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EMPLOYEE DEMOGRAPHICS PLAY ROLE IN QDIA SELECTION

By Paula Aven Gladych

Companies that sponsor 401(k) plans need to consider employee demographics when deciding which types of qualified default investment alternative to offer, according to research by Manning & Napier.

A so-called QDIA is a plan that does all of the work for plan participants. These can include target-date funds, lifestyle funds or managed accounts. Participants put money into them and someone else does the work of managing the assets and diversifying the investments. As workers move closer to retirement, their investments become less risky.

"Demographics are an emerging trend in the industry," says Shelby George, senior vice president of adviser services for Manning & Napier. In addition to manager selection, investment committees and plan sponsors need to address other unique plan circumstances when doing their due diligence on qualified default investment alternatives.

Target-date funds are "still the QDIA of choice and they are expected to continue to grow year over year," George says. "We continue to see that explosive growth in target dates. One of the ways industry has been helpful to plan sponsors is continuing to think about how we can improve target-date due diligence. That is constantly under refinement and is very beneficial to plan sponsors. A focus on demographics is a part of that."

Not retiring

Numerous studies have recently come out highlighting that people who have reached retirement age are not retiring. A Prudential survey in the U.K. found that one-fifth of retirees say they don't feel ready to give up working, while 51% of the people due to retire this year would consider working past state pension age. Twenty-four percent of respondents who are scheduled to retire this year have already chosen to delay their retirement.

Prudential's "Class of 2015" study shows that the phased or delayed retirements that became necessary during the economic downturn have become the norm. Recent studies in the U.S. paint a similar picture.

That change in retiree mindset should be taken into consideration by employers as they pick investment options for their workplace retirement plans.

"We have seen some industry interest in better understanding demographics and how they play a role in retirement planning generally," says George. "When you think about auto features like automatic enrollment, part of it is in light of demographics. With TDFs there has been some discussion of glide path and what the appropriate glide path is in terms of the demographics. What we hope to see … is the broader use of demographics in QDIA due diligence."

Based on a plan sponsor's demographics, risk-based investments or target-date funds might be the most suitable default investment alternative, or a custom target date, traditional or pre-packaged target date fund might be a better option, she says.

"We don't see as much focus on that yet. We hope to eventually," George says.

A report by Jeffrey Coons of Manning & Napier, and Fred Reish and Bruce Ashton of law firm Drinker Biddle & Reath LLP, said that plan demographics go beyond participant age. Other factors that should be considered when performing due diligence on a QDIA include "planned retirement age, assumed employee turnover, expected employee and employer contributions, behaviors at retirement and expected withdrawal levels."

Employers also must consider the age in which their employees began contributing to their 401(k), whether defined benefit pension benefits are also offered at the company and the likelihood of lump sum distributions, the report found.

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Because life cycle funds invest in both stocks and bonds, the value of your investment will fluctuate in response to stock market movements and changes in interest rates. Investing in life cycle funds also involves a number of other risks, including issuer-specific risk, foreign investment risk, and small-cap/mid-cap risk as the underlying investments change over time. Investments in options and futures, like all derivatives, can be highly volatile and involve risks in addition to the risks of the underlying instrument on which the derivative is based, such as counterparty, correlation and liquidity risk. Also, the use of leverage increases exposure to the market and may magnify potential losses. Additionally, some target date funds invest in other funds and therefore, may have additional risks associated with the underlying funds. Principal value is not guaranteed at any time, including at the target date (the approximate year when an investor plans to stop contributions and start periodic withdrawals).

Qualified default investment alternatives (QDIAs) were defined in the Pension Protection Act of 2006 as part of a broader effort to remove several impediments to automatic enrollment and provide safe harbor for plan fiduciaries who, in the absence of participant investment direction, invest participant assets in certain types of default investment alternatives. A QDIA must be diversified so as to minimize the risk of large losses; however, all investments involve risk and not all QDIAs become more conservative over time.

"The QDIA Decision" was written by Jeffrey S. Coons, PhD, President of Manning & Napier in collaboration with Frederick Reisch and Bruce Ashton of Drinker, Biddle & Reath LLP. The full paper can be requested through the Our View section of the Manning & Napier website at https://www.manning-napier.com/Corporate/Insights/OurView/TheQDIADecision.aspx.

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