Maximizing 401(k) Plans
What Automation, Education, and Advice Can Achieve for Participant Outcomes

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Maximizing 401(k) Plans

What Automation, Education, and Advice Can Achieve for Participant Outcomes

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Presentations by:

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Agenda

- The impact, adoption and role of automatic features
- The influence and usage of investment advisory tools
- The role and importance of employee education
- Questions
Maximizing 401(k) Plans: Automation

Michael Herndon
AARP, Manager of Financial Security
About AARP

- Nonprofit, nonpartisan membership organization for people 50+
- Roughly 38 million members (approximately 50% of the membership are still working)
- At least one office in all 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands
- Vision: “A society in which everyone ages with dignity and purpose, and in which AARP helps people fulfill their goals and dreams.”
Why AARP is Interested in Retirement Plan Design

- Financial security in retirement is an AARP priority as it is essential to help us reach our vision
- Defined contribution (DC) plan automation is a key lever in driving retirement savings and security
- AARP, FINRA and Retirement Security Project (RSP) created Retirement Made Simpler (RMS) campaign to help support DC plan automation
Automatic Features Basics

- Utilizes current inertia
  - Participation
  - Investments
  - Deferral rates
- Remains employee decision
- Supported by behavioral finance studies, and employer and employee surveys
Automatic Features Trends

All DC Plans Adoption of Automatic Enrollment

Source, PSCA 52nd Annual Survey, September, 2009
Automatic Features Trends

Percent of employer plans containing an automatic enrollment feature?

- All Employers (n=806)
- Employers with auto escalation (n=222)
- Employers without auto escalation (n=580)

Source, AARP “Existing Employee Research,” 2010
Automatic Features Trends

Growth in Percent of Plans Having Adopted Automatic Enrollment by Plan Size

Source: Aon Hewitt Benefit SpecSelect
Automatic Features Trends—Poll

Does your plan contain an automatic enrollment feature?
When your company first adopted automatic enrollment for your 401(k) plan, did your company automatically enroll...*

- Only new hires: 58%
- All non-participating employees who were eligible for the plan: 35%
- Don't Know/Refused: 6%

Source: AARP “Existing Employee Research,” 2010
Automatic Features Trends—Poll

If your company has adopted an automatic enrollment feature, did you apply it to all non-participating employees or only new hires?
**Automatic Features Trends**

- **It helps employees save more for retirement**
  - All Employers: 89%
  - Employers with neither feature: 67%
  - Employers with auto escalation only: 52%
  - Employers with auto enrollment only: 63%
  - Employers with auto enrollment + escalation: 74%

- **It is easier to pass nondiscrimination testing**
  - All Employers: 50%
  - Employers with neither feature: 54%
  - Employers with auto escalation only: 49%
  - Employers with auto enrollment only: 35%

- **It demonstrates that we are a socially responsible company**
  - All Employers: 40%
  - Employers with neither feature: 26%
  - Employers with auto escalation only: 27%
  - Employers with auto enrollment only: 30%
  - Employers with auto enrollment + escalation: 35%

- **It can reduce the plan pricing or fees charged by plan provider**
  - All Employers: 24%
  - Employers with neither feature: 21%
  - Employers with auto escalation only: 24%
  - Employers with auto enrollment only: 27%
  - Employers with auto enrollment + escalation: 30%

- **It helps retain employees**
  - All Employers: 47%
  - Employers with neither feature: 33%
  - Employers with auto escalation only: 30%
  - Employers with auto enrollment only: 24%
  - Employers with auto enrollment + escalation: 27%

- **It helps recruit employees**
  - All Employers: 62%
  - Employers with neither feature: 50%
  - Employers with auto escalation only: 40%
  - Employers with auto enrollment only: 20%
  - Employers with auto enrollment + escalation: 17%

Source: AARP “Existing Employee Research,” 2010
Automatic Features Trends

Why does your 401 (k) plan not have automatic enrollment? (Base: Employers without auto enrollment; n=465)

- Employee challenges: 30%
- Cost: 20%
- Content as is: 14%
- Lack of information: 10%
- Administrative challenges: 9%
- Want it to be the employee's decision: 7%
- Economy: 4%
- Legal Concerns: 2%
- Other: 9%
- Don't know / refused: 13%

Source, AARP “Existing Employee Research,” 2010
Employee Sentiments on Automatic Features

Positive about Automatic Enrollment:

- All employed adults – 69%
- Employed adults who were automatically enrolled – 89%

Source, AARP “Styles Data,” 2010
Employee Sentiments on Automatic Features

Positive about Automatic Escalation:

- All employed adults – 57%
- Employed adults who were automatically enrolled – 84%

Source, AARP “Styles Data,” 2010
Automatic Enrollment Suggested Practices

- At time of automatic enrollment implementation, apply to all non-participants
- Offer it to non-participants once every two to three years, or even every year
- Any given year may be the “right place at the right time” for a given employee
Automatic Plans’ Deferral Rates

Default Automatic Enrollment Rates - 2010

Source: Aon Hewitt Benefit SpecSelect
Automatic Plans’ Deferral Rates

Default Automatic Deferral Rate

Source: Fidelity Perspectives, Summer 2009
Automatic Plans’ Deferral Suggested Practices

- Aim higher than the average of 3%
- Consider setting it at maximum percentage you match
- Set deferral rate to increase automatically each year
- Roll out higher deferral rates and increases all at once (e.g. 6% with annual increases to 12–15%)
Automatic Plans’ Escalation Features

- Automatic enrollment at average 3% and even 6% may not be enough to help employees reach retirement savings goals

**Consider this:**
35 year-old with no current retirement savings earns $50,000. Saves 3% of salary each year. Employer matches half. Needs an estimated $1.3 million saved to support her retirement. Will fall short by more than $800,000.
Automatic Plans’ Escalation Suggested Practices

- Escalate beyond company match
- Escalate until an employee reaches 9%–12% of pay
- Apply escalation once per year (i.e., employees must opt out of increases annually)
Automatic Plans’ Default Investments

- Follow DOL guidance for appropriate investments
- Default to option that allows for long-term growth that can outpace inflation
- Consider target-date and balanced funds
Automatic Plan Default Investments: A Comparison

Employee #1:
30-year old contributes $2000/yr in Money Market fund with average annual return of 3%

Employee #2:
30 year-old defaults into Lifecycle fund with average annual return of 7%
Total Savings at Age 65

- Employee #1: $200,256
- Employee #2: $426,107
Putting It All Together: Company Success Story

- 2003: Company worked with provider with experience implementing auto 401(k)s
- 2004: Auto-enroll all new non-union employees
- 2006: Educated eligible employees who weren’t participating
  - Mailed letters detailing the automatic 401(k) process
  - Enrolled at a 4% (to take advantage of full company match) in a lifecycle fund
Putting It All Together: Company Success Story

Union Workers

- Evraz negotiated through their bargaining unit
- Union accepted an automatic 401(k) plan as long as it included an opt-out feature
- Set the savings rate at two percent with a one percent match
Putting It All Together: Company Success Story

Results:

- Participation grew substantially
  - From 50% to 97% for non-union
  - From 40% to 70% for union workers

- Employee feedback overwhelmingly positive

- Administration costs remained the same as pre-automatic enrollment days
Automatic “Annuitization”

- Next frontier in automation of DC plans
- Applies automation to spend-down side of the retirement equation
- Like a traditional pension, defaults employees account or portion of, into regular guaranteed lifetime income
- Are not very popular with participants:
  - Difficult to understand
  - High fees
  - Gamble on longevity
  - May preclude use of money for financial emergencies
Automatic “Annuitization”

Yet they express positive feelings towards their employer defaulting them into “a series of equal, monthly retirement income payments that are guaranteed to last for life.”

Source, AARP “Styles Data,” 2010
Today’s Topic Summary

- Trends—Automatic growth slowed but continues to be the norm
- Employee attitudes—Continue to have positive feelings about it
- Automatic enrollment—Apply to all employees annually
- Automatic escalation—Set to go above company match
- Automatic plans’ default investments—Follow DOL guidance
- Automatic annuitization—Keep an eye out for both in-plan and distribution phase products and services
The Influence and Usage of Investment Advisory Tools

Alison Borland
Aon Hewitt, Retirement Strategy Leader
Why Offer Savings Plan Participants Help?

- Importance of savings in employees achieving retirement goals
- Participants’ investment decisions often naïve or emotional
  - Market timing during market decline or rally
  - Limited use of funds/asset classes
  - Lack of rebalancing
- Recognition of the diverse needs of workers
How Prevalent is Help?

- Target date/lifecycle funds: 83% (already offer) and 3% (very likely to offer in 2011)
- Online investment guidance: 56% (already offer) and 9% (very likely to offer in 2011)
- Online third-party investment advisory services: 37% (already offer) and 10% (very likely to offer in 2011)
- Managed accounts: 36% (already offer) and 11% (very likely to offer in 2011)
- Phone access to third-party advisory services: 35% (already offer) and 8% (very likely to offer in 2011)
- In-person third-party advisory services: 27% (already offer) and 5% (very likely to offer in 2011)

Source: Aon Hewitt Hot Topics in Retirement 2011 (Preliminary)
Does Offering Participants Help Make a Difference?

- First report of its kind in the industry
- 7 large 401(k) plans with over 400,000 participants and $20 billion in assets
- Time period: 2006-2008
- Three types of Help reviewed
  - Target date funds
  - Online investment advice
  - Discretionary managed accounts
Help in Defined Contribution Plans: Is it Working and for Whom?

Analysis of help offered in defined contribution plans

- Are participants using professional help better off?
- Which participants use professional help?
- What kind of help do they use?
Are Participants Using Help Better Off?

Median Returns by Age Group
2006-2008

Help group includes all participants using a managed account, those with an allocation of 95% or more in an age-appropriate target date fund, or a recent online advice user. Recent online advice users includes participants who have logged on in past year, and have received specific recommendations.
Why Are Non-Help Participants Performing So Poorly?

- Inappropriate risk levels
  - NHPs often have too low risk or too high risk for their horizon
  - Cost is 1.38% per year on average

- Inefficient portfolios for a given risk level
  - NHP portfolios not as efficient
  - Cost is 0.67% per year on average

Assuming a lump sum invested for a 20-year period earning 1.86% higher annual returns. Actual impact for a given participant will varying depending on asset allocation and plan contributions.
Are Participants Using Help?

Yes. On average, one in four used Help.

- Usage ranges from 15-35% across plans
- Varies with demographics, plan design, time offered
- Defaulting participants improves usage

Help Group includes: Target date fund users with allocations >95% of account balance, recent online investment advice users, current managed account users
Who Is Using Help?

Participant Demographics Vary By Type of Help

- Target date funds used by younger participants, new hires with lower balances
- Managed accounts used by older participants with average balances
- Online advice used by younger, higher income participants

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<thead>
<tr>
<th></th>
<th>Target Date Funds</th>
<th>Managed Accounts</th>
<th>Online Advice</th>
<th>Non-Help</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average age</td>
<td>38.0</td>
<td>48.8</td>
<td>40.6</td>
<td>45.0</td>
</tr>
<tr>
<td>Average balance</td>
<td>$6,295</td>
<td>$45,816</td>
<td>$69,057</td>
<td>$42,845</td>
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<tr>
<td>Median balance</td>
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<td>$18,667</td>
<td>$23,073</td>
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<td>Average salary</td>
<td>$34,802</td>
<td>$48,585</td>
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<td>Average contribution</td>
<td>4.1%</td>
<td>5.7%</td>
<td>7.1%</td>
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<td>Average tenure (yrs)</td>
<td>3.8</td>
<td>12.5</td>
<td>9.4</td>
<td>9.8</td>
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What Are The Implications for Sponsors

- Range of options needed to help the most participants
  - No “silver bullet” that appeals to everyone
  - Different participants have different needs

- More help needed for near-retirees
  - Greatest variation in risk preferences
  - Least amount of time to recover from market downturn

- Best way to increase help usage is through defaults
  - Default gets new hires started on right track
  - Expand QDIA\(^1\) to existing participants

\(^1\) QDIA, or qualified default alternative investment, as defined in the Department of Labor’s final rule, Default Investment Alternatives under Participant-Directed Individual Account Plans, 72 Fed. Reg. 60452 (Oct. 24, 2007).
Emerging Forms of Help

Investment advisory help is one important way to support participants in their quest for financial security; others include:

- Broader financial planning
- Extension of help beyond employment, into retirement
- Debt counseling
- Help for families
Best practices in investment education:
Lessons learned from

The Eddy Awards

Presented by:
Nancy Webman, Editor, Pensions & Investments
Does Investment Education Work?

- Some still allocate assets to every target-date fund offered
- And some allocate all assets to company stock
Are The Majority of Plan Participants Just Poor Investors?

The P&I Eddy Awards prove the naysayers are wrong to paint everyone with same, broad brush
Recognizing the best practices in defined contribution plan investment education
Plan sponsors have demonstrated numerous ways participant behavior has changed as a result of their education efforts.
Increase Participation

RESULT: 4.2% of non-participants enrolled in the plan

Plan Sponsor: Southeastern Freight
Service Provider: T.Rowe Price
Increase Participation

RESULT: 
30% of employees completed an easy enrollment/change form

Plan Sponsor: AAA Cooper Transportation
Increase Participation

RESULT:
Jumped from 24% to 44% in the Puerto Rican plan

Plan Sponsor: Phillips-Van Heusen
Increasing participation is not the only goal for investment education programs

Diversification is another
Diversification

RESULT:
Average number of funds increase to 6.1 from 3.2

Plan Sponsor: Meijer
Increase Deferrals

RESULT: 14% increase their deferrals

Plan Sponsor: ILC Data Device Corp.
RESULT: 28% response rate with an average deferral of 6.3%

Increase Deferrals

Plan Sponsor: Children’s Hospital of LA
What are some of the tricks that plan sponsors and service providers use to entice plan participants to read AND take action?
1. Use A Theme

Plan Sponsor: Omni Hotels
1. Use A Theme

Plan Sponsor: Dean Foods
2. Use English—Avoid Jargon

- Short sentences and paragraphs
- Break up type with graphics and photos
- Make pages inviting to read not intimidating
3. Fewer Pieces The Better

- Send out one brochure
- Consolidate the information
4. Easier The Better

Call to action should be easy to understand and easy to complete

- Tear out, self-addressed
- Quick enrollment form
- Pre-Populate whenever possible

Plan Sponsor: Children’s Hospital of LA
5. Be Creative

Plan Sponsor: Estes Express
5. Be Creative

Plan Sponsor: Resorts Hotels & Casinos
6. Freebies

Plan Sponsor: MGM Mirage
Questions?
Thank you! Contact us for additional information:

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Resources

- RMS  www.retirementmadesimpler.org
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