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Considerations in Choosing a Target Date Fund

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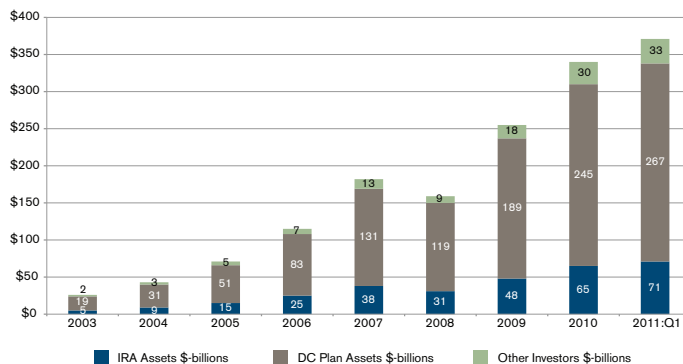
As a retirement plan sponsor considering target date funds (TDFs) as an offering in a 401(k) plan and similar arrangements for your employees, you face many choices. The explosive growth in the number of fund offerings in recent years, along with regulatory guidance, raises several issues for plan sponsors seeking ways to encourage workers to save and invest for retirement in an appropriate way.

This article explores some of the key areas plan sponsors should consider when selecting a TDF.

Growth in TDFs

With over \$371 billion in assets in TDFs and over \$338 billion of that amount in retirement accounts as of March 31, 2011, there is a significant level of investment in these vehicles, according to the fund industry trade group the Investment Company Institute (ICI). In particular, the ICI reports that assets in defined contribution retirement plans have grown from \$19 billion in 2003 to over \$267 billion in TDFs by March 31, 2011 (see Figure 1).

FIGURE 1: DOLLARS INVESTED IN TDFs (IN BILLIONS)



Two developments led to the significant number of TDFs being offered in the marketplace. The first was the 2006 Pension Protection Act, which provided for “qualified default investment alternatives” (QDIAs). Under this provision, a plan sponsor as a fiduciary would be protected against participants’ claims of improper investment if amounts were contributed to a QDIA in accordance with regulations to be issued by the Department of Labor (DOL). The second was the DOL’s publication of a final rule in the fall of 2007 that spelled out the types of investments – including TDFs – that qualified as QDIAs.

The mutual fund industry, in particular the sub-section involved in TDFs, experienced renewed interest and growth. Just about every retirement plan began adding them. From the plan sponsor’s view, TDFs offered a relatively simple-to-explain investment vehicle or a means to send contributions into an appropriate investment vehicle if participants did not formally select one.

The “Wake-up” Call

But in late 2008 to early 2009, TDFs came face to face with a test of their suitability. During that period, the Dow Jones Industrial Index dropped from over 12,000 to under 8,000. A Government Accountability Office report, “Defined Contribution Plans: Key Information on Target Date Funds as Default Investments Should Be Provided to Plan Sponsors and Participants,” noted that TDF investment performance varied considerably. “Between 2005 and 2009 annualized TDF returns for the largest funds with 5 years of returns ranged from +28 percent to -31 percent,” the report stated. The varying returns were driven by the different allocations of stocks and bonds along the TDFs’ “glide paths” (more on this on the following page).

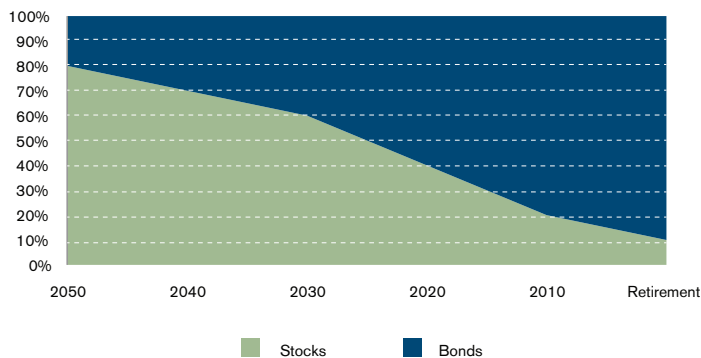
The financial crisis and market downturn's effects on TDFs and retirement savings vehicles heightened Congress's and regulators' interest. Many plan participants nearing retirement with TDFs having the year 2010 as a target date experienced sizeable investment losses. As a result, the DOL late in 2010 proposed modifications to its regulations related to disclosures by plan sponsors for TDFs and QDIAs. In addition, the Securities and Exchange Commission (SEC) proposed a rule to regulate how TDFs are advertised to potential investors, including retirement plan sponsors and plan participants. The SEC's proposed rule would require TDFs to disclose more clearly and prominently such information as the asset allocations, the risks involved, and the specific trajectory of the glide path.

The Glide Path

A TDF is sometimes referred to as a lifecycle fund. The TDF provides an allocation of stock, bond, and cash mutual funds under a mechanism known as the glide path that tapers down (see Figure 2) from a larger stock allocation at its starting point to a higher cash/bond allocation at its terminal date (i.e., the target date).

The reduction in stock exposure over time is intended to lower the risk and volatility of the fund, starting with a higher stock allocation in the beginning portion of the glide path, where investors would have a longer time horizon to work through volatility. Approaching the end of the glide path, the fund will have more bond exposure, intending to provide more stable returns and potentially regular interest income. The end of the glide path, also referred to sometimes as the "landing" or "terminal" point, typically reflects where the fund will reach its most conservative investment allocation.

FIGURE 2: GLIDEPATH FOR SAMPLE TDFs



In general, a mutual fund company will have a series of funds with various target dates. This design aims to meet the needs of investors with different target date points in the future (often

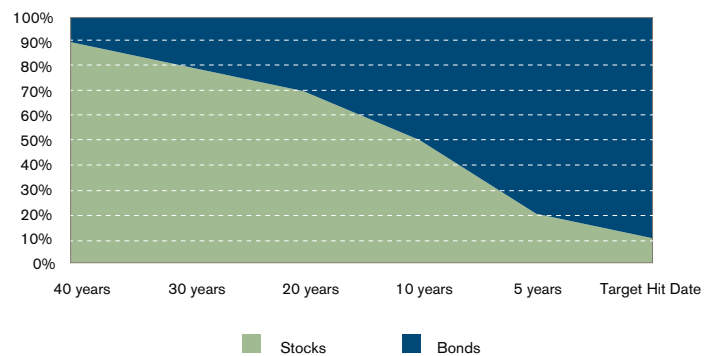
at retirement) when the assets will be needed. A fund family typically will have a series with target dates ranging in iterations of five or 10 years, such as the Target 2020, Target 2025, and Target 2030 funds. Each of the funds will follow the same general glide path; however, the funds will have a different future date at which they will meet their terminal point.

The "To" vs. "Through" Factor

A significant problem that became apparent in the market downturn was the lack of understanding or the insufficient description of a critical piece of the glide path.

Many plan sponsors and participants perceive the fund's named "date" as the date at which the fund will hit its most conservative allocation. For example, the Target 2020 fund may hit its most conservative allocation near 2020. This type of fund is a "To" series of fund. (See Figure 3.)

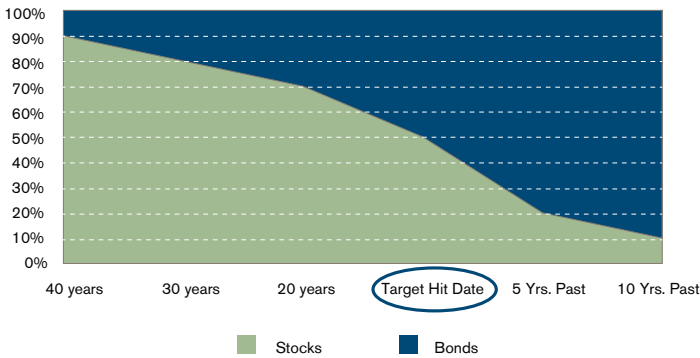
FIGURE 3: "TO" TARGET DATE FUND



Other funds extend the number of years beyond the date stated in their name to reach their most conservative allocation. These funds are the "Through" series of funds and will reduce their stock allocations past the date stated in the fund name, hitting their most conservative allocation some years later (see Figure 4). The reason for this is to factor in some level of life expectancy beyond the date stated in the fund's name (i.e., "The 2020 Fund" will continue to shift allocations over the 10 years immediately past 2020).

The DOL's and the SEC's proposed rules specifically home in on this potential area of confusion. The proposed rules – not yet in final form – would require that the disclosures related to TDFs include an explanation of the allocation and when the fund will reach its most conservative allocation. Also, if there is a date stated in the name of the fund, the disclosure would require some details on the age group for whom the fund would be appropriate.

FIGURE 4: “THROUGH” TARGET DATE FUND



Armed with the basic data, you will then be able to consider the following in the TDF selection process:

- The TDF's glide path – The “to” or “through” glide path will affect how the fund is invested over time and the potential risk and returns. But plan sponsors should also consider the glide path's asset allocation when it is most weighted with stock and the pace at which it shifts to a more conservative allocation.
- The TDF's underlying investments – Whether the fund is indexed (and thus, passively managed) or actively managed will likely have a bearing on the expense ratio of the fund and its cost and fees. Plan sponsors also should look deeper into the underlying investments, examining the TDF's allocation of stocks and bonds. One thing to bear in mind is that saying a fund at a given point on the glide path consists of 50% stock will not sufficiently tell the whole story: is that portion, for example, made up of riskier emerging/foreign stock or of U.S. large cap stock?

Other considerations may include: the fund manager's tenure; whether the fund has been rated; the services that will be included; any conflicts of interest in asset allocation selection; the TDF's “target” date increments; whether in-house or third-party asset managers are used; whether the use of a single fund family is appropriate; the conditions under which a fund manager will have discretion to make allocation or investment changes; and the fees charged.

Ongoing monitoring

Monitoring the TDF will entail an examination of its return on investment or fund performance. With the variety of investment managers providing TDFs and the many types of investments that may underlie a fund, monitoring on an apples-to-apples basis is likely to be difficult.

To benchmark the fund to one of the many indexes available, a plan sponsor may have to find an index that closely follows the

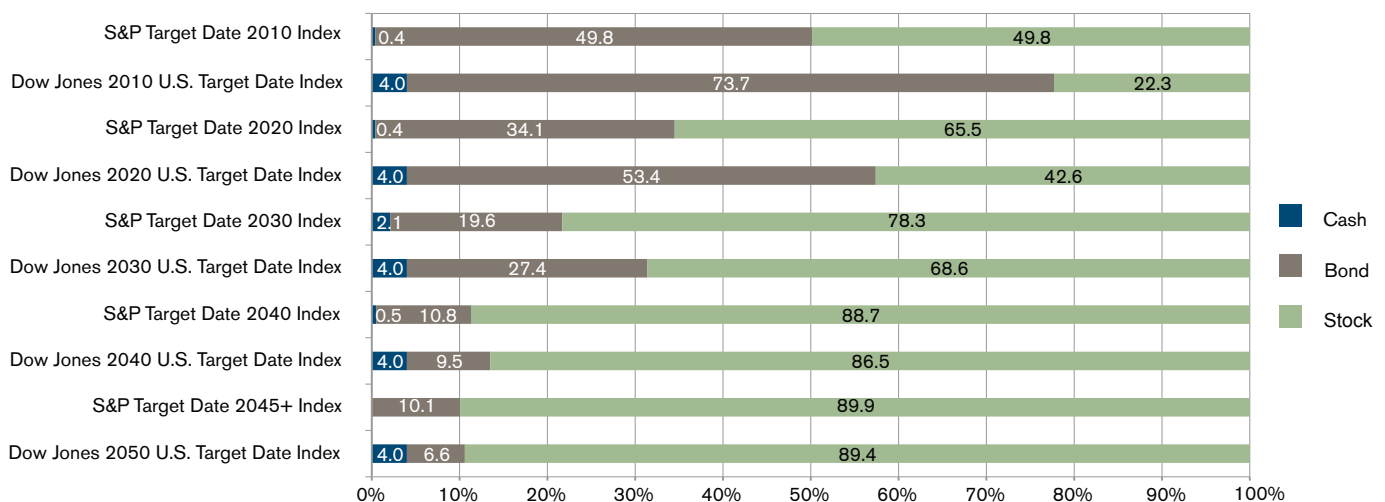
Plan Sponsor Considerations

As a sponsor, your foremost consideration will be your fiduciary duties in selecting, monitoring, and communicating a TDF option. Although this role entails many issues that are beyond the scope of this article, there are some key areas to consider.

Selection of a TDF

A number of factors should be considered in performing due diligence in selecting a TDF and the process itself, along with the steps taken, should be documented. Because you must act solely in the best interest of plan participants, your fiduciary duty will require that you have some fundamental information. Demographic data will be essential, including their age, salary, savings contribution rate, plan participation tenure, and employment turnover. Besides employee information, other basic considerations that will have a bearing on selecting a TDF include whether the employer offers other plans (such as a defined benefit plan or another defined contribution plan, perhaps one with an employer stock component) and the plan features such as distribution options. (A plan sponsor is not likely to have access to such other considerations as the existence of benefits the participant's spouse has or personal individual retirement accounts.)

FIGURE 5: TARGET DATE INDEXES



allocation and glide path of the TDF series in the plan. Figure 5 shows two examples of how the allocations of indexes at points in time can vary, just like the actual TDFs. It also may be necessary to create your own benchmarks to mirror the allocation or underlying investments of the TDFs.

Sponsors should regularly review the TDF to determine if there have been any changes to the glide path or asset allocations. Consider: What was the reasoning behind the change? What, if any, underlying funds have been added or removed from the fund? With these types of changes, are employees still invested in the most appropriate fund?

The communication effort

Communicating the fund to employees is an important fiduciary function and may form the basis of the TDF being an appreciated investment offering. To ensure that employees understand the fund series and how to utilize it may very well hinge upon the “to” versus “through” glide path explanation. If the plan uses the series as a QDIA via an automatic enrollment feature in particular, the sponsor’s responsibility for clearly and accurately explaining the TDF will be paramount. The disclosures should provide details about the fund series and explain how the fund operates, its allocation mix, future adjustments in allocation to its target date, and fees.

Although TDFs have been marketed as a “set and forget it” investment and while this moniker may hold true in most situations, one additional communications challenge may be to explain the conditions under which participation is ideal, i.e., that a TDF is designed as a single source investment vehicle. The potential advantages TDFs offer may be diluted if participants invest in a TDF alongside other investment options.

Some Final Observations

TDFs appear to be here to stay and are likely to remain popular with many participants. Plan sponsors should make a high priority of having an understanding of TDFs, how they differ in their glide paths, the underlying investments, the management expenses, and the operating structures. In addition, you should establish a method to monitor the TDF’s ongoing performance. And do your due diligence in the selection and monitoring of the TDF, as well as provide appropriate information in disclosures and other communications.



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Outsourcing for Mid-sized Organizations

Steve White, FSA, and Penny Plante, CEBS

Recent trends make now a good time for mid-sized companies to consider extending benefit administration outsourcing to defined benefit (DB) pension plans and health and welfare (H&W) plans. The maturing outsourcing market, coupled with increasing administrative complexity, is prompting renewed calls for a cost comparison between outsourcing and internal administration.

These trends, along with the risks and limited flexibility that come with internal administration, may tilt the balance in favor of outsourcing. And the best part is that once an organization has transitioned to outsourcing, you as the plan sponsor can focus on the strategic decisions that have greater impact on your organization and its employees.

This article explores the significant advantages that outsourcing benefits administration may have for medium-sized organizations, those with 1,000 or more employees. Additional details appear in a fuller article by the authors that was published in *Benefits Quarterly*, available at: <http://publications.milliman.com/publications/eb-published/pdfs/midsized-proposition-benefits-outsourcing.pdf>.

The Mid-sized Market

Although outsourcing of benefit plan administration has been the norm for 401(k) and other defined contribution (DC) retirement plans of all sizes, many mid-sized organizations have maintained in-house administration for two important functions:

- H&W plan administration, including enrollment, carrier feeds, billing and call center/online services; and
- DB pension plan administration, including database maintenance, benefit calculations and call center/online services.

Many mid-sized employers have considered outsourcing this work in the past, but ultimately retained their internal structure. Higher costs for outsourcing was most likely the deciding factor, but other reasons may have been involved, such as a desire to preserve the organization’s culture when interacting with employees and concerns about the ability of an outside vendor to do this correctly.

The Changing Cost Comparison

As the outsourcing market has matured, several factors used in comparing the cost of in-house administration with outsourcing have undergone significant changes. A plan sponsor that has benchmarked outsourcing fees in the past may be surprised by the results of repeating that exercise now. Fees will likely be similar to, or even lower than, those quoted several years ago. Several factors are influencing this:

- **A Maturing Industry**—Benefits outsourcing processes have become more efficient over time and systems development costs have stabilized. These changes mean higher potential profit margins. The result for plan sponsors shopping in the current market is more negotiating leverage—particularly for implementation fees, but also for ongoing fees. Although a full waiver of implementation fees for DC plan outsourcing has been the norm for many years, this is not the case for H&W and DB plan outsourcing, in part because the implementation work is more involved. However, the trend today is clearly in the direction of lower implementation fees.
- **Increased Competition**—The maturing industry has also brought to the fore firms that are more likely to be committed long term to the outsourcing business, whereas in the past the initial foray for many might have been an experiment. The players remaining are looking to grow and improve their services. There is clear competition to gain new clients, and this serves to moderate potential fee increases.
- **Offshoring**—Many outsourcing vendors have offshored portions of their work. Administration outsourcing capacity and talent in India and other countries have grown rapidly, with the result that an increasing number of services are completed or supported in offshore locations.

The cost of internal benefits administration also has been rising. Many plan sponsors are finding it increasingly difficult to maintain internal administration at the same cost. There are pressures on both staffing and information technology (IT) systems:

- **Internal Administrative Staff**—The increasing complexity of the benefits world simply requires more knowledge and more work from internal staff. This makes it difficult to maintain consistent staffing levels, in terms of both numbers and pay. More complexity also leads to more employee questions, putting additional pressure on internal call centers or administration support groups.
- **IT Expenses**—Systems requirements are increasing for effective administration. Plan changes, compliance, and security requirements are constantly in flux, as are evolving employee demands for online tools and other enhancements.

Both factors result in administration system enhancement requests that require more IT expertise and increased capital needs.

Financial Risk Considerations

In addition to assessing costs, an organization must evaluate the financial risks associated with its administration structure. In the past, a mid-sized employer may have viewed outsourcing as the riskier approach, particularly if the benefits administration process is adequately functioning.

But a different picture actually emerges in looking at the overall issues. As in the case of the cost comparison perspective, the financial risk considerations shift the advantage to outsourcing, even if total costs are slightly higher. The following financial risks are worth considering.

Staffing Risk

Staffing risk refers to the loss of internal staff with the current and historical knowledge necessary for accurate administration. For mid-sized organizations that administer plans internally, much of this knowledge may reside with one or two individuals. Often these employees have many years of experience, as well as the skills to keep up with the increasingly complex legal environment of these plans. Losing these employees can severely impact the ability to maintain an internal administration structure.

Addressing this risk through succession planning is difficult. Retaining sufficient experienced staff to ensure redundancy and smooth staff transitions can be cost-prohibitive. Training new staff in advance of expected retirements can be risky if the experienced administrative staff leaves unexpectedly. In addition, new staff will find acquiring institutional knowledge in a short learning period difficult, while attracting new staff with experience may be costly. A move to outsourcing provides an opportunity to formally document administration procedures and capture the historical knowledge within a team. Through this transfer of knowledge, the plan sponsor ensures the successful transition of responsibilities to the outsourcing partner and gains a tool for measuring its partner's performance.

Systems Risk

Systems risk refers to the impact on the plan if the system becomes obsolete. Because benefits administration in all but the very small plans is dependent on computer systems and electronic data, a very real threat exists for administration system obsolescence. The internal or external entity maintaining the system, for example, may discontinue system support, particularly as software programs or hardware ages. And as new system requirements emerge—including from plan design changes and features, compliance requirements, and privacy restrictions—the current system may not be enhanced sufficiently.

Effective outsourcing addresses the system risk by transferring the system maintenance requirement. For the outsourcing firm, the administration system is a core resource that is maintained and updated over time.

Database Risk

Database risk refers to the plan sponsor's exposure if historical data becomes incomplete, corrupt, or disorganized. This risk is particularly acute for pension plan administration, where data dating back 30 years is still required to administer current benefits.

Complete and accurate database maintenance is possible with internal administration. But if a plan sponsor uses multiple databases or paper files, it often leads to a data structure that is not complete. This can result from inconsistencies among multiple data sources, organization changes such as mergers or acquisitions, physical loss of files, or loss of key personnel.

One key by-product of outsourcing is the opportunity for data cleanup as discrepancies are discovered. In addition, the data documentation and organization that is part of the conversion to outsourcing may provide an opportunity to correct any administrative or operational flaws that may be discovered.

Error Risk

Error risk refers to the cost of correcting administration errors, including the hard-dollar costs of unrecovered overpayments and the soft dollars in the time required to correct the errors.

Outsourcing vendors are not immune from making errors. However, they are better positioned to set up adequate controls and checks to minimize errors. In addition, the outsourcing vendor is responsible for work required to correct its errors, and the sponsor may be able to recover some or all of any hard dollar costs associated with an error.

Meeting Employee Expectations

From an employee service perspective, the benefits of outsourcing are compelling. Demands have increased for accuracy, timeliness, attention to detail and customer service. Employees, regardless of their ages, expect ready access to information on their benefits. Employees who have had such access for many years with their 401(k) plans will increasingly lose patience with slow-motion, paper-only options for their DB plans and H&W benefits.

With outsourcing, an employer is able to tap into the administration technology of the outsourcing vendor. Examples of outsourced administration options that can be difficult to replicate internally are many, including online access to tools and resources for:

- Online H&W enrollment elections;
- Pension benefit modeling;

- Quick access to summary plan descriptions and other important documents;
- Links to external sites including wellness information sources and the Social Security Administration;
- Health plan cost estimators and other tools to assist employees with choosing the health plan that fits their needs;
- Integrated tools to communicate multiple benefits, including total retirement planning tools reflecting combined amounts from DC and DB plans; and
- Plan communication and disclosures.

Moreover, outsourcing offers expanded capacity to ensure consistent service, such as:

- Full-service call center with expanded hours, recorded lines, training, and metric measurements;
- Consistent turnaround of administration functions regardless of competing internal demands; and
- Quick implementation of plan and regulatory changes or significant changes in the plan population.

Regardless of whether an employer outsources or not, benefit administration costs are not trivial. However, they are still low relative to the total costs of the plans. Now more than ever, employers have the opportunity to enhance plan and benefit visibility not only to their employees, but also to the employee's partner or spouse. Outsourcing allows the sponsor to leverage the administration costs to maximize the understanding and appreciation of the plans, and in turn the value of the plan for the sponsor.

Employer Focus and Flexibility

A final consideration in the in-house versus outsourcing comparison is how the decision affects the focus and flexibility of the sponsor's human resources (HR) department.

A shift in HR focus from administration to strategy has long been hailed as the primary benefit of outsourcing. The outsourcing vendor handles the transactional work that otherwise limits an HR team's time and allows the team to pursue the more important role of strategic planning for benefits and other HR functions. Over time, this argument for outsourcing has been strengthened, as benefits have become more costly and complicated. In particular, with healthcare reform taking effect in increments, plan sponsors must stay on top of the changes, their effective dates, and the implications to the administration of the employer's plans.

Plan sponsor flexibility is also a positive result of outsourcing. Annual enrollment and other times with high administration workflow can place serious strains on internal HR capacity. Any of the following can present a major challenge to internal benefits administration:

- Plan design and security changes that impact administration requirements;
- New employer groups or plans added through acquisition;
- High transaction volumes driven by a reduction in force or location closure; and
- Administrative changes driven by new legislative or regulatory compliance.

Is Outsourcing Right for You?

The analysis of outsourcing versus in-house benefits administration continues to evolve. For many mid-sized organizations, however, the cost dynamics have shifted in favor of outsourcing, and the hidden costs associated with the risks of in-house administration is equally compelling to support outsourcing.

Administration costs represent a small component of total plan costs, but effective administration can have a tremendous effect on perceived plan value. An outsourcing solution's ability to enhance employee service, online tools, and communications should weigh heavily in the decision. In addition, the potential flexibility gains in terms of plan design and supporting one-time events may become critical in the future.

If any of the following applies to your mid-sized organization, you may want to consider outsourcing:

- Staff is limited, so they struggle to keep up during annual enrollment or when other new changes are implemented.

- One or two people on the HR team hold much of the historical knowledge.
- The system (or worksheet) currently used is out of date and difficult to modify.
- Getting support from IT personnel is difficult.
- Records are not centralized—some in paper files, some in other databases.
- The organization struggles to keep administration consistent with the most recent law changes.
- Calculation or administration errors have led to costly legal settlements.
- Online tools for employees to model their own pension estimates instead of calling HR are desirable.
- Staff can't get daily work done because of participant calls.

A shift to outsourced administration is not easy, but the case for outsourcing is strong. Many have made the move, and very few have turned back. And the best part—once an employer has transitioned, it can refocus on the strategic decisions that have greater impact on the organization and its employees. Staff can spend the year-end thinking about strategy for the following year, and not merely surviving the administration crunch.



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