QDIA evolutions — Moving defined contribution plans into the future

By Jason Shapiro

Introduction

With 81% of employers offering only defined contribution (DC) plans to new hires,[1] the stakes have never been higher for DC plans to facilitate successful retirement outcomes for American workers. This will require coordination across plan design, investment design and communications. From an investment perspective, we believe the qualified default investment alternative (QDIA) is the most direct way to impact retirement readiness given the increase in auto-features such as automatic enrollment (recent data show that 73% of plans automatically re-enroll versus 52% in 2009[2]). This can produce a strong, stable pool of assets that may be used to potentially create better participant outcomes through increased diversification, improved portfolio construction and other valuable features. Before we get into the topic of this paper, QDIA evolutions, a level-setting question may be useful:

How many different QDIAs are there?

☐ One
☐ Three
☐ More than three

The good news (in terms of keeping you engaged with this paper) is that all of the above choices are correct.

If you look at the state of the current market, you could argue there is effectively one truly utilized QDIA, with 93% of plans currently using target-date funds.[3] The Department of Labor, however, specifies three potential QDIAs for sponsors to choose from (see our 2015 paper "Are managed accounts a better QDIA?" for a description of the three: target-date funds, managed accounts and balanced funds). This paper, however, will show that the more comprehensive answer is "more than three." We believe through combining the three allowable QDIAs in thoughtful ways, and utilizing available features and systems innovatively, sponsors have the potential to create new solutions that meet the definition of a QDIA and help improve outcomes for participants. We qualify that statement by acknowledging that many QDIA evolutions are in their infancy and need to progress further before we expect waves of plan sponsors adopting these approaches. That said, we believe evolution is necessary as target-date funds include implied, and often unintended, consequences such as bundled decision making and loss of scale in core lineups, while managed accounts are arguably not an ideal fit for default participants. Our view is that there are alternate implementations sponsors should consider. We discuss three such QDIA evolutions in the following pages.

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[1] Willis Towers Watson 2017 U.S. Defined Contribution Plan Sponsor Survey
[2] Ibid.
[3] Ibid.

America loves hybrids

When growing up in Queens, New York, my favorite part of the summer was when the sun started to set, and all of the children on the block came outside to catch fireflies. There was something extremely satisfying about following those irregular flashes of light, grabbing into the night air, and then seeing that greenish-yellow flash coming through your cupped hands. One night, I was feeling particularly clever. I found a clear glass jar inside my house, poked a number of air holes in the lid and caught about a dozen fireflies inside. I had unknowingly created my first hybrid, combining a jar and some fireflies into an insect-powered lamp.

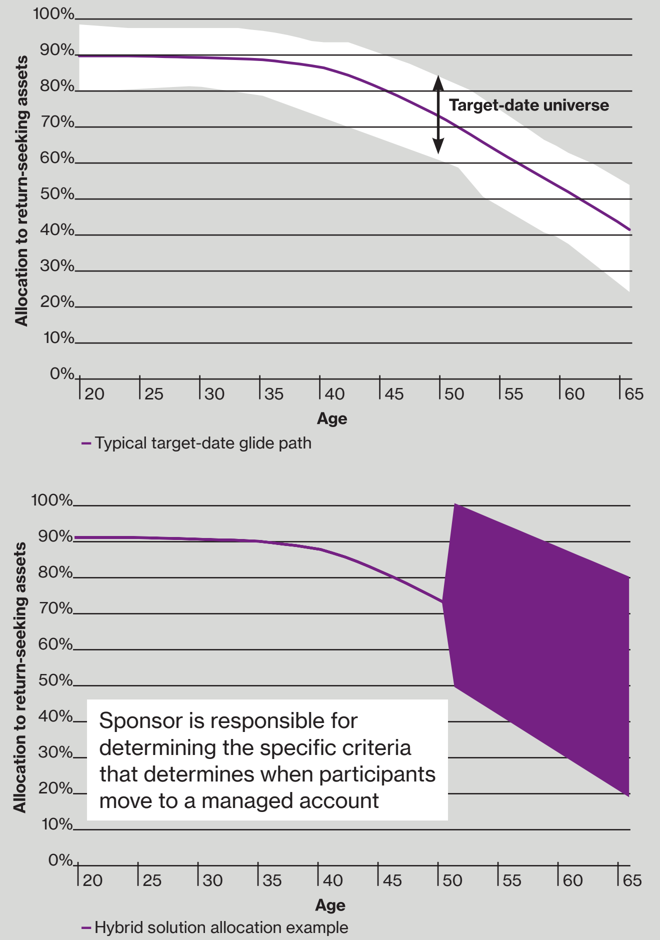
Luckily, our adoration of hybrids did not stop there. Whether we're talking about hybrid vehicles, smartphones or my new favorite – syncing my smart lightbulbs to streaming movies – we love taking things that are good and combining them to create something better.

QDIAs are no exception. In fact, in our 2017 paper "Managed accounts: Today's service may not be tomorrow's solution," we mentioned hybrid models as a potential way to balance cost and customization in a QDIA solution. Since the time of that paper's publishing, hybrid QDIA solutions have continued to develop. We have watched some sponsors implement new QDIA solutions, heard plan administrators tout their capabilities to support hybrid QDIAs and seen advisors developing views on best practices around enhanced QDIAs.

The hybrid solution most commonly cited today is illustrated in *Figure 1*. Effectively, it is a low-cost generic asset allocation vehicle that transitions to a customized managed account later in a participant's career. Note that the shaded portion of the bottom chart can theoretically be wider than what is shown, though empirically providers will often overlay certain portfolio constraints for optics and stand-alone reasonableness.

For illustrative purposes only

Figure 1. **Typical target-date glide path vs. hybrid solution**



General consensus from the investment community is that portfolios should be highly growth-focused for participants early in their careers given their long time horizons and high levels of human capital (i.e., future earnings). It is therefore questionable whether early career participants should pay a premium for a managed account to create a customized asset allocation. Practitioners will often cite other benefits of managed accounts, such as encouraging higher savings rates and diversification away from company stock, though we argue there are less expensive ways to achieve those objectives than by layering on an additional portfolio-level management fee. At some point, though, participants may benefit from the customization afforded by a professionally managed account. It is reasonable to posit that the benefit of managed accounts is correlated to age, given participants nearing retirement generally have more complex financial situations and will hopefully be more engaged in their upcoming retirement planning. Combining these considerations leads to a potential solution similar to the bottom graph in Figure 1. Specifically, the default consists of a low-cost asset allocation vehicle early in a participant's career (which may be implemented through a target-date fund, balanced fund or alternate allocation process), and it automatically transitions defaulters to a managed account at a certain trigger point. This trigger point may be age-based or may consider a number of factors, including tenure or income, to name a few.

As shown in *Figure 2*, the hybrid approach aims to combine the low-cost, efficient asset allocation process of target-date funds (or similar asset allocation vehicles) and the benefits of customized advice in managed accounts. There are some areas for consideration with a hybrid approach, as laid out in the table, which we'll describe in a bit more detail.

Figure 2. **Features of traditional vs. hybrid QDIA approaches**

Feature	Target-date funds	Managed accounts	Hybrid QDIA
Asset allocation	Single glide path	Individually customized	Customized later in career
Portfolio construction	Manager-selected funds	Utilizes core funds	Core funds later in career
Holistic advice	Not included	Included	Included
Participant engagement need	Low	High	High later in career
Fiduciary decision points	Well defined	Well defined	Less well defined
Cost	Typically lower	Typically higher	Typically moderate

Asset allocation and portfolio construction: Depending on the asset allocation vehicle utilized earlier in a participant's career, there may be a disconnect between the philosophy and process used at different points in a participant's working life. For example, a sponsor may utilize a passive target-date fund early, but the managed account used later may allocate more to actively managed funds. The key here is to understand the asset allocation and portfolio construction processes of the potential providers to create a solution that is consistent with plan fiduciary beliefs. Another consideration is while managed accounts will typically use only the core lineup, managed account providers have recently increased their capabilities and willingness to invest in non-core options, subject to recordkeeper constraints, which may create an opportunity for improved portfolio diversification within the QDIA construct.

Holistic advice and participant engagement need: Like all managed account solutions, the value proposition is highest when a participant fully engages (e.g., provides information about her goals, constraints, external assets). Today, in a market where the majority of managed account implementations are opt-in (not QDIAs), there is still a marked lack of customization, which would only worsen if offered as the default. That said, there are ways participant engagement can be enhanced within hybrid solutions:

- **Provider technology integration:** In the mid-2000s, managed account providers received little information from administrators by default – often only DC account balance and age. Today, providers are able to pull in significantly more information without participant engagement, such as salary, account balance, age, contribution rate, retirement age, gender, state of residence, match formula, pension amount, loan amount, brokerage window allocation and outside assets. As the ability to customize with less engagement improves, so will the value proposition for hybrids.
- **Communications:** Sponsors have increased the way they monitor their plans both at the aggregate and participant levels. Developing leading strategies to engage with participants, including targeted communications, can facilitate higher levels of participant education, improved usage of tools, higher levels of engagement and an all-around improved experience.

Fiduciary decision points: Compared with other QDIA alternatives, hybrids do come with additional fiduciary decision points a sponsor needs to consider. When should participants transition from the generic asset allocation to the managed account? Which factors should be considered for determining that transition point? What level of consistency is required between the processes and philosophies of the early-career allocation approach and the managed account implementation? These are all important questions, and given the infancy of hybrid solutions the answers are not yet well formed. We urge sponsors to discuss these items with their advisors to clearly lay out the benefits and considerations of various approaches. Additionally, sponsors should engage with their recordkeepers to understand the behaviors of their participant bases to help inform their decisions. For example, if participants seem not to engage with platform planning tools at age 50 but have high levels of engagement at age 55, sponsors may prefer a later transition point to a managed account.

Cost: The focus of any solution should be on the net of fee value proposition. As costs decrease, the hurdle rate for the additional value hybrids need to provide over less customized solutions also decreases. Using market adoption as an indicator, it is clear fee levels are currently too high to create high levels of interest by institutional plan sponsors. That said, there is certainly a break-even point where sponsors would show interest in hybrid solutions, so providers and sponsors should engage in open dialogue to figure out the cost structure that would make hybrids an attractive solution.

We believe hybrid solutions have potential to provide differentiated outcomes for participants, though for those not ready to consider hybrids, another potential QDIA evolution may be of interest: unwrapped target-date funds.

To wrap or not to wrap

Unwrapped target-date funds are in some ways a hybrid in and of themselves. They are effectively the combination of traditional model portfolios and custom target-date funds. A plan sponsor or third party creates a custom glide path that could factor in the sponsor's plan design, participant demographics and behaviors, and the sponsor's investment beliefs. Once designed, the plan's core lineup would be mapped to model portfolios, which may then be used as the building blocks to create appropriate portfolios at various participant ages. This schematic is displayed in *Figure 3*.

The unwrapped target-date model offers advantages compared with off-the-shelf target-date funds and also versus traditional custom target-date funds as summarized in *Figure 4*.

Figure 4. **Advantages of unwrapped target-date funds**

Benefit	Comments
Better plan governance	▪ Leverage due diligence already conducted on core fund lineup ▪ Core lineup retains scale benefits leading to better overall pricing ▪ Asset allocation evaluation independent of underlying fund management
No additional infrastructure needed	▪ No need to strike additional net asset values ▪ Cost competitive with off-the-shelf solutions ▪ Cost efficiencies versus custom target-date funds ▪ Potentially low fees charged by providers to support service
Simpler communication with participants	▪ No need to explain suite of investment options, only that a service can manage the asset allocation for them ▪ No need for five-year buckets – can have allocation for each age
Customization possible	▪ Incorporate investment beliefs, fee budget, plan demographics, non-core options (vendor-permitting)
Evolution ease	▪ Flexible structure facilitates evolution of QDIA, such as pairing with distribution option/strategy

It is also worth acknowledging some of the unique considerations around an unwrapped solution, summarized in *Figure 5*.

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Figure 3. **Unwrapped target-date fund schematic**

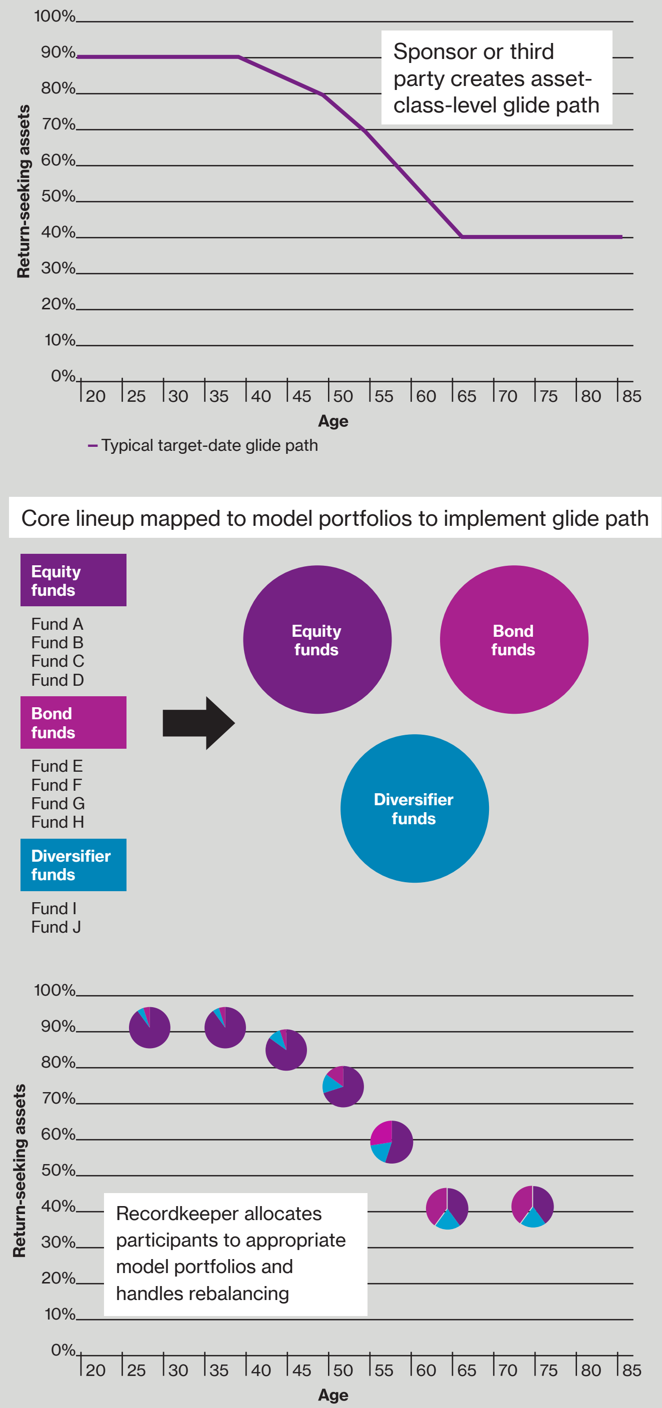

Figure 5. **Considerations for an unwrapped target-date fund**

Consideration	Comments
Recordkeeper-specific availability	▪ Ability to implement solution is vendor-specific and requires communication and planning between sponsor and administrator ▪ Specific capabilities, such as reporting and rebalancing methods, will vary ▪ Ability to wrap fees and charge solely to the QDIA users varies by provider
Determining fiduciary roles	Requires fiduciary services providers across a number of tasks, including: ▪ Building age-based strategic allocation glide path ▪ Fund selection/manager changes ▪ Rebalancing rules ▪ Custom fact sheets (to the extent needed for service)

Is there demand for an unwrapped customized solution? The data tell us there may be. While only 9% of plans between $200 million and $499 million use custom white labeled funds and only 2% of plans less than $200 million do so, **66% of plans** $5 billion and above use custom white labeled funds.[4] One significant difference between smaller and larger plans is the scale that comes with higher asset values allows for the creation of custom structures with very modest trust, custody and unitization fees, given those are often fixed costs spread over larger asset bases. This leads us to posit that there could be interest in an unwrapped solution, specifically because it alleviates some of the cost and operational considerations of creating unitized fund structures. While this may provide cost-efficient access to more customized QDIA solutions to small/midsize plans, the unwrapped concept may also be attractive for large plans for the same reasons noted above.

Why are we doing this again?

So far we have talked about two QDIA evolutions that have the potential to provide unique value propositions to the DC marketplace. Still, before we go too far, it likely makes sense to take a step back and consider what we are aiming to accomplish in DC plans today. We argue DC plans are tasked with serving as the primary retirement plans for many American workers and helping them generate sustainable income in retirement. What becomes more complex is that DC plans are asked to accomplish this lofty task while not only retaining many of the current characteristics and features of DC plans (e.g., choice, liquidity, institutional costs) but also providing some of the benefits foregone by the lack of defined benefit (DB) plans for many participants (e.g., more guaranteed income). In fact, when asked about the specific retirement income factors individuals consider important, many noted access to additional funds, possibility for growth, investment flexibility, automatic stable payments and guaranteed income components, among others.[5] Many of these objectives conflict, so in order to address the desires of participants, sponsors should consider how features may be utilized in a dynamic QDIA and how those pieces interact to provide participants with a customized solution that meets many of the desired criteria.

While not prescriptive, one potential retirement income implementation is described in *Figure 6*. This illustrates the participant's DC balance converted into retirement spending through Social Security deferral (light gray), deferred annuity purchase (dark gray) and non-guaranteed spending through remaining assets that are invested in a multi-asset portfolio (purple).

Figure 6. **In-retirement, income-focused default example**

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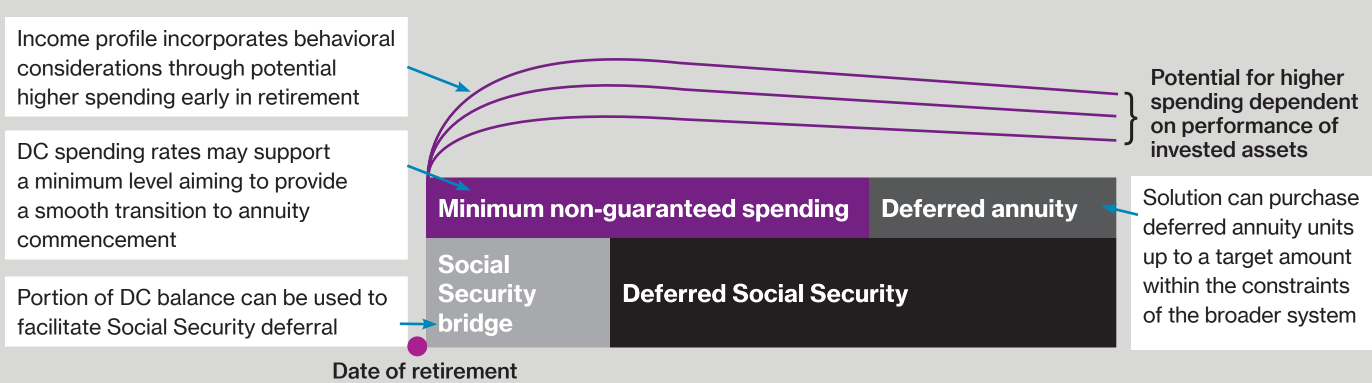

[4] Willis Towers Watson 2017 U.S. Defined Contribution Plan Sponsor Survey
[5] The Cerulli Report, Evolution of the Retirement Investor 2015

A QDIA designed to provide sustainable income can function similarly to a target-date fund, managed account or other multi-asset class solution while also incorporating more customization in the retirement spending phase. The specific components could include:

Guaranteed income: Loss of control and lack of liquidity is a common criticism of lifetime income products. While guaranteed products have had limited uptake by individual participants, the QDIA could remove that behavioral bias by facilitating the purchase of deferred income annuities. Deferred annuities protect against longevity risk, manage cost and provide more robust guaranteed income sources. The QDIA could be designed to limit additional income purchases if a participant already has substantial guaranteed income (e.g., generous pension benefit).

Flexible spending with downside protection: The liquid component of the solution could support a minimum spending level even through adverse market conditions by ensuring discretionary spending can help bridge the gap to the deferred annuity described above. A portion of the retirement balance could support dynamic spending, which provides not only inflation-adjustments but also the ability for spending to grow above inflation with positive capital market experience.

Behavioral considerations: Higher discretionary spending may be more valuable to a participant early in retirement. A QDIA may be developed to support distributing higher levels of income early with decreasing total income later, while still meeting the QDIA's broader goals and objectives.

Ability to facilitate other optional features: Participants may want to take advantage of non-investment income strategies, such as deferring Social Security. The QDIA could be dynamic in terms of distribution to support such strategies for engaged participants by utilizing accumulated savings to manage the participant's total retirement income profile.

These characteristics are not meant to be prescriptive but rather demonstrate valuable features we believe may be integrated into a holistic QDIA solution that are generally lacking today. Implementation considerations requiring discussion include desired annuity features, insurer selection and oversight, and portability, among others. These hurdles may be overcome and should be discussed as part of broader DC investment design reviews.

Conclusion

As mentioned at the outset of this paper, target-date funds are currently the dominant QDIA in the DC market. We are advocates of target-date funds in DC plans and believe they do a number of things very well: address asset misallocation, streamline participant decision points and reduce costs through their tremendous scale. Plan sponsors, advisors and managers have done an admirable job of advancing target-date funds to the extent possible, mainly through evolving glide paths, lowering costs and adding marginal diversification to target-date portfolios. Today, however, target-date funds are asked to do more than they ever have in the past – to be a retirement readiness vehicle for a heterogeneous population of plan participants. We need to critically ask ourselves as an industry whether target-date funds are up to the task. If not, we should consider what the next step for QDIAs should be.

We believe all of the ideas discussed in this paper have merit and should be reviewed by plan sponsors. Now is the time to start thinking about building a leading, best-in-class QDIA, before we start to see the waves of retirees relying primarily on DC reaching retirement age. If we wait until those participants are ready to leave the workforce, it may be too late.

Willis Towers Watson actively researches the QDIA marketplace, including the current QDIA options as well as potential QDIA evolutions. Please reach out to a Willis Towers Watson consultant for more information.

Contact

Jason Shapiro
Director, Investments
+1 212 309 3496
jason.shapiro@willistowerswatson.com

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