)(a), plan sponsors have always been required to ensure that the fees paid to various service providers are reasonable, yet in many cases they were not able to exercise it because the providers had no fiduciary obligation to disclose them." The DOL's regulation under ERISA §408(b)(2) is, in effect, shifting that burden, requiring covered service providers to disclose their fees and services and thus giving plan fiduciaries the information they need to fulfill their mandate.

Separately, the new disclosure rule under ERISA § 404(a)(5) seeks to provide plan participants with better information about their investment options and plan expenses. Fees that might have been hidden in the back pages of lengthy legal documents or in some fine print will now be displayed on participants' quarterly statements, in combination with other disclosures that are repeated annually.

In light of these new regulations, financial advisors are taking action now to prepare themselves, the plan sponsors, and plan participants for the upcoming changes, such that these activities are done on their own terms, rather than scrambling to catch up or having competitors do it for their clients.

Three Key Steps

1. EDUCATE AND PREPARE PLAN SPONSORS FOR THE UPCOMING CHANGES.

Advisors can play a key role in helping plan sponsors navigate through the noise and understand the impact of the changes. "401(k) plan sponsors and participants were inundated with information before these new regulations came out," says Sarah Simoneaux, president of Simoneaux Consulting Services. "Advisors who are able to clearly and simply communicate both in person and in writing the impact of the rules will not only retain business, but also win new business." She suggests creating a one-page summary of the rules and how they impact the sponsor's plan, with a roadmap to sources where plan sponsors can get more information.

Many advisors also believe it is important to initiate conversation about the participant disclosure and educate employees on the changes to their statements. "These different service elements will need to be segregated and likely as separate billing transactions, which will likely require proactive communication to participants, as they will see an additional quarterly fee deduction from their accounts," says Joe Goldberg, head of defined contribution services at Buckingham Asset Management (BAM), a large provider of retirement services to advisors and plan sponsors.

He cautions that it might take some time before there is full clarity around the proper implementation of this regulation. Advisors can also demystify some provider and participant statements that seem at odds with reality, such as the lack of administrative fees in some cases of revenue sharing.

2. REVIEW AND, IF NECESSARY, REVISE ADVISORY CONTRACTS/ SERVICE AGREEMENTS WITH PLAN SPONSORS.

As a matter of best practice, advisors should review their existing contracts and service agreements with an ERISA attorney ahead of the regulation effective date. "The 408(b)(2) regulation requires that specified service, status, and compensation disclosures be made by January 1, 2012. The failure to do so will cause the arrangement with the plan to become a prohibited transaction under ERISA," says Fred Reish, a leading ERISA attorney at Drinker Biddle & Reath LLP in Los Angeles.

3. BENCHMARK THE PLAN FOR REASONABLENESS OF FEES AND SERVICES.

To ensure that the expenses paid to service providers are reasonable, plan sponsors typically have two ways to assess the fees they are paying relative to the value they are receiving: Either conduct a request for proposal (RFP) process, or benchmark the plan. Tom Kmak, CEO of Fiduciary Benchmarks Inc., believes that benchmarking is a better alternative with a threefold advantage:

(1) The scope of the project is broader since it allows the metrics for the plan, such as participation and deferral rates, to be compared with the same metrics of other plans.

(2) The time to complete the exercise is considerably shorter.

(3) The cost is decidedly less, from a time and expense standpoint.

Advisors seem to agree. "Even with all of this transparency, we still find it necessary to stress the importance of proper fee benchmarking relative to service and encourage our prospects and clients to seek third-party fee benchmarking services," says John Resurreccion from Index Fund Advisors, a California-based RIA working with plan sponsors. Industry experts also believe advisors can add significant value to plan sponsors by helping them interpret the data. "For the most part, plan sponsors will not have the knowledge or experience to evaluate the disclosures from the service providers, such as the recordkeepers. Focused 401(k) advisors will be able to help plan sponsors satisfy their legal obligations under ERISA by helping with the evaluation, including benchmarking, of the disclosed information," Reish says.

If all this sounds daunting, there are 401(k) turnkey solutions that can assist advisors (please see next Advisor Focus article starting on page 20). Either with the turnkey support or using internal resources, advisors can view these changes as an opportunity to strengthen relationships with existing clients, present a compelling value proposition to prospects by helping them "get the house in order," and service their wealth management clients who are business owners or are involved in 401(k) plans.

Advisors can play a key role in helping plan sponsors navigate through the noise and understand the impact of the changes.

Susan Conrad, vice president with Retirement Plan Advisors at Plancorp, believes that "CPAs in our region have appreciated our proactive communication regarding the regulatory changes. Our efforts have helped them inform and prepare their clients and position us as an industry resource." ■

This information is intended expressly for discussion purposes only and should not be misconstrued or otherwise interpreted as legal advice or the legal opinion of qualified ERISA counsel. Please consult with qualified ERISA counsel for more information regarding your individual circumstances.

DC TURNKEY SOLUTIONS BENEFIT ADVISORS AND PLAN SPONSORS

The majority of advisors who have found success in wealth management also have the skills and attributes to build a successful retirement plan business. For advisors, engaging with DC plans presents a good opportunity both to grow their practice and to help a broader group of people who otherwise might not have access to their investment solutions. The opportunity is tremendous, especially in today's changing regulatory environment.

The second option involves an outsourced model that has only been available to advisors in recent years.

The key for advisors is understanding how to capitalize on the opportunity without creating risk for their existing business.

One option is to build an in-house DC business unit. That means hiring people with knowledge in opera-tional aspects, service provider selection and monitoring, as well as familiarity with fiduciary best practices and current regulation, investments, benchmarking, plan design, client servicing, etc. Then advisors must provide the appropriate resources to develop marketing materials, analytical tools, legal documents, and other resources needed to launch and sustain the DC business.

The second option involves an outsourced model that has only been available to advisors in recent years. While advisors maintain the relationship with the client, the turnkey solutions provide a host of operational and marketing services, including ERISA 3(38) investment services to the plan sponsor. Advisors benefit from having a fee-based platform that streamlines their DC processes and allows them to use their current skills and focus on servicing the plan without substantial investment in launching the DC business, or taking on fiduciary risk.

We recently asked three DC turnkey providers who emphasize prudent investing to discuss their solutions. The answers below reflect the opinions of Scott Pritchard, man-aging director at BAM Advisors Access (www.advisorsaccess.com), Gary Allen, principal at Prudent Retirement Services (www.prudent-retirementservices.com), and Erich Reinhardt, VP of advisor relations at Loring Ward Total Retirement (www.totalretirement.com).

DC Dimensions: What prompted you to develop this 401(k) turnkey solution for advisors?

Scott Pritchard: Advisors have an unprecedented opportunity in the 401(k) marketplace, but many of them don't have the expertise, the materials, or the support to capture that opportunity. Given that we have worked with 401(k) plans since BAM's founding in 1985 and have been a TAMP for over ten years, we recognized that we were uniquely qualified to deliver a solution that could help advisors seize the chance to win 401(k) business.

Gary Allen: The idea actually came from other advisors who were familiar with our specialization in qualified retirement plans. They asked us if it was possible for them to collaborate with us on retirement plans. Prudent Retirement Services (PRS) was born as a result of those first inquiries more than five years ago.

Erich Reinhardt: Loring Ward has been a firm that was built by advisors for advisors. For some time, our advisors have asked for a solution that would allow them to deliver the same investment solution and experience to ERISA plans that their wealth management clients have enjoyed. This was a natural evolution to the continual enhancement of our offering for advisors.

DC Dimensions: What are the main services you provide to advisors? What are the benefits to them?

Scott Pritchard: BAM provides expertise, materials, and support at every step of the 401(k) process, from marketing to implementation to client service. In essence, we are an advisor's "401(k) back-office," which allows them to focus on what they do best: managing client relationships.

Gary Allen: PRS provides a large number of services to advisor firms in the PRS network, which can be categorized as follows: practice management support, marketing/sales support, client conversion/transition, and comprehensive client services. We take pride in offering flexible turnkey solutions customized to each PRS network member.

Erich Reinhardt: There is a wealth of services that we provide to advisors. From education, through our one-day retirement symposiums and on-demand video education series, to marketing, coordination of providers, implementation, and strategizing. Above all, Loring Ward is a strong partner for advisors with our twenty-year history and nearly $7 billion in assets under management.

We offer our partner firms the opportunity to build a business model that fits the needs of their firm and their clients.

DC Dimensions: What has been the advisor response so far?

Scott Pritchard: The response has been fantastic. Advisors recognize the opportunity to increase their profitability and deepen client relationships by offering an innovative 401(k) solution that doesn't require a dramatic change to the advisor's business model.

DC Dimensions: Who are the best candidates for your platform?

Gary Allen: The best candidates for the PRS platform are advisors who are looking to expand their business into the retirement plan marketplace on their own terms. We offer our partner firms the opportunity to build a business model that fits the needs of their firm and their clients. We believe that the PRS turnkey solution offers advisor firms the best opportunity to "build a key" that will open the most doors for their business. In essence, the PRS solution becomes an extension of the advisor firms' current wealth advisory practice, offering the least disruption and the most support. If someone is interested in getting into the retirement plan business quickly, efficiently, and profitably, the PRS network is the right place for them to be.

DC Dimensions: Would having an additional layer of costs make the advisor uncompetitive or the plan costs too high?

Erich Reinhardt: Costs are always an important factor when considering services, but not the only factor. Cheaper isn't always better. The key for plan sponsors is to first identify what they have and how much they are currently paying—an advisor can be a great asset to plan sponsors in this process. Then they can determine if enhancements can/should be made and compare costs to determine if it is beneficial to proceed. We believe that our services offer great value to both advisors and plan sponsors. ■

For a copy of the complete interviews, please contact Apollo D. Lupescu at apollo.lupescu@dimensional.com.

DIMENSIONAL MANAGED DC

An introduction to Dimensional Retirement's Managed DC solution

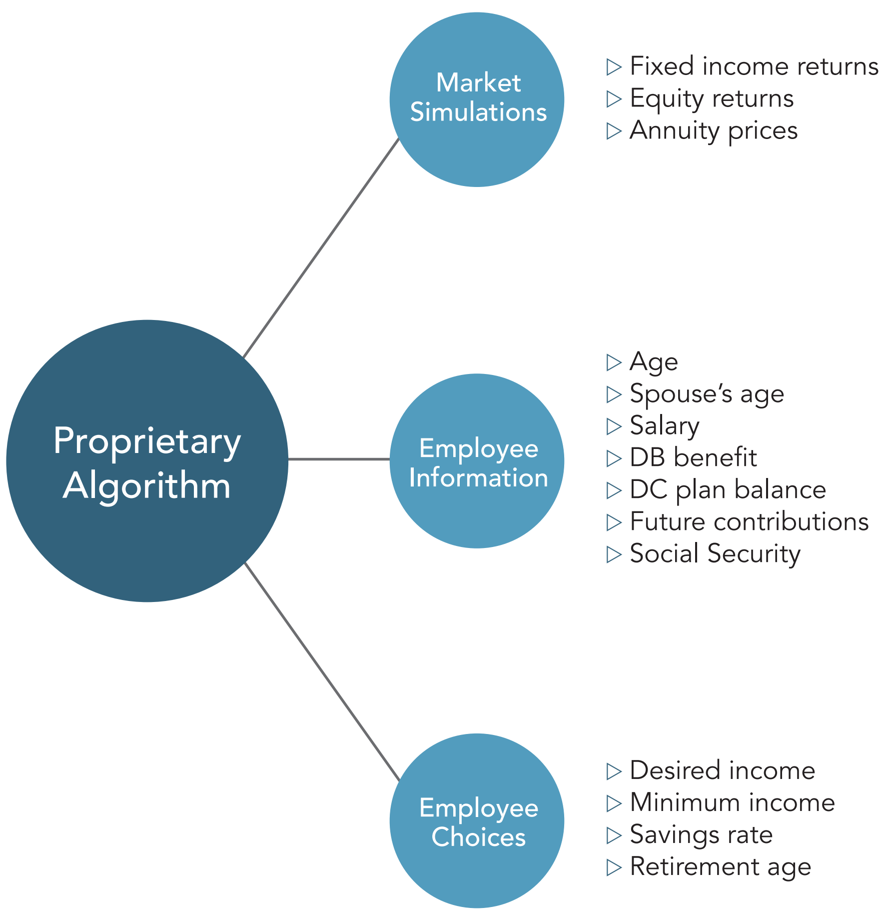
By ROBERT BRAZIER, senior editor, Dimensional Fund Advisors

Dimensional Managed DC is a personalized, risk-managed retirement solution designed to help participants achieve inflation-protected income throughout retirement. The solution is fully integrated, incorporating a retirement income planning process, asset allocation strategies that are personalized for each participant, and ongoing investment management. At each step of the process, the focus is to maximize the probability that each participant will reach his or her desired retirement income goals and to minimize the risk of ending up below a certain minimum income.

Works with Default Options or It's Customizable

For those participants who never engage in the process, pre-defined, default settings are employed. For those who choose to take a more hands-on approach, they may opt to customize their settings. Portfolio allocation and investment execution are then handled "under the hood" without requiring the employee's involvement. A patented, science-based algorithm is used to dynamically manage interest rate, market, and inflation risks, and to reflect changes in assets, market conditions, and personal circumstances.

FIGURE 1 INPUTS TO THE ALGORITHM



Creates Unique Implementation Plan for Each Participant

Unlike target date funds that use a simple calculation based on one variable—the participant's age—to decide the equity/fixed income split, Dimensional Managed DC creates a customized, dynamically managed solution based on each participant's goals, life situation, current assets, expected future contributions, and desired outcomes.

Manages Risks with an Assets-and-Liabilities Driven Strategy

Most retirement solutions only focus on the allocation of what is currently in the participant's retirement account. Dimensional Managed DC also considers future savings in order to create a unique plan that better addresses each participant's goals and life situation. For each participant, we create a retirement planning balance sheet—with the ability to include government-provided benefits, legacy defined benefit (DB) plan benefits, current defined contribution (DC) plan balance, and expected future contributions (human capital) on the "asset" side and the participant's retirement income requirement on the "liability" side.

FIGURE 2 BALANCE SHEET FOR AN INDIVIDUAL PARTICIPANT

ASSETS	LIABILITIES
Social Security income	Retirement income requirement
DB plan benefit	
DC plan balance	
Future contributions	

FIGURE 3 RISK INCREASED BY AIMING SIMPLY FOR "GROWTH"

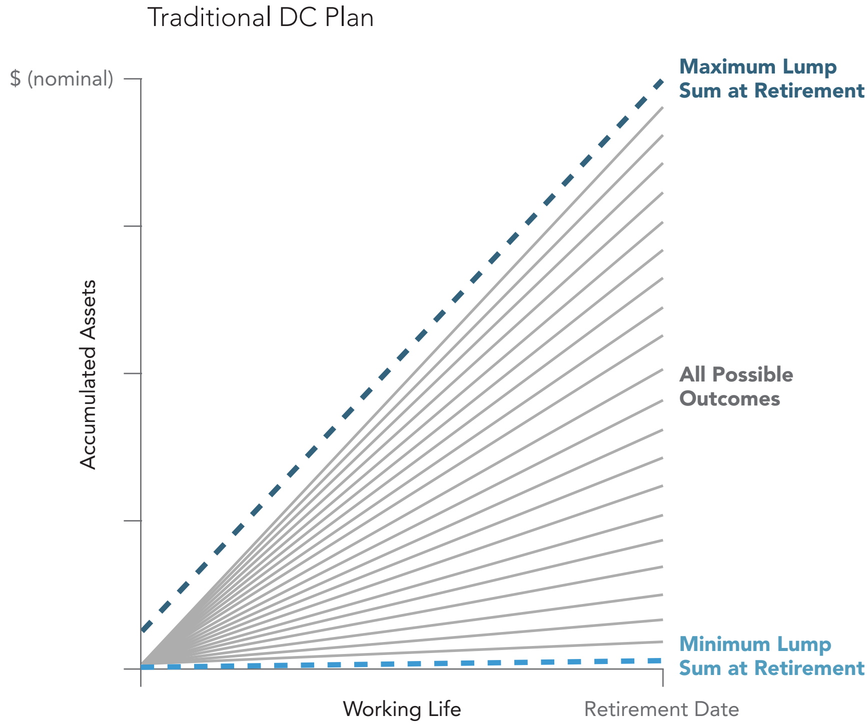
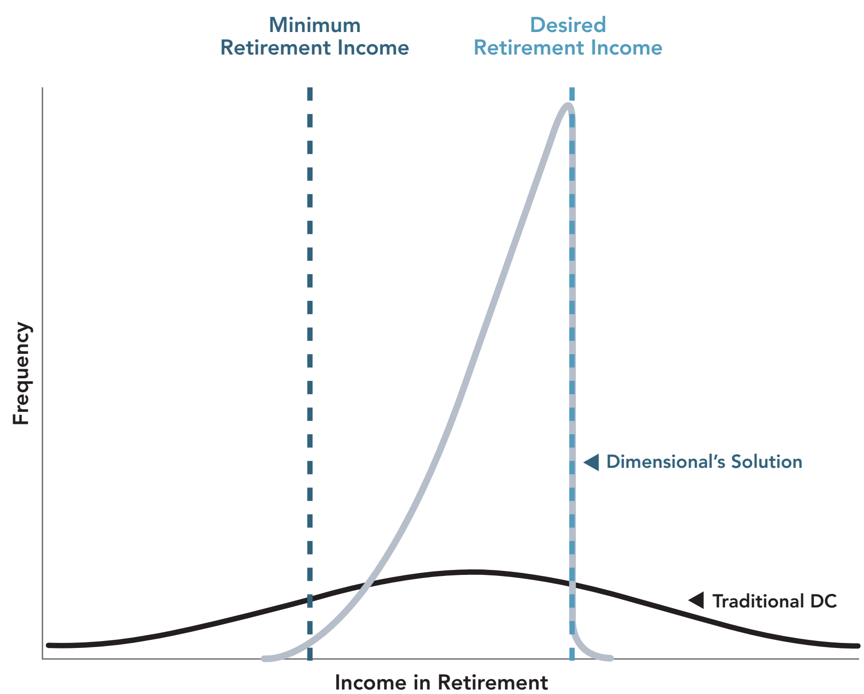


FIGURE 4 RISK MANAGED BY AIMING FOR SPECIFIC OUTCOMES



For Illustrative Purposes Only.

Risk Management Decreases Uncertainty

Traditional DC solutions seek to maximize the growth of assets as their primary goal. Dimensional's solution seeks specific retirement income targets. The primary goal is to minimize the probability of not achieving an income level necessary to maintain a comfortable standard of living in retirement—a real concern and risk facing participants. By narrowing potential outcomes while increasing the probability of achieving the desired income target, Dimensional's Managed DC solution seeks to address the uncertainty faced by many investors saving for retirement.

How Assets Are Invested

Within each participant's customized plan, two portfolios are employed from specially engineered fixed income and equity strategies managed by Dimensional Fund Advisors. First, a low-risk, hedged approach invested in fixed income securities is used to minimize the expected probability of not achieving the participant's minimum income requirement. Second, the remaining assets are invested in a broad equity, dynamically optimized strategy designed to target higher expected returns and maximize the probability of reaching the participant's higher desired income target.

Transforming Theory into Practice

Dimensional Managed DC seeks to better address what participants really need—the means to achieve a consistent source of income in retirement. To this end, Dimensional's Managed DC solution has taken the best thinking from advances in managing risks relative to investors' goals and combined this revolutionary approach with Dimensional's low-cost, value-added investment strategies. ■

The underlying investments in Dimensional Managed DC (fixed income and/or equity securities) are subject to market risks and may fluctuate in value over time. There is no guarantee of achieving the target income payout during retirement.

ABOUT DIMENSIONAL

Now in its thirtieth year, Dimensional implements great academic ideas in revolutionary ways. The company got its start by transforming early research on small stocks into the first micro cap fund in the market. Later, research by Gene Fama and Ken French inspired new strategies with deep value exposures. Dimensional Managed DC is the latest example of the firm's commitment to combining science and practice. Building on the research of Nobel laureate Robert C. Merton, Dimensional Managed DC has engineered a new way to invest for retirement that addresses a real need in the market today.

Dimensional is a global institutional asset management firm with around-the-clock trading capabilities out of offices in Austin, Santa Monica, London, and Sydney. The firm also maintains offices in Vancouver, Toronto, Amsterdam, and Berlin. Dimensional acts as investment advisor, or sub-advisor, for hundreds of financial advisor and institutional clients, including corporate defined benefit and DC plans, public retirement plans, family offices, financial institutions, endowments, and foundations. As of June 2011, the firm managed about 250 investment vehicles and had approximately $230 billion in assets under management, including $17 billion in DC assets.

UPCOMING DC EVENTS | 2011

SEPTEMBER

				1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	

September **14** | Chicago, IL
DIMENSIONAL INVESTMENT FORUM

September **15** | Austin, TX
DIMENSIONAL ADVISOR 401(k) WORKSHOP

September **19–22** | Las Vegas, NV
PSCA ANNUAL CONFERENCE

OCTOBER

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2	3	4	5	6	7	8
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16	17	18	19	20	21	22
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October **23–26** | National Harbor, MD
ASPPA ANNUAL CONFERENCE

October **27–28** | Santa Monica, CA
DIMENSIONAL ADVISOR ADVANCED 401(k) SYMPOSIUM

October **30**–November **1** | San Francisco, CA
P&I WEST COAST CONFERENCE

2011 DIMENSIONAL DC CONFERENCE
CHICAGO BOOTH GLEACHER CENTER
Held July 13, 2011

For conference materials from this event, information about Dimensional's Annual Investment Symposium in January 2012, or other upcoming events, please visit us at **http://dfaus.com/u/3da.**

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