PLAN DESIGN | PLANADVISER Winter 2023

Let It Ride

Options and features that can encourage pre-retirees to stay in-plan.

Reported by BETH BRAVERMAN | *Art by* GEORGIE MCAUSLAND

As more plan sponsors begin thinking about their plans as vehicles for accumulation plus decumulation, rather than simply accumulation, they are also reevaluating their plan design with an eye toward incentivizing pre-retirees to remain enrolled once they no longer work.

More than 40% of plan sponsors said they prefer for retiree assets to remain in the plan, while another third are actively seeking to retain retiree assets, according to 2023 data from Cerulli. Demographic shifts have made this even more a priority in recent years, as plans recognize that the wave of Baby Boomer retirements means they are at risk of losing many of their largest account balances.

Taxpayers rolled nearly $620 billion into individual retirement arrangement plans in 2020, the most recent year for which IRS data is available—more than double the $300 billion that was rolled over in 2010. That trend could lead to the loss of institutional pricing and drive up costs for a plan as a whole.

Courtney Stroope, managing director of retirement solutions at Creative Planning Retirement Services in Dallas, says more paternalistic firms also see decumulation options as the best way to serve their participants and help them move toward a more financially secure retirement, a view that her firm endorses.

"We really come from this mindset of 'These participants were a critical part of your workforce, for years, if not decades,'" she says. "So offering them these options and helping them make good, financial decisions in the next chapter in their life is a great way to honor all that they've given the organization."

It may also help reduce legal liability.

"Plan sponsors have a fiduciary obligation to look at and understand the needs of the current workforce of employees but to also understand how it affects terminated employees with an account balance still in the plan," Stroope says.

Data Can Make the Case

For plan sponsors that hesitate to encourage retirees to remain in their plan, Ellen Lander, principal and founder of Renaissance Benefit Advisors Group, now a Hub International company, in Pearl River, New York, often shows them data on their plan that illustrates what percentage of their assets is with active vs. terminated participants, and what percent of the participant base is active vs. terminated. For some plans, the share of terminated assets can be close to 50%.

Then, Lander reminds them that they may not mandate a cash-out for participants who have a plan balance over $5,000—an amount that will increase to $7,500 starting in 2024, under a provision in the SECURE [Setting Every Community Up for Retirement Enhancement] 2.0 Act.

"They can't kick them out anyway," Lander says. "So [suggest they] get comfortable with keeping them in-plan. There are many benefits to [their] having terminated people in the plan. It's a win-win."

But even for clients on board with designing a plan that keeps in-plan retirees in mind, committees generally have less experience designing a plan that allows for decumulation. Retirees typically have different goals and more complex financial needs than those still saving for their golden years. That creates an opportunity for plan advisers to help the sponsor determine the plan design changes that make the most sense for its plan and participants.

Plan advisers can also make sure their clients are working with a recordkeeper that can deliver the products, investments and other solutions needed to provide a best-in-class experience to in-plan retirees, says Taylor Hammons, head of retirement plans for Kestra Financial in Austin, Texas. Then, advisers, recordkeepers and plan sponsors can work together to communicate and promote such features to the appropriate audience.

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"If they're going to do it, they have to do it right," says Nathan Voris, head of channel strategy for Morningstar's retirement and workplace solutions in Richfield, Ohio. "If you want people to stay in a plan, you have to build out the features, products and services a retiree needs. It can be as simple as the sponsor looking at its payout provisions and making sure its managed account product has a high-quality managed spending component."

Recognize Diverse Needs

Such conversations between plan advisers and their plan sponsor clients reflect a recognition that this is the first time in history that employers potentially have five generations of workers participating in their retirement plan.

"Plan sponsors need to really think broadly about the variety of needs and population segments they're serving," says Teresa Hassara, senior vice president of workplace savings and retirement solutions at Principal Financial Group in Carlisle, Massachusetts. "They have people working full time, early career workers, part-time employees, and those exiting and going into retirement. There's a fundamental shift that plan sponsors need to make, and an adviser can help them philosophically think through whether they believe the retirement plan should cover participants from hire through retire—and then develop a program with that in mind."

While retirement-income solutions have received much attention in recent years, thanks to provisions in the SECURE Act of 2019 that make it easier for plan sponsors to incorporate annuities into their plans, that is only one component of creating a retiree-friendly plan.

"Retirement income is important, but there are many things plans can do before they even get to that point to make sure they're ready for retirees," Voris says. "There are certainly some product innovations and recordkeeping platform enhancements that could be made concerning payout provisions, and there also needs to be education."

The default for withdrawals in many 401(k) plans remains a one-time distribution, Stroope notes.

"This is probably the largest account balance that any individual has for retirement, and, for the most part, we're still seeing people using it on a pre-tax basis," Stroope says. "That can be a huge tax hit, or one that pushes them into an IRA and they take all the assets out of the plan."

Instead, plans should, at a minimum, allow for systematic withdrawals, low-cost, or free, distribution, and a seamless process for moving money from a 401(k) into a checking or other bank account, Voris says.

For Clients to Keep in Mind

For clients that want to help their retirees who remain enrolled, advisers can make sure the plan allows for rollovers into it, to enable these participants to bring in outside assets. In this way, you make it easier for them to have a holistic view of their finances and manage those in a streamlined way.

You should also make sure that the plan is not charging retirees the additional plan fees that the sponsor pays on behalf of active participants, Hammons says.

"Historically, in our industry, there was a school of thought that terminated participants should just take their account balances and go somewhere else, and, if they were going to stay, we'd let them pay for their own account administration," he says. "That's a disincentive, and that topic needs to be vetted out and discussed again."

Additionally, urge clients to consider how the plan treats the beneficiary after a participant passes away, Hammons says. That may be a significant concern for retirees, who are typically older than active participants.

"If the plan only allows beneficiaries to take out the funds in a lump sum, or it forces them out immediately, the plan sponsor might want to look at other options [if available]," he adds. "That [limitation] could make retirees nervous because they won't be there to advocate for their beneficiary, who might have to roll out of the plan."

Reevaluate the Investment Menu

Plan advisers can also help plan sponsors reevaluate their investment menu through the lens of serving both workers and retirees to find a range of investment choices that serves both groups. That would be in addition to target-date funds that go through, rather than to, retirement, and would potentially even include a lifetime income component.

"We already know that when we have auto[mated] solutions, we have great uptake," Hassara says. "When we do auto-enrollment, 94% of participants stay, and if they have auto-escalation they increase their savings. So you have to believe that if we could bundle the common needs of retirees into an automated service on top of that, that, too, would be successful."

Plan sponsors might also consider additional fixed-income options for retirees, who may have a lower risk tolerance than other participants. Other retiree-focused products might include lifetime income solutions, managed spending plans within managed accounts, and minimum distribution features.

Self-directed brokerage windows can also serve retirees who want to keep assets in the plan but work with an outside adviser to make personalized choices based on their time horizon, risk tolerance and other goals.

"Some recordkeepers offer this solution with no or low trading costs and offer third-party adviser access—usually through some type of power of attorney document—to help facilitate those trades or exchanges on the participant's behalf," Stroope says.

Whichever investment choices a plan sponsor puts in place for retirees, it needs to keep convenience and service in mind, Hassara adds. "Convenience [means] it's easy to understand the investment solutions, and they can get help when they need it from people who are knowledgeable or tools that are easy to use," she says.

Get Participant Buy-In

Once a plan has withdrawal options and other retiree-friendly features in place, it also needs an education campaign to make sure participants are aware of them. The sponsor should reach out to participants well before they give their notice for retirement.

"If the sponsor tries to tell people at their point of retirement that it has investment options and educational classes for them, it's too late to capture their attention, imagination or commitment," says Teresa Hassara of Principal Financial Group. "They've been thinking about and planning for retirement well before they signaled it to their employer. The sponsor has to signal through communications whether its organization thinks about the plan as being 'to' or 'through' retirement."

One opportunity advisers can suggest for engaging and educating participants as to in-plan retirement options might be when catch-up contribution notifications are sent to 50-year-old participants.

"It should be made part of the culture, so the financial coaches on staff and recordkeepers are talking about managed spending and other retirement products to anyone over 50," says Nathan Voris of Morningstar. "Maybe there's a different web or mobile experience for folks as they get closer to retirement. These are basic blocking-and-tackling things."

Such communications could continue all the way through the exit interview when the employee retires. Among the information the company provides them at that point should be clear and concise information about the benefits of staying in the plan, including bankruptcy protection, institutional pricing and fiduciary oversight. *—BB*

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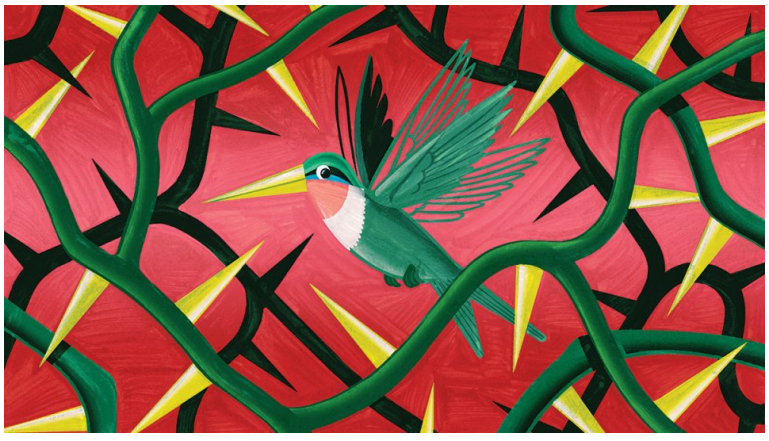

How quickly does a fiduciary have to remove an underperforming investment from its plan's investment menu? And under what circumstances can custom funds be deemed imprudent? *Melina Jacobs v. Verizon Communications*, a case brought before the U.S. District Court for the Southern District of New York in 2016, took on these questions.

The suit, like many brought under the Employee Retirement Income Security Act, was settled out of court—in this case, after seven years of litigation. Although settlements do not carry the force of precedent or contribute to case law, the case still offers some thought-provoking insights into these questions.

The Case

In February 2016, Melina Jacobs brought a complaint under ERISA alleging that her former employer maintained investments on its defined contribution plan menu that underperformed and had excessive fees.

Specifically, the suit alleged that Verizon maintained custom "funds of funds," including a custom target-date fund suite, that carried "excessive risk and redundant layers of fees" and underperformed "off-the-shelf" TDFs. The complaint cited a Vanguard managed suite as an example of a target-date fund that had lower fees and higher performance than did the Verizon custom suite over the class period, starting in 2010.

The investments, the plaintiff alleged, underperformed partly because of their complexity and partly because of their customized nature—both of which drove up

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management fees—but also because Verizon failed to adequately monitor the component funds within each investment.

The Global Opportunity Fund, one fund within many of the custom funds, was identified in particular by the plaintiff for underperforming its benchmark over several years and should have been removed, the complaint said. According to its prospectus, the Global Opportunity Fund is an actively managed global equity value fund that uses a strategy aiming to "add value, relative to its benchmark, by investing in the most attractive markets on a global basis, while simultaneously underweighting, or shorting, markets that are viewed by the fund managers as overvalued."

The lawsuit characterized these funds as a "multi-dimensional labyrinth of actively managed 'custom' investment choices."

In response, Verizon filed a motion to dismiss, which was denied in September 2017.

The court ruled that the factual allegations in the complaint were adequate to state a claim: "The Complaint pleads that the Verizon defendants kept—as a 'core asset' most of the Verizon Plans' investment options—a fund that had wildly underperformed its benchmark over a 10-year period. This fund also barely surpassed the return of a money market investment, which offered much less risk. Finally, the Global Opportunity Fund—despite its poor performance—featured an expense ratio higher than any other investment option available to Verizon plan participants. These allegations are sufficient to defeat a motion to dismiss."

The parties went on to negotiate, this July, a settlement of $30 million for a class of approximately 160,000 participants. One-third of the settlement will go to the law firms representing the class, with the remainder going to plan participants as tax-deferred contributions to their accounts or rollovers into individual retirement plan accounts.

The Discussion

Despite the settlement, this case provides important insights for fiduciary retirement advisers.

Daniel Aronowitz, the owner and founder of Euclid Speciality Managers, underwriters of fiduciary insurance in Washington, says holding fiduciaries to account for investment underperformance over a brief period of time "could potentially open up many plans to allegations of underperformance."

The plaintiffs argued that fiduciaries should switch out investment options after 36 months of underperformance, but, Aronowitz says, this really is not long enough to fairly judge the prudence of an investment, especially in a retirement context.

Retirement investments are normally made with an eye toward the long-term, and one cannot determine whether the fund is underperforming unless "at least five to 10 years" have passed and the asset has shown clear signs of distress. Aronowitz says most advisers recommend against switching out retirement investments frequently, as this can result in unnecessary losses and higher fees.

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The Global Opportunity Fund was first introduced to the plan in 2007 and removed in 2017, a 10-year span, but, Aronowitz notes, "2008 was a washout for the entire market," and many other investments underperformed their benchmarks as well.

Further, Verizon made changes to its fund offerings in the meantime during its quarterly fiduciary meetings, "tinkering" with them and "was hardly asleep at the wheel."

Mark Boyko, an ERISA plaintiff attorney in St. Louis, along with partner Bailey Glasser, says that funds of funds such as those in Verizon's plan, are not uncommon among larger plans. These funds do require "greater diligence on the underlying funds," and this "generally involves higher fees," but larger plans can often accommodate this burden prudently through "economies of scale."

Yet, Boyko explains, custom funds, though not inherently imprudent, are still suspect. "Off-the-shelf" funds from asset managers "generally have lower fees" and "have asset allocations that have been tested across multiple economic cycles," echoing arguments made in the plaintiff's pleadings.

Some fiduciaries will create custom funds to meet the specific investment needs of their participant population, but this is something of a "cop-out," Boyko says, because off-the-shelf funds, especially TDFs, are also designed with specific investment needs in mind. "The goal of all target-date funds," custom or not, "is to prepare the participant for retirement around the date of that target-date fund." There is thus little to no advantage in making custom TDFs, at least for most plan sponsors, he says.

Although "no investment is inherently prudent or imprudent," under ERISA, according to Boyko, it *is* imprudent to include an investment if it has a lower return but with a similar risk profile as another similar product—which the plaintiffs alleged of various funds in the Verizon plan.

Boyko says the case law on timing is thin. How quickly an investment should be dropped due to underperformance is something that "experts will debate in basically every case."

Despite this vagueness, Boyko noted some features that can make funds an easy target for a lawsuit that advisers should keep in mind.

He notes that some funds can be tested based on their strategy rather than timing. If a fund says, for example, that it protects investors from an economic downturn, and then does significantly worse than the market average during a recession, then there is hardly a need to debate a specific number of years a fiduciary should wait before removing the investment. The hypothetical fund "didn't do what it was supposed to do, and sometimes you can tell that very quickly."

Aronowitz and Boyko both agree, however, that it can be difficult to predict which cases proceed past the motion to dismiss stage. "We think it's a crapshoot," Aronowitz says. "The same set of facts can go either way, depending on which judge you have."

Boyko says, "If you find a pattern" to which cases beat motions to dismiss, and which ones do not, "Please let me know." He adds that there is a "certain level of inconsistency in what cases are dismissed and which ones aren't," but complaints challenging funds that are brand new, that have a long period of underperformance, or that represent a conflict of interest for the fiduciaries are more likely to survive a motion to dismiss.

Reported by Paul Mulholland

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