Reinventing the Defined Contribution Plan: Research, Analysis and Recommendations
Prudential Retirement’s Secure RetirementSM program is an initiative designed to improve participant outcomes by applying lessons from behavioral finance, risk management and defined benefit fundamentals.

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I. Introduction—Improving Participant Outcomes by Applying Lessons from Behavioral Finance, Risk Management, and Defined Benefit Plan Fundamentals

Over the past 20 years, Defined Contribution (DC) plans have seen unprecedented growth. Today, in fact, most Americans who receive retirement benefits through work are offered a DC plan as the cornerstone of their retirement program. Despite their popularity, however, DC plans have not generated significant balances for most participants. In fact, industry statistics consistently reveal that there are large numbers of plan participants who are not building the necessary assets to provide themselves with a secure retirement. And as these participants age, they risk falling further and further behind.

This is a major problem that requires serious attention. In this white paper, Prudential Retirement will demonstrate an industry-leading understanding of the situation, offer convincing research and analysis, and present a series of recommendations designed to increase the probability that DC plans will deliver secure retirement outcomes for tomorrow’s generation of Americans.

We believe plan sponsors can answer the needs of these at-risk employees by focusing on several straightforward ideas, namely:

- Using plan design defaults that harness natural participant behaviors and leverage lessons from research in behavioral finance,
- Incorporating the best elements of the defined benefit model—e.g. automatic enrollment, professional asset allocation and a focus on retirement income—into the DC model,
- Creating a smaller set of plan asset allocations/investment options—in recognition of the fact that asset allocation has been shown to be as important as fund selection—with options that include lifestyle and target maturity funds,
- Encouraging comprehensive retirement planning that addresses accumulation needs and is based on ensuring adequate retirement income, and
- Including lifetime income options that help participants focus on outcomes and mitigate risks.

DC service providers can help participants directly by:

- Educating them on retirement income, not just wealth accumulation,
- Helping them implement and maintain a risk-appropriate investment strategy,
- Acknowledging the limitations of communication initiatives and employing tactics based on behavioral finance,
- Providing advice and guidance on how to manage job transitions and secure income at retirement, and
- Developing and offering products that protect accumulated balances and generate lifetime income solutions that address participants’ needs.

As you review this paper and consider its recommendations, please keep in mind the extensive research Prudential has gathered to reach these conclusions. We have over 75 years of experience in providing Defined Benefit (DB) plans and have been providing administrative services to DC plans for more than 40 years. And we have a thorough understanding of the challenges faced by plan sponsors, consultants, brokers, advisors and industry experts serving the retirement marketplace. These Secure Retirement proposals incorporate insights and best practices garnered from comprehensive, candid and objective discussions with the academic community and business practitioners about the weaknesses and strengths of the current DC model.

As such, we believe that the suggestions we are offering will, if implemented, significantly improve the retirement landscape for generations of Americans to come.
Unlike generations past that relied primarily on DB plans and a generous Social Security program to achieve a secure retirement, America has become a nation of investors that relies heavily—sometimes solely—on defined contribution plans to save for the future. This “DC-first” or “DC-only” approach appeared to be an attractive solution for many years, especially as the stock market steadily rose in the 1990s. Employees valued the portability of DC plan assets while employers enjoyed greater appreciation for their retirement programs with the addition of the higher profile, DC plan. The DC plan had the added advantage of being less expensive than the more traditional DB plan. (The amount of assets invested in DC plans bears out the rapid acceptance of these plans.) While in theory DC plans have the potential to equal the retirement benefits accumulated under traditional DB plans, in practice typical DC plan participants are only replacing a fraction of what they would have accumulated under a DB plan. The low level of absolute savings, easy access to loans, cash-outs at job changes, poor asset allocation and limited access to advice have the cumulative effect of producing very poor results for most DC plan participants.

At the same time, there are significant questions about the strength of the Medicare and Social Security systems. How will these programs fund their obligations? What changes will be made to their benefit structure? And, most importantly, what can American retirees realistically expect to receive from these programs? Questions about the long-term solvency of federal programs make the performance of work-based savings plans all the more important.

These are extremely important considerations because Americans tend to believe that Social Security will provide them with more income than reality indicates. The fact is Social Security may replace as little as 35 percent of a “high earner’s” preretirement income. In contrast, surveys indicate that average wage earners believe Social Security will provide 60 to 80 percent of their highest wage earning years. Without an accurate calculation of retirement expenses and an understanding of the income amount provided by Social Security, participants risk seriously underestimating their need for workplace savings.

And things could get even worse when you bear in mind the studies that show Americans are living longer and, as they reach retirement age, may not be ready to handle the rising cost of living. This is particularly worrisome when one considers the impact of rising healthcare expenses.

With these factors in mind, it is clear that something needs to change. If not, Americans planning for retirement will continue to fail at each of the three stages along the retirement savings lifecycle:

- Enrollment and Wealth Accumulation—Getting started and saving enough for retirement
- Pre-retirement—Protecting accumulated balances, closing shortfalls and understanding retirement income and healthcare needs
- Entering Retirement—Generating lifetime income

But not all the news is negative. Research conducted jointly by PLANSPONSOR magazine and Prudential Retirement shows that plan sponsors are willing to employ new products and services in their efforts to make DC plans more effective. In fact, 88 percent of plan sponsors who responded to the PLANSPONSOR/Prudential survey agreed that automatic enrollment was worth the additional effort. Further, contribution escalation programs—where deferral rates are increased automatically over time—have also started to gain interest among sponsors.2

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1 “What Replacement Rate Do Households Actually Experience in Retirement?” Center for Retirement Research at Boston College, 2005 and “U.S. Social Security Administration,” 2004, Social Security Trustees Report. (“High earners” had wages of $58,400 to $90,000 in 2005.)

Let’s explore in more detail the critical issues facing today’s retirement plan participants.

A. ENROLLMENT AND WEALTH ACCUMULATION—GETTING STARTED AND SAVING ENOUGH

This initial stage of the retirement lifecycle is, obviously, the foundation for the other stages. As such, it is critical to consider the following issues first:

➣ Insufficient Participation—Many individuals either start saving for retirement too late or never begin saving at all. According to “Coming Up Short: The Challenge of 401(k) Plans” by Alicia H. Munnell, 26 percent of eligible workers are not participating in their 401(k) plan.

➣ Insufficient Contribution Levels—According to the Employee Benefit Research Institute (EBRI), the national savings rate is at its lowest level since the 1930s, declining from 9.4 percent in 1970 to just 1 percent in 2004. Even after individuals begin saving for retirement through a DC plan, most are failing to save enough to adequately fund their future retirement income needs. Munnell’s study found that only 8 percent of participants contribute the maximum, and that the average 55- to 64-year old has less than $42,000 saved for retirement in a 401(k).

➣ Inappropriate Investment Allocations—Many participants are overly invested in company stock or fixed-income investment options and poorly diversified with inefficient portfolios. Further, they often fail to rebalance their portfolios. Specifically, according to Munnell, more than 50 percent of participants do not diversify their 401(k) investments, and according to the EBRI, most participants “will never change the mix of investments once set in place.” Still, other studies suggest “participants use naïve diversification strategies heavily influenced by the menu offered by their plan.”

It is also important to note here that many workers simply do not know how much money it takes to live comfortably in retirement. According to the EBRI’s “Retirement Confidence Survey,” 61 percent of employees have not determined how much money they will need to save for retirement. Of those who have calculated a goal, only 64 percent actually remember it. The implication is that over 70 percent of participants do not even know their destination, much less how to get there.

B. PRE-RETIREMENT—PROTECTING ACCUMULATED BALANCES, CLOSING SHORTFALLS AND UNDERSTANDING RETIREMENT INCOME AND HEALTHCARE NEEDS

For many individuals approaching retirement, there is a clear lack of understanding about retirement income needs and sources of retirement income. Simply stated, most participants do not fully understand the risk of outliving their retirement income and are often surprised at the amount of money needed for a financially comfortable retirement.

Participants tend to focus on a lump-sum amount rather than a monthly stream of retirement income. For example, with lifetime spousal benefits, a $1,000/month annuity payable for life with a 2.5 percent COLA would require a balance of over $225,000 at age 60. Most participants would assume that $225,000 would generate much more than $1,000 per month in income, and an overwhelming majority would take the $225,000 in cash instead of an annuity because based on the assumption that they could “do better” managing the lump sum. Unfortunately, compelling evidence suggests that most individuals would spend down such a balance well before their expected life span or that of their spouse.

2 “Saving for Retirement on the Path of Least Resistance” by Choi, Laibson, Madrian and Metrick, Updated: July 2004.
3 Based on the cost of purchasing a 75 percent joint and survivor annuity at age 60 with a 57-year-old spouse and a 2.5 percent COLA, based on 1994 GAR (static) mortality at five percent with no expense loading.
Further, participants tend to use unrealistically high assumptions about the earning power of their retirement assets and ignore the effects of volatility. For example, they might assume that a 50/50 blend of stocks and bonds should earn at least 10 percent. But this is a far higher rate of return than a reasonable assumption using historic rates of return would indicate. Using Ibbotson Associates data for the years 1927 to 2002, such a blend yielded about 8 percent with annual rebalancing and no investment expenses. A modest 50 basis points in expenses lowers the net expected return to about 7.5 percent. And since returns are volatile, and are not realized at a steady 7.5 percent, current life expectancies suggest that the average 60-year old choosing a spend down rate of 7.5 percent would almost certainly outlive his or her assets.

There is also an over-emphasis on accumulation/account balances, rather than income replacement as an end goal, as well as a failure to appreciate and understand the need for a guaranteed income stream during retirement. The importance of investments that offer inflation protection is also consistently overlooked. Further, many participants tend to become recklessly conservative as they near retirement (i.e., move too much of their portfolio into fixed-income alternatives) and abandon equities upon market declines.

Additionally, participants nearing retirement often fail to use their pre-retiree years to close their retirement savings shortfall. Often, because of their inability to estimate the income-producing capabilities of their current DC account balance, they may not even recognize that a gap exists. Most participants will not really understand they have a shortfall until they reach retirement—a point at which their options will be limited. Recent legislation allowing for catch-up contributions for those over age 50 can significantly assist pre-retirees in improving their post-retirement prospects.

While Americans are typically optimistic about most things in life, in the case of longevity, we tend to expect shorter lives than mortality statistics would suggest. Perhaps this is a different form of optimism—one in which we hope to live only as long as we remain healthy and maintain a high quality of life. Whatever the cause, the failure of most Americans to recognize the probability of longer life spans and increased healthcare costs later in life makes it more likely that our financial assets will not generate sufficient retirement income.

C. ENTERING RETIREMENT—GENERATING LIFETIME INCOME

As individuals change jobs or reach retirement, they are faced with the critical decision of what to do with the money they have saved during their working years. Unfortunately, too many of these retirement savers make one or more critical mistakes that move them away from the secure retirement they desire:

➣ Virtually no DC participants annuitize a portion of their account balances.

➣ Too often DC account values are consumed when job changing (i.e. participants take their money in a lump sum rather than rollover their balances).

➣ Participants overestimate the ability of their financial assets to generate income and underestimate risks of inflation, market volatility and an extended lifespan.

➣ Many conservative participants allocate little or no assets to equities even though their investment horizon (including retirement) may span many decades.

On their own, these factors can lead to a financially difficult retirement for many participants. Combined, they may leave retirees well short of their retirement savings goals.
III. Realities of Participant Behavior

A. OPTIMISTIC TO A FAULT

Clearly, the educational programs run by providers at the request of plan sponsors are intended to give participants the tools they need to adequately execute a retirement savings strategy. Unfortunately, industry statistics reveal a startlingly low success rate for the average American. In fact, they show participants are ill equipped to answer the key questions related to their DC plan:

➣ How much should I contribute?
➣ How should I invest my savings?
➣ When and how often should I change my investments?
➣ Should I invest in my company’s stock?
   If so, how much?
➣ How should I handle distributions of my assets?

The failure of many DC plan participants to adequately plan for retirement is well established. Yet, many of today’s workers remain confident they will achieve a comfortable lifestyle after they stop working.

Through most of the 1990s, the rise in the stock market seemed to explain why they felt this way. However, despite substantial market declines, confidence remains high.

In fact, according to one survey, 21 percent of workers feel very confident and 45 percent feel somewhat confident about having enough money to live comfortably in retirement. Clearly a disconnect exists. Dallas Salisbury, CEO and President of the EBRI, puts it succinctly: “Americans are chronically optimistic about their retirement prospects despite a variety of market conditions…”

But this confidence is misplaced if you look at the following statistics released by the EBRI:

➣ 54 percent of participants have no idea how much money to save for retirement
➣ 44 percent do not think they can save an extra $20 per week
➣ 31 percent allocate their retirement plan accounts by either random guessing or dividing their assets equally among the investment options available

Moreover, government studies have found that nearly 28 million—or 40 percent of U.S. households—do not have retirement savings accounts of any kind beyond Social Security.

B. FAILURE TO TAKE ACTION—INERTIA-DOMINATED HUMAN BEHAVIOR

Over and over, it has been proven that individuals saving for retirement do not take the necessary steps to bring them closer to the financial security they desire. For example, once participants choose an investment mix they rarely make changes to their portfolio. According to the EBRI, 83 percent of participants have never rebalanced their retirement plan accounts.1

What then is a sponsor to do? The answer lies in acknowledging that a large percentage of plan participants are either unable or unwilling to learn how to manage their retirement accounts. Acceptance of this participant behavior will allow sponsors to move beyond education. For some, advice may be the trigger to greater savings. For others, pre-packaged programs of savings or turnkey product solutions may be the answer. One size does not fit all. But one thing is clear: the “do-it-yourself” approach of providing a lot of “funds” and a flashy mailing does not work for most.

1 “13th Annual Retirement Confidence Survey” conducted by the Employee Benefit Research Institute (EBRI), American Savings Education Council (ASEC), and Mathew Greenwald & Associates (Greenwald)
2 13th Annual Retirement Confidence Survey
3 13th Annual Retirement Confidence Survey
4 13th Annual Retirement Confidence Survey

“ The failure of many DC plan participants to adequately plan for retirement is well established. Yet, many of today’s workers remain confident they will achieve a comfortable lifestyle after they stop working.”
There are several explanations as to why participants fail to take the needed actions to secure their retirement, including assessing and updating their retirement portfolio:

1. Participants' lack of familiarity with basic investment planning principles and the resultant fear of making the wrong choice. Many participants simply follow the default option offered by their employer. Roughly 25 percent of eligible employees will not participate if enrollment requires an active effort.

2. Participants assume that the default options offered by the plan sponsor are based on a careful analysis of what is "right" for them.

3. Participants think they will evaluate the information on investment options at some point after they enroll in the plan, but then never find the time to do so. This behavior highlights the importance of the default as a means of helping combat participant inertia.

4. Participants routinely underestimate both the length of their retirement and income needs, neglecting to consider increased longevity and healthcare costs associated with their advanced age.

Even when participants recognize the benefits of reviewing their portfolios and adjusting their asset allocation, research indicates they are unlikely to make changes. Auto-enrollment addresses participant inertia while concepts like auto-rebalancing help those with status quo bias.

C. GOOD INTENTIONS, BUT LACK OF FOLLOW-THROUGH

Many individuals have good intentions when it comes to building a solid financial future. They want to save more. They want to put money aside for a secure financial future. They want to choose an appropriate mix of investments. Yet, these good intentions do not always translate into good execution. In fact, far too many individuals never follow through on their intentions.

D. INACTION WHEN FACED WITH COMPLEXITY

Offering too many investment options under a plan often confuses participants with information overload and may hamper decision-making. One study suggests that increasing the number of choices actually decreases plan participation.10

Individuals do not see saving for retirement as a simple process, particularly when it comes to setting up their account and choosing their investments. They want to take these important steps, but do not always move forward because they do not have the time or knowledge—or confidence—to move beyond the thoughts of building a solid financial future.

E. INSUFFICIENT MOVEMENT BEYOND INITIAL ENROLLMENT OR CONTRIBUTION

It is not just pre-enrollees who fail. Even participants have trouble taking action after they enroll or choose their investments. According to Agnew, Balduzzi and Sunden, “70 percent of plan participants do not rebalance their portfolio more than once, average rebalancing frequency is one trade every 33 months, and average monthly turnover is in the order of 2 percent.”11

And participants have trouble for the same reasons as pre-enrollees—they either cannot find the time to take the next step, do not know they need to take another step, or, if they do know they need to move ahead, are fearful of doing so because they do not know enough.

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9 Choi, Laibson, Madrian and Metrick, Updated: July 2004
F. FAMILIARITY BIAS—EXCESS HOLDINGS OF COMPANY STOCK

Another problem facing retirement savers is “familiarity bias”—the concept that individuals over-invest in options or programs that they have had experience with in the past. This familiarity bias explains why a high percentage of participants are more comfortable with their own company’s stock than with broadly diversified stock funds.

“It seems that naïve diversification is combined with naïve extrapolation of past returns and an apparent lack of concern for the risk consequences of company stock investment.”

G. LOSS AVERSION AND RECKLESS CONSERVATISM

Loss aversion—or risk aversion—is also a huge detriment to many retirement savers. Many of these individuals simply do not invest in equity-based options because they’re afraid of losing money. The end result is typically that many individuals nearing retirement put too much of their money in conservative options, which leads to underperformance and retirement savings unequal to the demands of increased longevity.

“Researchers have worried that women in particular might invest too conservatively. In general, studies of risk aversion show that women are more risk averse than men.”

H. WEALTH ILLUSION AND THE INABILITY TO TRANSLATE ASSET BALANCES INTO INCOME

The primary purpose of a DC plan is to provide participants with the means to fund a safe and secure retirement. For most participants, account activity seldom goes beyond making a contribution, choosing a few funds, and looking to see if their account balance has grown. As more and more funds are being added to investment lineups and greater emphasis is being placed on investment education, sponsors have lost track of the fact that “adequate retirement funding” means contributing sufficient funds to secure the level of income an individual requires throughout retirement. The activity of accumulating assets is one step in the process of achieving that goal, and yet many participants treat it as the goal itself.

The fact is many participants do not understand how large a “nest egg” they’ll need for a secure retirement. Survey after survey shows that many individuals are falsely overconfident about their chances for a financially successful retirement. The lump-sum accumulation value may seem like an inexhaustible sum of money to the employee. This is referred to as the “wealth illusion.”

Any attempt to break down the wealth illusion through education brings its own risks. In the DC/Individual Retirement Account (IRA) world, the most widely accepted spend down strategy is to take 4 percent per year (ignoring expenses) and then adjust this amount annually each year for inflation. Therefore, to provide $40,000 of real income during retirement, an employee would need roughly $1 million at retirement. The idea of accumulating this amount can be daunting to many, and could actually discourage savings.

“The activity of accumulating assets is one step in the process of achieving that goal, and yet many participants treat it as the goal itself.”

Conversely, DB plans have provided a specific monthly pension amount that employees easily understood. We believe that a strategy that focuses on accumulated balances and monthly income at retirement will appear much more tangible and reasonable, and will be much more effective. The end result should be increased contributions and a higher probability of employees reaching their savings goals.

12 Choi, Laibson, Madrian and Metrick, Updated: July 2004
IV. Recommendations for Helping Participants Through Each Stage of the Retirement Planning Lifecycle

As stated earlier, Prudential’s research and analysis have yielded a series of recommendations that form the basis of our Secure Retirement philosophy. In this section, we’ll examine these recommendations as they apply to the three stages of a participant’s retirement lifecycle. While each recommended best practice may not be right for all plans sponsors, taken as a whole they represent the best approach to drive superior retirement outcomes for DC participants.

A. GET EMPLOYEES STARTED AND HELP THEM ACCUMULATE WEALTH

The retirement industry too often treats participants as if they are the chief investment officer for their own retirement plan. However, few participants have the knowledge or take the time to behave as their own trustee. They are not effectively setting goals and place little or no importance on taking control of their retirement planning. The result: inadequate retirement income.

Plan sponsors could go a long way to putting participants on the right track by making some simple, yet profound changes in the basic operating philosophy of their plans. Here are four key considerations.

1. Design Your Match for Maximum Advantage

   Research indicates “…the match threshold may serve as a powerful focal point in employees’ choice of a contribution rate.” In short, employees save to the match, which is why we want intelligent plan design that will stretch the match out to 50 percent of 6 percent, not 100 percent of 3 percent. Specifically, a dollar-for-dollar 3-percent match is likely to produce an overall savings rate of 4 percent. But 50 percent of 6 percent costs the sponsor no more money and is likely to increase overall savings by 50 percent (doubling employee savings). Automatic enrollment should default participants to at least the amount needed to get 100 percent of the company match, either initially or when combined with Contribution Escalation, as described on pages 14 and 15.

2. Introduce Auto-Enrollment

   The optimal approach for getting employees enrolled in their retirement plan is auto-enrollment on day one of employment. In other words, they are automatically enrolled in the plan their first day on the job. The primary reason is that most participants pay the closest attention to their benefits on or about their date-of-hire. It is at this time that new participants often meet face-to-face with human resources and review their salary and benefits.

   Enrollment in the DC plan should occur at this point, before the first paycheck arrives. Generally speaking, individuals will live on the net pay they receive. If net pay, from the start, reflects a contribution to the plan, then most people will never “miss it.” If the new employee makes no election, they should be defaulted into the plan. Automatic enrollment at employment (no waiting period) will increase participation and encourage good saving habits.

   Still, this approach does not address the issue of current non-participating employees who were hired before auto-enrollment was initiated. These employees, too, need help saving for retirement. Plan sponsors could help these employees get on track for a secure retirement by automatically enrolling all non-participating employees as a one-time initiative.

3. Default Contributions to Asset Allocation-Based Tools or Products

   Analysis by Ibbotson and Kaplan shows that asset allocation is responsible for about 90 percent of the variability of a portfolio’s returns over time. In other words, investing in a variety of assets across a variety of asset classes is critical to reducing portfolio risk and, thus, helping increase the likelihood of achieving a more secure financial future.

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14 Choi, Laibson, Madrian and Metrick, Updated: July 2004
15 “Does Asset Allocation Policy Explain 40, 90 or 100 Percent of Performance?” Roger G. Ibbotson and Paul D. Kaplan, Association for Investment Management and Research, 2000
Many sponsors, however, in an effort to help participants create a diversified portfolio, offer too many investments. Some plans offer 50 or more mutual funds plus a brokerage platform. While this level of choice may be desirable to an active, engaged investor, it is overwhelming to most participants. In fact, some studies suggest that increasing fund choice actually decreases 401(k) participation.\textsuperscript{16}

With that in mind, the core offerings in a DC plan should include a reasonable or manageable number of funds providing access to the same asset classes that a typical DB plan might employ. Thus, a participant could establish a program of investments and allocate among funds with truly different risk and return characteristics.\textsuperscript{17}

The sponsor’s and provider’s responsibility doesn’t end at investment selection. While this process helps provide participants with a lineup of options that supports their retirement planning efforts, using the investments to their advantage begins with adequate knowledge of asset allocation. Through education and communication, the provider can help drive home the value of asset allocation.

For participants who do not want to be engaged in selecting an asset allocation, a “programmatic approach” could be offered. The core investment program options would be complemented by hybrid investment vehicles such as balanced or target-maturity funds. Target maturity funds invest your money based on when you plan to stop working. For example, a fund with a target year of 2015 is designed for investors who plan to retire in 2015. As investors get closer to their retirement date, the fund will become increasingly conservative. These funds would allow participants to delegate asset allocation duties more fully to a professional fund manager or a professionally designed software tool.

When automatic enrollment is instituted, the plan must decide the default level of contribution and default investment allocations. Often, plans will use a very low level of contribution, perhaps 1 or 2 percent, and a contribution into a very safe fund like a money market or stable-value fund. For automatic enrollment to be truly effective, it needs to move beyond this minimal level. Many employees may interpret a two percent contribution to a money market fund as adequate savings if that is what the plan recommended. This defeats the main benefit of automatic enrollment, which is to get a person into a pattern of healthy retirement savings, not simply to get a minimal contribution.

Hence, defaulting participants into a money market fund via automatic enrollment fails to get participants on track to a secure retirement. Two better options are: 1.) to contribute to a lifestyle fund appropriate to the participant’s age or 2.) use an asset allocation mix of the plans core investment offerings based on age and risk tolerance rather than relying on the extremely difficult task of picking the appropriate individual stock(s). Participants should be notified of their contribution level, the investment, and a projection of the benefits of maintaining the automatic levels. Doing so should provide participants an opportunity to change the contribution or investment decision immediately. For many, their own inertia will drive them to accept the defaults as reasonable.

4. Default to, or Offer, Contribution Escalation Programs

For the typical participant, it will take potentially between 12 and 15 percent savings each year to accumulate enough money to achieve a secure retirement. Unfortunately, most employees target their savings percentage to the company match, which average between 3 percent and 5 percent. As a result, they are not saving enough to achieve a secure financial future. To combat this problem, a Contribution Escalation Program (CEP), which increases the employee’s savings level each year until they reach an effective target, can be put into place.

\textsuperscript{17} Corporate Executive Board, Retirement Services Roundtable, Voice of the Participant, 2002
Today, CEPs are emerging as a viable strategy with 7.1 percent of plan sponsors using this approach, as noted among retirement programs surveyed by PLANSPONSOR/Prudential.

Research done by Richard H. Thaler and Shlomo Bernartzi suggests using behavioral economics to increase employee savings through the Save More TomorrowSM program (SMarT) can prove quite successful by gradually increasing savings over time. The SMarT program gets people to commit in advance to future annual automatic increases in their retirement savings level, as demonstrated by Thaler and Bernartzi’s case study analysis.

In their study, Thaler and Bernartzi criticize automatic enrollment plans suggesting that the very inertia that helps increase participation rates for non-participants also can lower the savings rates of those who would have participated without automatic enrollment. Most participants elected the default savings rate of 3 percent whereas, when left to their own devices, many of these employees would have elected a higher savings rate. The key is to combine the high enrollment rates from auto enrollment with higher savings rates associated with a contribution escalation program. Once enrolled at good defaults, a plan should help participants easily move from a good to a better situation.

For example, participants would: 1.) automatically enroll in the plan, 2.) agree, at the time of enrollment (or defaulted with notice), to have their contribution rate raised by a given amount, and 3.) automatically increase their contributions concurrent with any future raises in pay until they reach a designated ceiling, such as 10 or 12 percent or a government limit.

The conclusions of the SMarT program have shown remarkable initial success:

➤ Most people (78 percent) who were offered the SMarT program elected to use it

➤ Virtually everyone (98 percent) who joined the program remained with it through two pay raises, and the vast majority (80 percent) remained with it through the third pay raise.

➤ The average saving rates for SMarT program participants increased from 3.5 percent to 11.6 percent over the course of 28 months.18

According to Thaler and Bernartzi, “Once people enroll in the program, few ever opt out. The SMarT program takes precisely the same behavioral tendency that induces people to postpone saving indefinitely (i.e., procrastination and inertia) and puts it to use.”

By accepting the fact that most participants are not involved, plans can take steps to provide a program that will work more seamlessly with their participant base. Changes in plan design are the most powerful tool a sponsor possesses to address the difficulties participants are having. The activities described in Section B. below, “Encourage Comprehensive Retirement Planning and Offer Products to Protect Accumulated Balances,” are intended to help participants understand, join, contribute to, and effectively manage their retirement without taking anything away from participants who wish to be actively involved. In fact, these activities will provide tangible benefits to even the most active plan users.

“By accepting the fact that most participants are not involved, plans can take steps to provide a program that will work more seamlessly with their participant base.”

18 “Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving,” August 2001
B. ENCOURAGE COMPREHENSIVE RETIREMENT PLANNING AND OFFER PRODUCTS TO PROTECT ACCUMULATED BALANCES

Changes to DC plan design are critical to the financial future of today’s and tomorrow’s retirement savers. Yet, reaching a secure retirement will likely take more than just DC investments. When an individual saves for retirement, they need to look at all their benefits and options—DC, DB, non-qualified, employee stock option plans, Social Security and personal savings.

With this information in mind, sponsors should do all they can to provide employees with access to as many of these options as possible. It is also critical that employers increase awareness surrounding retirement expenses, help employees understand the importance of saving as much as they can today, and offer products that are designed to help individuals protect the savings they have accumulated.

1. Are Participants Aware of Retirement Expenses and Income Needs?

One of the many reasons sponsors embraced DC plans was to fund the retirement income needs of their participants. Yet, today’s DC platform quietly promotes a focus on lump-sum accumulation rather than on a source of guaranteed monthly income that a participant’s account balance can generate.

While some may argue that plan participants often use DC plans for reasons other than creating retirement income, sponsors should recognize that these are alternative uses and not the plans’ main purpose. A review of industry statistics on retirement income adequacy should be enough to convince most that the income from DC plans will be critical to the average American. Individuals may continue to use the plans to save to buy a house or to create wealth they hope to pass on to heirs, but sponsors should focus on educating participants on how to use the plan for its primary purpose.

To do so, educational materials should be adjusted to speak first and foremost about how to build a source of retirement income through the plan. The planning materials should ask participants to determine the monthly expenses they expect in retirement and then show how contributions to the plan can build a balance capable of generating income to meet these expenses. Only after the income needs are met should participants be thinking about wealth accumulation.

Further, an update of future retirement income should be presented to participants. At least annually, participants should receive a statement showing projected future income under the plan using reasonable future assumptions. After all, in most cases, the account balance is only relevant in its income generating capacity. The sponsor should offer participants access to a group payout annuity either through the plan or as an IRA so that participants can access income-generating annuities at an attractive price. Education about retirement income and longevity risk should be provided frequently to participants, particularly to those over age 50.

“Today’s DC platform quietly promotes a focus on lump-sum accumulation rather than on a source of guaranteed monthly income that a participant’s account balance can generate.”
2. Emphasize Catch-Up Contributions and Strategies for Closing the Gap

One of the most important pieces of retirement legislation in recent years is The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which was enacted on June 7, 2001. The act includes numerous mandatory and optional modifications to the tax-qualified retirement plan rules, most of which are designed to help individuals save more for retirement.

Probably the most significant—or at least the most-talked-about—change is the increased contribution limits for retirement plan participants. Delivered in a progressive schedule, the amounts have gone from $11,000 in 2002 to $15,000 in 2006. Similar to the increased contribution limits are the increased catch-up contribution limits, which allow near-retirees to save above-and-beyond the regular limits—$5,000 in 2006 for workers 50 or older.

Many near-retirees, however, are not even aware they have the ability to contribute above and beyond their plan’s normal contribution limits. As stated on BenefitNews.com (August 2005), “only a small percentage of all participants are using the break to save more for retirement.” With this in mind, sponsors can begin to communicate this opportunity through participant statements, websites and personalized print communications.

Another feature of EGTRRA is the retirement savings tax credit—“the first and, so far, only major federal legislation directly targeted at promoting tax-qualified retirement savings for middle- and lower-income workers.” In essence, the credit (also called the tax saver’s credit) is a way to reward lower-wage earners for saving for retirement. Since the tax break is a credit instead of a deduction, it is a strong incentive to save. Tax deductions reduce taxable income, but credits reduce an individual’s Internal Revenue Service bill dollar-for-dollar.

3. Help Protect Accumulated Wealth

In addition to understanding EGTRRA’s advantages, individuals should also be informed about strategies for making their retirement dollars last as long as they should expect to live. One such strategy is delaying retirement. The fact is many individuals would benefit from delaying the day they stop working. This decision would help them earn and save more dollars before retiring and help delay taking Social Security payments (which would, in essence, raise their monthly Social Security payout).

There are other important strategies that sponsors and providers should be emphasizing to help their employees protect the money they have already saved for retirement.

To start, sponsors and providers alike should be discouraging loans and “cash-outs”. Departing employees (e.g. job changers, those who were terminated, retirees) should be dissuaded from taking a lump-sum cash distribution when leaving the plan. This would clearly require better interaction and consultation with participants.

Another key step is ensuring that employees do not have too much money in company stock. The joint study between PLANSPONSOR and Prudential showed that more than half of sponsors surveyed offer company stock through their retirement plan; and about 52 percent are concerned that employees may be over-invested in company stock.

Additional research shows that company stock now averages over 27 percent of the typical plan. Is it reasonable for a typical individual to have over a quarter of their retirement savings invested in a single stock? After all, this is also the company they rely on for a paycheck. This concentration of assets defies the basic principles of diversification and can create significant risk for these participants.

Brokerage windows present yet another confusing choice; they’re difficult to explain and send the
message that the plan isn’t about building retirement income, but about “playing the market.”

It is critical, then, that providers and sponsors take the initiative to help participants make choices appropriate to their time horizon and risk tolerance. This message is certainly important to every generation of investor, but it is particularly significant to near-retirees who do not have as much time to recoup losses caused by overexposure to equity investments. But it must also account for the recklessly conservative investors who rely too heavily on fixed-income investment offerings, participants who abandon equity instruments following a market downturn, and those who concentrate their portfolios solely in equities or company stock.

One possible answer here is providing income solutions integrated with a participant’s long-term asset allocation. With an income floor in place, greater sustained exposure to equities becomes more likely.

Another potential solution includes access to fee-based advice. According to the EBRI, only four in 10 workers have taken steps to calculate how much they need to save by the time they retire in order to live comfortably in retirement and one-third say they do not know or cannot remember the result of the calculation. Clearly, a significant percentage of participants need a professional planner’s help.

And we should not assume participants are against advice-based products. In fact, it is quite the opposite. According to the 2002 Corporate Executive Board Study, Voice of the Participant, more than half of respondents consider advice to be extremely or very important.

Another key step to helping near-retirees and retirees protect their retirement wealth is offering (or at least educating them about) products that provide guarantees yet still promote long-term equity exposure. These products, which are currently available, are designed to convert DC distributions into guaranteed lifetime income on a one-time basis. The individual is able to lock in future guaranteed monthly income, but still retains an opportunity for investment growth. Other products are designed to help individuals delay the initial receipt of Social Security for a few years, thereby enabling them to reap the highest possible payout.

C. ENCOURAGE A SMOOTH TRANSITION TO RETIREMENT

As individuals near retirement, they will be faced with a variety of important decisions—decisions that could impact the way they live out their golden years. As such, sponsors and providers alike have an opportunity to help ease the transition from employee to retiree.

It is also vitally important that retirees understand the need for investment growth. Investing all of one’s money in fixed-income options is not likely a solid solution. A better approach would be to add or retain equity exposure after locking in some floor level of guaranteed income. Moreover, an individual’s rate of withdrawal should be built around the prospect of a longer retirement.

Here are six key contributions for employees to consider:

1. Choose a Date—It may sound like a simple step, but many employees do not understand the impact of the retirement date that they select. Without a proper understanding of this date, participants cannot appropriately estimate the impact of their income from work, the growth of their DC account contributions and investment earnings, the size of their Social Security benefits, the continuation of employer provided health benefits and employer funding for health benefits, continued DB plan accruals, and the number of years for which their investment portfolios must generate income. As such, they are not sure how much money they will need to maintain their standard of living after they stop working.

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21 13th Annual Retirement Confidence Survey
22 Retirement Services Roundtable, Voice of the Participant, 2002
2. Consider Part-Time Work—The face of retirement is changing. The notion that people retire at 65 and never work again is outdated. The reason? Insufficient retirement plan balances and a drive among many aging workers to remain active and to continue contributing to society. Additionally, given the increase in expected longevity, the average retirement is likely to last between 20 and 30 years. This issue can be addressed in a variety of ways. Part-time work is one of them. A realistic expectation is that retirees will work to supplement their income and that they will mix part-time employment into their retirement lifestyle.

3. Protect Against Longevity Risk—Longevity risk may not be the most prevalent thought among individuals saving for retirement, but the fact of the matter is that many retirees will outlive their assets. As such, many participants would benefit from delaying Social Security to maximize their lifetime benefits (primary benefits) and for reasons of tax advantage (secondary benefit). It is also vitally important that retirees understand the need for investment growth. Investing all of one’s money in fixed-income options will not likely offer a solid solution. A better approach would be to add or retain equity exposure after locking in some floor level of guaranteed income. Moreover, an individual’s rate of withdrawal should be built around the prospect of a longer retirement.

4. Guarantee a Paycheck in Retirement—By encouraging employees to invest in products with a guaranteed payout, sponsors/providers are helping to ensure that employees/clients will have ample income to survive a retirement that could last 20, 30 or more years.

5. Protect Against Inflation—Inflation can be a huge detriment to retirement savers, especially those who invest in options with little growth potential. As stated earlier in this paper, there are products available today that offer guaranteed income and growth potential. Participants could either use products that combine these features or use separate products that: 1.) secure an income floor and 2.) are designed for growth. Participants should seriously consider income products that include an inflation-adjusted benefit even though this means a smaller initial monthly income than products without such an inflation adjustment.

6. Address Healthcare Concerns—Americans are living longer lives. On one hand that is a good thing—unless that longer life is fraught with costly health problems (problems that could quickly erode and consume an individual’s retirement savings). The EBRI estimates that medical costs could add 20 percent or more to the amount of pre-retirement income that the vast majority of Americans who lack employer-sponsored, retiree health care will need to replace. Specifically, in its analysis, the EBRI demonstrated that a 55-year old who planned to retire at age 65 would need $230,000 at age 65 to cover the out-of-pocket costs of health care (premiums, deductibles and co-pays)—assuming that individual lived until age 80. Very few Americans understand the size of their health care liability and even less have taken action to fund it. Medicare supplemental insurance and long-term care insurance can help retirees address those rising, and often unexpected, health care costs. As Terry Savage points out, “When you own a long-term care policy, you can live the retirement lifestyle you’ve planned without worrying about extended health-care expenses being a burden on your spouse or your family.”

D. MAINTAIN INVESTMENT AND FUNDING AS PARTICIPANTS WORK FOR MULTIPLE EMPLOYERS

The reality of the current labor force is that participants make poor decisions regarding their retirement plan assets when they leave an employer. Many fail to actively manage the assets that remain in their former employer’s retirement plan. Others take the money in a lump sum, choosing to use it for an immediate need rather than its intended purpose—a secure retirement. Plan providers should offer rollover services that encourage participants to retain their DC balance when transferring jobs, and to consolidate assets to develop a clearer view of the overall retirement readiness picture.

23 13th Annual Retirement Confidence Survey
V. Challenges to Creating Lifetime Retirement Income

Longer life spans and healthier retirements mean participants can spend 20 or even 30 or more years in retirement. If retirement assets are not managed properly, there is a real threat that participants may outlive their retirement savings. Therefore, the money participants set aside for retirement not only needs to keep growing, it needs to be preserved as well.

A. PLAN FOR WHAT IS NEEDED DURING RETIREMENT

Instead of thinking about what they need “at” retirement, participants should plan for what is needed “during” retirement—it is the difference between accumulation and income. Given the rising cost of medical care, prescription drugs, living expenses, and normal everyday activity, it is necessary to help participants plan for a monthly income instead of a lump-sum amount.

Additionally, saving for a lump sum instead of a monthly income can lead to false security or wealth illusion. For example, participants may feel their $350,000 account balance will last throughout the course of their retirement. But since the average retirement can last upwards to 20 years, that amount suddenly does not seem so secure. That same $350,000 account balance would need to earn an annual rate of 6 percent to produce a monthly income of $2,508 for 20 years.

B. ILLUSTRATE INCOME AND OFFER PRODUCTS THAT CONVERT SAVINGS INTO MONTHLY INCOME

An important first step in this direction is offering products that allow participants to convert savings into a monthly retirement income. Some products recently brought to market offer participants an opportunity to mitigate—or even eliminate—certain risks by transferring them to another party. DC plan participants can use them to provide downside protection. More conservative or less savvy investors can use them as a means to eliminate or dramatically lower their anxiety.

Here is a brief list of some potential lifetime income options:

1. Personal Pension Products. These products, which allow participants to purchase units of lifetime income within their DC plan, would help participants to easily understand the “lifetime income value” of their account balance. As they approach retirement, participants could lock-in a future lifetime income stream with either a lump sum or periodic payments in the form of a group or individual deferred annuity.

2. Asset Allocation Portfolios with Accumulation and Income Guarantees. Asset allocation is generally recognized as the primary means of successfully managing investment risk. Once a participant has an established asset allocation framework in place, it should not be difficult to develop cost-effective wrap programs that guarantee minimum rates of return, protect step-up values, and allow such balances to be converted into income. These features will allow participants to maintain access to their funds (liquidity) while delivering guarantee and income features that will allow them to know they have locked-in a minimum level of retirement income.
3. Guaranteed Accumulation Products. These products offer the ability to provide guarantees of principal or step-up portfolio values. This approach can accomplish two goals: 1.) Locking in a minimum value at a participant’s target retirement date helps ensure that poor market performance will not greatly erode his or her portfolio value and will leave a balance that could be fully or partially annuitized; 2.) Giving participants the peace of mind that a portion of their portfolio balance is protected from downside risk, frees them to be more aggressive with their non-guaranteed assets.

Such products can offer participants the opportunity to receive their assets through a lump sum, through an income stream over a specified number of years (not annuitized), or through an annuitized income benefit that cannot be outlived.

C. ADVICE ON DISTRIBUTION

Participants have felt strongly about the need for advice at the time of distribution. Appropriate distribution advice is a key component in the participant’s realization of a secure retirement. Since many participants request a distribution with a plan of action to carry out, it is imperative that distribution advice be presented well before the actual transaction occurs. Presuming that participants would be influenced by practical distribution-related advice, helping them formulate a well-reasoned approach allows them to minimize emotional aspects of the decisions being made.

VI. Addressing the Concerns of Sponsors

Clearly, the recommended Secure Retirement℠ changes we have outlined in this paper will not take place overnight. In fact, considering the fact the current mindset is roughly 20 years in the making, it is safe to say that many of the changes may take years to be fully embraced by all plan sponsors. However, we can comfortably conclude that many innovative plan sponsors, as well as many regulators, are very supportive of the ideas discussed in this paper.

A. COMMON PLAN SPONSOR CONCERNS

We understand that plan sponsors will not immediately embrace each and every recommendation. In fact, in our discussions with plan sponsors, we have found that there are several common concerns. One of the most prominent is fiduciary exposure—sponsors want to make sure they are still meeting their fiduciary responsibilities and minimizing their risks. The regulatory concerns of sponsors also include: the irrevocability of contributions received through auto-enrollment, limited access to these funds and tax penalties for participants on pre-retirement distributions, conflicting state and federal laws on wage withholdings, the loss of 404(c) protection in connection with auto-enrollment default investment allocations, liability associated with default fund selection, and joint and survivor rules for annuities.

Concerns regarding operational complexity have also surfaced. The question here is: Will sponsors respond favorably to the notion of periodic contribution escalations or auto enrollment—programs that are more difficult to administer than today’s straightforward enrollment/contribution structure?

And there are understandable considerations about administrative disruptions. For example, employees may be uncomfortable with changes in the match structure, automatic enrollment and contribution escalation.

These concerns, although understandable, should be balanced against the inevitable exposure that comes from the inability of participants to retire comfortably on the retirement savings they have accumulated through their sponsor’s standard, unaltered DC plan.

Already, class action lawsuits have been filed on behalf of individuals who feel that their employer did not help them adequately prepare for the financial demands of retirement.

This paper also reflects serious, preliminary discussions with various regulators who have offered encouragement when presented with the concepts and recommendations we have outlined.

B. FEAR IS NOT A LICENSE TO AVOID ACTION

Therefore, fear of exposure should not be viewed as a license for sponsors to avoid action. In fact, sponsors may expose themselves to more risk by not taking many of the actions we have proposed.

There appears to be a growing willingness among sponsors to embrace new ideas and plan innovations:

➢ The joint study between PLANSPONSOR and Prudential shows that 95 percent of respondents agree that automatic contribution escalation programs are a workable idea. Nearly 60 percent “strongly” agreed.

➢ This same PLANSPONSOR/Prudential study also showed that more than one-third of respondents would consider adding an option that allows pre-retirees to purchase units of an annuity that would provide a guaranteed income stream in retirement.

According to a recent Retirement Security Project study—“The Automatic 401(k): A Simple Way to Strengthen Retirement Savings”—24 percent of 401(k) plans with at least 5,000 participants have switched to automatic enrollment.

This all makes sense when you consider the nagging doubts that seem to trouble plan sponsors. For instance, a recent survey by CFO Magazine26 revealed that 56 percent of employers believe their employees will not be able to retire comfortably. Another 49 percent said they believe their employees do not invest wisely.

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A. DRIVING BETTER RETIREMENT OUTCOMES

Simply stated, the industry must begin driving better retirement outcomes. As stated earlier, DC plans have seen unprecedented growth over the past 20 years and become a dominant force in the U.S. pension market. Unfortunately, industry statistics consistently reveal that there are large numbers of plan participants who are not building the necessary assets to provide themselves with a secure retirement. As these participants age, they risk falling further and further behind.

The plan sponsor, financial advisor, and provider can all do more to support the participant in the goal of ensuring a secure retirement. Again, the emphasis must be on driving better retirement outcomes. As such, rather than viewing retirement as a generic goal, this model suggests that in order to make retirement a meaningful topic to an individual, it needs to successfully move participants through each stage of the retirement lifecycle; providing them with the tools to plan and execute toward that goal.

Such a program would make strong use of behavioral finance research, take the best of the DB world and put it into the DC platform, and help individuals manage the inherent risks associated with securing guaranteed lifetime income.

B. THE BENEFITS OF SECURE RETIREMENT

With Secure Retirement℠, DC plan service providers can help sponsors better meet the needs of these at-risk participants. The first step is to realize that most of the common features in a DC plan—large numbers of mutual funds, company stock, investment education that focuses on wealth accumulation—do not do much to help typical participants feel comfortable with the plan and to take appropriate action. They also do not address the unique needs of older participants, whose accounts frequently hold the largest share of plan assets.

Plan sponsors can address the needs of at-risk participants by focusing on straightforward ideas, namely:

- Use plan design techniques that harness natural participant behaviors and leverage lessons from behavioral finance,
- Emphasize asset allocation and ease of execution with options that include lifestyle funds rather than an exhaustive selection of investment options, and
- Include lifetime income options that help participants focus on outcomes and mitigate risks.

DC service providers can also help participants directly by:

- Educating them on retirement income issues, not just wealth accumulation,
- Helping them implement and maintain a risk-appropriate investment strategy,
- Acknowledging the limitations of communication and education programs and employing the lessons of behavioral finance,
- Developing products and tools to illustrate the importance of a “paycheck” in retirement, and
- Providing education and advice on how to secure income at retirement.

In conclusion, reinventing DC plans by introducing lessons from behavioral finance, risk-management techniques and defined benefit fundamentals has the potential to greatly expand the effectiveness of DC plans and deliver superior retirement outcomes to participants.

For more information about our Secure Retirement approach, contact your Prudential Retirement representative and financial advisor. Or call toll-free at 800-353-2847 to speak with a Prudential Retirement sales professional.