DC plan design- *the good and the bad*

A sound long-term DC strategy should be influenced by the future earnings power, circumstances and goals of each individual. This added human element makes DC plan design particularly challenging.

Few DC systems around the world seem to understand the fundamentals of good plan design. DC plans fall into various traps, such as equity cultures that are not strong enough, excessive home bias in equity investing, and investing in the wrong sort of bonds.

These shortcomings exist because the key drivers of DC investment policy are not well understood. The two key drivers are:

- that the strength and characteristics of an **individual's** future earnings potential should determine the equity/bond split at each age

- that the goals for retirement are key to determining the balance between risk and reward through **the member's lifetime and according to their circumstances.**

A one size fits all approach is inevitably a compromise.

This leads to some of the mistakes that DC plans make. There is often a misconception that the lowest risk position for a DC investor in the long term is equities, whereas we would contend it is long-dated, inflation-linked bonds. Because pensions are spent in real money, it is purchasing power that really matters to the DC investor. This point is often underappreciated.

As for the best blend of return and risk, our best expectation is that this can be achieved by investing in global equities with some currency hedging. However, most pension assets worldwide have a significant 'home' bias, which is inexplicably stronger in DC than in DB assets.

That brings us to equity risk. Recent experience aside, equities have suffered very few negative years in almost two decades prior to 2000. This makes the probability of loss difficult to judge. Behavioural studies have shown that people generally are notoriously poor at assessing the significance of rare or unusual events.

Investors are often surprised to discover that there is a 30% chance of a one-year loss in global equities, and that the average amount of this loss is 9%. But contrary to popular belief, balanced funds are not much less risky. A balanced 70% equity 30% bond fund carries roughly a 25% probability of a one-year loss. What is more, the probability of loss in any 10-year period is still a relatively high 6%. This means that one decade in every 16, equity investors will lose money. The alarming overstatement of the so-called time diversification of risk for equities has led too many people to invest in equities for the wrong reasons. We are not saying that DC members should not invest in equities, but it should be for the right reasons, and with a full appreciation of the risks involved.

The acid test of a sound strategy for a long-term investor therefore lies in balancing the 3% equity premium with the long-term riskiness of equities in the context of the investor's goals and future earnings potential. However, DC plans worldwide largely fail to take all these aspects into account. Most are driven by the long-term fiduciary liability concerns of the sponsoring employer and not by efficient investment principles.

We believe that individuals should stay invested in equities for longer than they generally do in order to gain potentially higher benefits. But this will require the investor to save more to protect against the possibility of poor investment experience. Members who do not make this commitment will curtail their ability to support investment risk and should reset their investment strategy accordingly.

Similarly, few DC systems offer the flexibility that is needed upon, and after, retirement. The US is one of the better systems, while the UK in many ways is not. We favour the option to have an annuity, some lump sum payment, and a draw-down facility. Some markets handcuff individuals to too great a degree at retirement.

Towards a better DC framework

Though in our view none of the DC markets worldwide currently

represents best practice, it is possible to identify good features among them.

Current DC plan design can be categorised in three ways.

- The simplest is the single fund, which dictates one strategy for all members.

- More complex is the 'lifestyle' model that offers a fixed number of managed strategies ranging from aggressive to cautious. Given the right equity mix and progression over time to retirement, these funds are very efficient for a DC investor.

- The third model is the 'open choice', typified by 401(k) in the US. This permits investors to choose among many specialist products, often targeted at specific subsets of the investment market, in contrast to the balanced baskets on offer from the other two DC models.

The single fund model is outdated as it is inflexible and typically too conservative.

The second model has reasonable flexibility, it is attractive to most members (though choice is limited), and in theory it is investment efficient given the right equity/bond mix. The disadvantage to the employer is the risk of future liability.

Turning lastly to the 401(k) model, the key feature is that investors must be competent. However, evidence is that member education has so far been lacking.

Our goals for best practice in DC plan design are flexibility and efficiency. Drawing on the best features of all three models, we can create a better framework for DC plans. The basic features should include a core list of funds for core contributions, incorporating lifecycle characteristics and ensuring that member education is adequate. There should also be extended choices for certain types of additional contributions, so that competent members can benefit from the full range of opportunities.

The lifecycle principle is sound as it ensures that members do not rely on too high a contribution from risk too close to retirement. It also fits the thesis that future earnings power and individual circumstances should determine how people invest their DC assets. However, the lifecycle approach has not developed as it should because it is difficult to design average or default lifecycle strategies that cater to individual needs. Also, education has been inadequate.

In conclusion, lifecycle strategies represent a way forward for DC investments, but far more work is required by all of us in the industry to make this approach successful.

DC trends in the US

Defined contribution plans have become the dominant plan design within the US retirement system measured in both the number of workers covered and total assets. As of 2001, more than 40% of private sector workers participated in a DC plan. Some 28% had DC plan coverage only, an additional 15% were covered under both a DB and DC plan, and only 6% had DB plan coverage only. The coverage shift toward DC plans reflects both employee preferences for their greater flexibility and portability, and employer preferences for their more predictable cost management features.

However, the current bear market has exposed some weaknesses in the design of investment options and how members invest their retirement assets.

Many DC plans are designed to encourage employee ownership of the sponsoring company's stock as well as accumulating retirement savings. Concentrated stock ownership is often at odds with employees' retirement security and the construction of well-diversified investment portfolios. Some 43% of companies with DC plans require their matching contributions to be invested in company stock, which has led to a large undiversified exposure to company stock in employees' DC plans. Companies are now making some moves to address this issue by modifying transfer restrictions or establishing a ceiling on company stock holdings.

The design structure of investment options can also be improved. At present, lifestyle or asset allocation funds frequently appear as one option among many offered to employees. This means that employees may take on inappropriate levels of risk. Greater promotion and use of these types of funds would give employees better diversification and a more appropriate asset allocation for their own time horizon.

Another solution to these difficulties is to improve member education, an area that the bear market has exposed as inadequate. For example, Morningstar, a leading information provider on US mutual funds, recently found that investors predicted a 52% correlation between past and future fund performance, higher than is rational. DC plan members clearly need better guidance, particularly about prudent diversification and how much they need to save to meet their retirement expectations.

Things you **should** know to be a good DC investor

At one of our Global Asset Study conferences we asked attendees a variety of questions about what it takes to be a good DC investor. Here are some of those questions.

1 To achieve the least uncertain outcome in the long run in DC, you should invest in:

a) Cash
b) Fixed bonds
c) Inflation linked bonds
d) 'Balanced' fund (for example, 70% equities)
e) Equities

2 To achieve the highest return per unit of risk in growth assets, you should invest in:

a) Domestic equities - large cap
b) Domestic equities - all cap
c) 50% domestic equities, 50% foreign
d) Global equities
e) Global equities with some currency hedging

3 The additional return you can expect in future from global equities over long government bonds is:

a) 0% or under
b) 1%
c) 2%
d) 3%
e) 4%
f) 5%
g) 6%
h) 7%
i) 8%
j) 9% or over

4 The premium you are likely to produce from 100% equities over a balanced portfolio (taken to be 70% equities, 30% bonds) over 30 years is:

a) 5%
b) 10%
c) 15%
d) 20%
e) 25%
f) 30%
g) 35%
h) 40%
i) 45%
j) 50% or more

5 The probability of a one-year loss in global equities is:

a) 5%
b) 10%
c) 15%
d) 20%
e) 25%
f) 30%
g) 35%
h) 40%
i) 45%
j) 50% or more

6 The probability of a one-year loss in a balanced fund is:

a) 5%
b) 10%
c) 15%
d) 20%
e) 25%
f) 30%
g) 35%
h) 40%
i) 45%
j) 50% or more

7 The probability of a 10-year loss in global equities is:

a) 1%
b) 2%
c) 3%
d) 4%
e) 5%
f) 6%
g) 7%
h) 8%
i) 9%
j) 10% or over

8 The average amount of a 10-year loss in global equities is:

a) 2%
b) 4%
c) 6%
d) 8%
e) 10%
f) 12%
g) 14%
h) 16%
i) 18%
j) 20% or over

For the answers to these questions, please contact Deborah MacLeod on +44 (0) 1737 241144 or at deborah.macleod@eu.watsonwyatt.com