Let's Build a Defined Contribution Services Company from Scratch

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Industries, while often capable of positive change, also tend to accrue bad habits. Things are done a certain way because it made sense at some point. Choices become procedures, procedures become policy, and policy becomes an unquestioned assumption.

The Defined Contribution business goes back a long way: the 401(k) plan to 1981, the 403(b) plan to 1958, and the first deferred profit-sharing plan to 1916. How many wrong turns that now seem irreversible have we taken during these past decades? What if we could start over and create a DC provider called Blank Slate, Inc. – not changing the federal rules, but building a different business model around them? How might we do the job differently?

We'd like to suggest some ideas in answer to this question. Some of them could be adopted by almost any firm. Others would first require digging up some deep roots, and probably could best be implemented by, in fact, creating a new company from scratch.

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Putting the customer first is the most viable strategy for the long haul – not least of all because plan sponsor decision-makers are themselves plan participants.

Blank Slate, Inc. change #1: The Individual Participant Comes First – Really

Of course the industry today cares about individual participants, but if I may speak out of school, they are not always the *top* priority. And even when we do focus on them, we can be so boxed in by structures, traditions, and assumptions having little to do with individual needs that it is difficult to see the world the way the customer does, and to see individual participant needs as they truly exist.

Most of the rest of this essay will address specific examples of this claim. So for the moment let's focus on the suitability of a truly client-centered approach.

First, let's remember that the purpose of the federal legislation that created retirement plans was not to enrich financial companies but to benefit ordinary people by enabling and encouraging them to save for retirement. So, keeping in mind that the government could actually do this job itself, a focus on the good of the customer ought to be the default.

Second, putting the customer first is the most viable strategy for the long haul. Oftentimes (e.g., with IRAs and many 403(b) plans) the plan participant is the actual buyer. But even when an employer is the buyer, surveys repeatedly demonstrate that most of them also care about the financial welfare of their employees.[*] If they had the option of dealing with a provider that took care of plan members in demonstrably better ways, they would generally choose it – not least of all because plan sponsor decision-makers are themselves plan participants.

The recent experience of Ally Bank (formerly GMAC), though still less than two years old, is instructive here. They've had significant early success in re-launching themselves as a high-interest-paying but low-hassle

[*] The most recent is Deloitte's 2010 *Annual 401(k) Survey: Retirement Readiness*, the complete text of which is available at http://www.iscebs.org/Resources/Surveys/Documents/401(k)Survey_10.pdf.

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banking operation. Putting customers first by fixing obvious flaws can be a very viable business strategy.

Blank Slate, Inc. change #2: Don't Compete on Portfolio Performance

This strategy clearly makes little sense for companies who offer DC plan services primarily to promote use of their own products. But Blank Slate is a plan provider, not a product manufacturer, and it will best serve its customers (change #1) if it doesn't confuse its mission. In most cases, better net performance will result by not trying to compete on investment results. This strategy is manifested in at least three ways:

2a: No advertising about prior performance

A truth: "Past performance is no guarantee of future results." A less publicized truth: "Past performance is no *indicator* of future results." The fact that DC Provider A or Portfolio Manager X beat everyone else's five-year average is almost completely irrelevant to whether that pattern will repeat over the next five years. Some data even suggests the opposite: that top performers in one cycle tend to fall below average in the next one, which might just be the law of averages setting in, or it might be due to psychological factors (such as overconfidence on the part of successful managers) or structural ones (viewpoints and methods suited to one phase of the economy being unlikely to work as well in the following phase; or the influx of new money into successful funds resulting in earlier investment strategies no longer being viable).[*]

Since past performance is irrelevant, we should stop

[*] Some of these points, and related ones, are addressed in "Command Performance When Choosing an Investment Manager," a brief and not overly technical article by Nick Sykes, available on the Mercer website at: http://www.mercer.com/articles/1393920. Another recent study suggests that past performance does help predict future performance for *hedge* funds, but there is neither a large enough nor a long enough body of data yet to prove that argument.

talking about it – except to *explain* to plan participants that it is irrelevant, so that they are not deceived by people suggesting otherwise.

2b: Promote low-cost fund options – such as index-based ETFs – to participants.

The use of mutual funds or other instruments that carry more than minimal management fees is a disservice to plan participants, because any given fund's *most likely* performance is to match the market (or the applicable market segment) on a gross basis, and to under-perform on a net basis. In most cases, the larger the fee, the worse the long-term result.

Inevitably, some funds (roughly half of them) will beat the market in a given year, but hardly any will beat the market consistently over a period of decades. And there is no way to know or even make a sound guess in advance which funds those will be. So the most rational decision, except in unusual circumstances, is to select market index funds and/or ETFs with their much lower fees. Not that these are perfect investment instruments, but they are the least imperfect for the typical plan participant.

2c: Educate participants on fund selection based on net expected performance and specific investor needs.

A minority of participants will have a legitimate need for specialized investment options. A few will want to play the markets using their asset allocation choices. Therefore, a menu of managed funds should be offered. But funds that take an extra 100 or 50 or even 10 basis points off the net return start out in a losing position, and individual participants need to understand this before choosing them. Fees should be completely disclosed, of course, but that is not enough. Funding options with the lowest fees should be easiest to select, and set up as default choices. Options with higher fees should be segregated, and should be listed with truly useful guidance about when they might be appropriate – or not.

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Blank Slate, Inc. change #3:
Re-Think Asset Allocation Strategies
for Working-Age Participants

Poor asset allocation hurts almost everyone: individual participants because it reduces their wealth, plan sponsors because it undercuts the effectiveness of the benefit program they are paying for, and DC plan vendors because it puts a brake on growth in assets under management.

Starting with a blank slate, here's what we could do that's different, and better:

3a: Offer the option to allocate into non-qualified accounts.

Legally, this would occur outside the plan, and mechanically it would require a separate payroll deduction entry.[**] But it benefits both the DC plan vendor and the participant. Blank Slate, Inc. would gain, because they would capture totally new money: funds that participants today do not want to commit to retirement, and funds that affluent participants want to contribute beyond the tax-qualified limits. More important, Blank Slate, Inc., would also have very little motivation to encourage tax-qualified over non-qualified investment, so it could give the kind of unbiased advice on that subject that is rare today.

For example, young people are usually encouraged to get a head start on their retirement saving – good advice, except that their financial needs in their 20s and 30s are likely to revolve around marriage, a home purchase, life insurance, children's education, and maybe starting a business. Tying up funds in qualified plans works against them much of the time. Often they end up withdrawing the money when they change jobs, and pay a 10% penalty, which more

[**] In addition, employer contributions would still need to be contributed exclusively to the tax-qualified plan so as not to be treated as compensation subject to payroll taxes.

If markets weren't cyclical, Efficient Frontier and Monte Carlo asset allocation models would offer good strategies, but since markets *are* cyclical, these models result in participants buying high and selling low.

than nullifies the advantage of tax deferral for any money that has been in the plan for less than about 10 years. Or they are simply not eligible to withdraw the money when they need it.

3b: Eliminate clever, counter-productive asset allocation models.

Allocation models that rely on the Efficient Frontier concept or that use Monte Carlo analysis are not suited to individual investors. They each have their own flaws, but their worst failure is common to both: they encourage participants to invest in funds that have a strongly positive recent performance, and to flee funds that have had negative results. If markets weren't cyclical, this would be a good strategy, but since they *are* cyclical, it results in participants buying high and selling low. A lot of these models were tweaked after the dot.com bubble burst, and again after the 2008-2009 crash. But these models should be completely discarded in favor of counter-cyclical models, or at least non-cyclical ones.

3c: Provide positive and pro-active advice.

This has to be done with care – either by collecting enough (voluntary) personal information so that advice can be wisely targeted to the appropriate individuals, or by keeping advice generic but timing it well. For example, when markets are falling or there has been a recent crash, participants should be informed about the history of previous crashes, and the general advisability of not liquidating their investments at or near the bottom. The opposite warnings might be sent to participants when markets are setting new records.

Participants might also be reminded about the advantages of taking a loan from the plan during economic times or life stages when this strategy might make sense. (The plan should, of course, offer loans, as well as Roth accounts, if it is participant-focused). Comments about the participant's recent asset reallocations can also be beneficial. Certainly, any

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such messages need to have appropriate caveats. But given that most plan participants are naïve about investment, Blank Slate, Inc. would not be doing them a favor by maintaining silence while they act foolishly, or foolishly fail to act.

Blank Slate, Inc. change #4: Provide Education and Advice Beyond Investments

The basic purpose of DC plan participation is to improve the quality of someone's life. By keeping that in mind and not getting lost in the numbers, Blank Slate can offer much better education and advice.

4a: An easy example: calculating retirement accumulation needs.

We routinely compute how much savings someone should accumulate by retirement, and thus how much they need to set aside regularly in the interim. But even if you could predict the future in detail, you could not put a cash price on what it costs for someone to have a happy, fulfilling retirement. Even if we could, we don't know what contingencies will occur that would increase or decrease this amount. So are these calculations a waste? No, because they have a different purpose that is valid and important: to *motivate* the plan participant to save – on the plausible belief that if they do, they will have more and better options when they do retire. But if the purpose is about motivation rather than prediction, surely we should approach it differently than we do today.

4b: A harder example: planning for life, not just for money.

DC plans, by their nature, are focused on retirement. Saving for retirement, though, means making lifestyle sacrifices in the interim, and foregoing other uses of funds that may be just as important, both financially (emergency savings, life insurance, saving for col-

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lege, starting a business, etc.), and non-financially (giving to charity, providing children with access to good schools, travel and other broadening opportunities, etc.). By not helping participants make retirement plan decisions in the broader context of their other concerns and needs, we make it harder for them to make those decisions wisely.

Blank Slate, Inc. change #5: Focus on the Actual Needs of Retirees

In the early years of the past decade, concern about what retiring Baby Boomers would do with their DC plan funds led to efforts to control withdrawals, mainly by calculating "withdrawal" rates that were surprisingly low. But this strategy was built around the needs of asset managers, not those of plan participants. A client-centered approach suggests different approaches – and, ironically, would generally produce better asset retention and even asset growth.

5a: Start talking about retiree cash flows instead of withdrawal rates.

New retirees are now often expected to live another 25 years or more. The notion that a retiree will need an essentially level (or smoothly inflating) withdrawal stream from a DC plan over such a span is simply wrong. Instead, a customer-focused plan would offer a more sophisticated financial model that shows (1) what the retiree's cash flow needs are expected to be under a *normal* scenario, and (2) what cash flows look like under specific financially *adverse* scenarios, like living too long, receiving inferior investment returns, or incurring extra large medical costs.

This approach is clearly much better for the participant, but it is also better for the asset manager, because sometimes the cash flows will be *positive*. In real-life retirement (not the fictional retirement of withdrawal rate models), even middle class families

You don't reduce risk by taking on more (investment) risk. If, when you retire, you don't have enough money to cover potential future expenses, then you simply haven't saved enough, and you need to *reduce* your exposure to risk, by working longer or ratcheting down your lifestyle.

have assets outside the plan that contribute at times to their retirement cash flows: home equity, life insurance, inheritances, small businesses, etc. A DC plan oriented to participant finances rather than its own is in a position to hold onto its assets when these other resources kick in. And if the plan included a non-qualified component, it could actually *gain* new assets when financially beneficial events occur.

5b: Encourage appropriate (i.e., minimal) risk-taking by most retirees.

A common message to retirees these days is to keep investing aggressively, because you face untold years of future inflation and you need to take investment risk to offset your inflation and longevity risks. But this is bad advice. You don't reduce risk by taking on more risk. If, when you retire, you don't have enough to cover potential future expenses, then your resources are inadequate, and you need to *reduce* your exposure to risk, usually by working longer or by ratcheting down your lifestyle. Taking more investment risk might increase your ability to keep living the high life, but it also increases your likelihood of going broke before you die. For most retirees, this is just the trade-off they want to avoid in their older years, and so Blank Slate, Inc. would never recommend even middling levels of investment risk for retirees, unless they clearly could afford to absorb losses.

5c: Give holistic advice.

We already discussed planning for life rather than just for money, but this is a critical issue for retirees.

Most people who reach retirement age these days are healthy enough to continue having a vigorous life, and most of them want to. Many actually want to continue working, though often in a completely different field, and perhaps with shorter hours, less pressure, a shorter commute, or other appealing qualities. Others are looking to spend money, usually on travel or other leisure pursuits, though sometimes on philanthropic projects, or helping family

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members. Sometimes families are restructuring – through divorce, remarriage, moving nearer to or in with children, and so on. Sometimes there are life-style changes – in diet, exercise, stress levels, even spirituality – that will extend life expectancy. And of course, sometimes there are gradual or sudden changes in health that shorten life expectancy, and impose onerous extra costs in the meantime.

Ideally, Blank Slate would help people understand such issues and how they interconnect, so wise choices get made, and money not only lasts, but is put to its best uses. At the least, Blank Slate would help people understand the financial consequences, so that they can manage their funds appropriately.

Blank Slate, Inc.: The Wise Choice

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If Blank Slate, Inc. has the edge, as we believe it does, how do you get there from where you are? As noted earlier, while some of the suggested changes may be at odds with the purposes or culture of many current DC plan service providers, other changes could be implemented easily enough. All that is needed is a willingness to innovate, access to appropriate expertise, and a modest investment in modifying current practices. What always has been, does not always need to remain. Your customers (and new ones) will applaud your efforts.

RetirementWORKS, Inc., and its parent company, Still River Retirement, provide *innovation, consulting and tools* to financial companies, employers, consumers, and consumer-based organizations, related to retirement. To learn more, go to: http://www.StillRiverRetire.com/consulting.