A 360 DEGREE APPROACH
To Preparing for Retirement
The Principal Financial Group is pleased to partner with CREATE-Research to publish this report, *A 360 Degree Approach to Preparing for Retirement*, which dives into innovations, gaps and trends within the U.S. retirement system. The report is authored by Prof. Amin Rajan, one of the most respected commentators on the subject of investment management.

At The Principal, we believe growing economic challenges, dramatic demographic changes and fiscally constrained governments have combined to create the era of personal responsibility in the United States and around the globe. Wherever they live, people are becoming increasingly responsible for their own financial futures. But they don’t have to go it alone.

A key point emerging from the research is how four distinct stakeholder groups each have an important role to play in helping Americans achieve a secure retirement. Asset managers, plan participants, financial advisors and plan sponsors have clear responsibilities within the retirement value chain, whether in the form of education, planning, product innovation or plan design.

The U.S. retirement system has progressed positively since enactment of the Pension Protection Act of 2006 and continues to evolve. But it’s clear there is still room for improvement, and The Principal is committed to being a part of the solution. We hope this report delivers fresh insights on trends and innovations that can help all Americans take action to achieve their financial goals.

Julia Lawler  
Senior Vice President  
Principal Financial Group
This report presents the latest in the annual series started by Principal Global Investors and CREATE-Research in 2009. The details of previous reports are given on page 24.

Our main 2013 report was published in June under the title *Investing in a Debt-Fuelled World*. It highlighted the approaches being adopted by investors in various segments based on the views of 713 top executives from around the world. This report has gone a step further by drilling deeper into the subject of retirement preparedness in the United States.

My foremost thanks go to a sub-sample of 148 U.S.-based asset managers, plan sponsors and financial advisors at the forefront of retirement planning in America. I have much valued their insights on this as well as previous occasions.

My special thanks also go to the Principal Financial Group and Principal Global Investors, who have sponsored the publication of this report without influencing its findings in any way.

This arm’s length support has enabled CREATE-Research to deliver impartial information to the global investment community over the past five turbulent years.

Finally, I am grateful to Lisa Rajan for managing the survey, data analysis and report writing and to Dr. Elizabeth Goodhew for editorial help.

After all the marvelous support I have received, if there are any errors and omissions in this report, I’m solely responsible.

Prof. Amin Rajan  
Project Leader  
CREATE-Research
## CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreword</td>
<td>i</td>
</tr>
<tr>
<td>Acknowledgements</td>
<td>ii</td>
</tr>
<tr>
<td><strong>Executive Summary</strong></td>
<td>2</td>
</tr>
<tr>
<td><strong>Product-Based Solutions</strong></td>
<td>8</td>
</tr>
<tr>
<td>Which innovations will be improving the product line up?</td>
<td></td>
</tr>
<tr>
<td><strong>Guidance-Based Solutions</strong></td>
<td>16</td>
</tr>
<tr>
<td>What do the various stakeholders need to do?</td>
<td></td>
</tr>
</tbody>
</table>
**EXECUTIVE SUMMARY**

"Thanks to improved healthcare, there is an 85% chance that one member of a healthy 65-year-old American couple will live beyond 85 and a nearly 40% chance that at least one of them will live beyond 95.

- AN INTERVIEW QUOTE

**INTRODUCTION**

Participant-directed defined contribution (DC) plans are the cornerstone of the private sector retirement system in the United States. Currently, they account for about $9.7 trillion of the approximate $16.5 trillion in total pension assets.

But in the eyes of many, they also paint a bleak future of inadequate savings, poor investment choices, high charges and inadequate retirement nest eggs.

This is indirectly corroborated by the Principal Financial Well-Being Index™, published quarterly by the Principal Financial Group. It shows at least three in five workers have remained concerned about their long-term financial future since the inception of the Index (Figure 1.1).

But the winds of change have been evident since the Pension Protection Act of 2006 (2006 Act). Using “nudge economics,” the 2006 Act makes a virtue of plan participants’ two well-known behavioral traits: inertia and procrastination. By giving birth to an autopilot version of 401(k), the 2006 Act has proved a watershed. However, there is also a more nuanced view: the 2006 Act has achieved more than expected but less than needed.
By itself, it cannot shield plan participants from the colder winds of aging demographics or volatile markets.

Hence, it’s time to take a fresh look at the downsides of the current system of 401(k) in the private sector and propose actions to minimize them.

Accordingly, this report has three aims:

• Highlight the positive innovations sparked by the 2006 Act

• Underscore the weaknesses that persist despite the improvements

• Suggest a 360 degree approach that would improve retirement outcomes

This research report relies on information emerging from the 2013 Principal Global Investors/CREATE-Research survey.

The survey covered 29 fund jurisdictions worldwide. The results presented here focus on the United States, using the data provided by 148 asset managers, plan sponsors and financial advisors with active involvement in the 401(k) space. They had $15 trillion in assets under management.

The survey was followed up by 30 interviews with a cross-section of respondents.

Unless otherwise stated, all the data provided in this report have emerged from the survey and the interviews.

MAIN FINDINGS

Three key messages have emerged from the research.

1. The 2006 Act has charted a fresh course in plan design and product innovation

Overall Achievements

The 2006 Act gave birth to an autopilot version of 401(k) via three key innovations in plan design: automatic enrollment of all eligible employees; automatic rises in deferral rates over time; and a selection of default investment options.

While participants retain the right to opt out, few do because of inertia and procrastination, both of which had historically ensured low enrollment rates, low deferrals and poor investment choices.

Notably, by giving a safe haven to lifecycle funds via a Qualified Default Investment Alternative (QDIA), the 2006 Act has also promoted a whole-life approach to retirement planning.

Thus far, the results are impressive. According to the Employee Benefit Research Institute, the proportion of private sector employers offering a 401(k) has risen from 72% in 2007 to 82% in 2012. In addition, QDIA has been adopted by 74% of sponsors.

**FIGURE 1.1**

Percentage of workers agreeing with the statement “I am very concerned about my long-term financial future.”

![Figure 1.1](image_url)
The 2006 Act has accelerated innovations in the two phases of lifecycle investing:

**Accumulation Phase**

In this phase, target-date funds have emerged as one of the top investment innovations of the last decade. With an age-based glide path of asset mix, they have gained traction, holding $500 billion of assets in 2012 — a figure likely to grow at a compound annual growth rate (CAGR) of 15%.

Evolving out of the traditional target-risk funds, target-date funds will morph into a best-in-class retirement product via two routes over time (Figure 1.2) — hybrid target-date funds and target-income funds.

**Hybrid** target-date funds will replace the traditional fixed income allocation in the glide-path with a pool of unallocated deferred annuities. Typically starting at 3% at the outset, the annuity income allocation will build up to 55% by the target date. The aim is to start targeting a retirement income benchmark in the accumulation phase, and adopt an appropriate glide path of asset allocation, as is done in DB plans.

**Target-income** funds will adopt an explicit retirement income benchmark — typically, the percentage of current income needed in retirement to maintain the current standard of living. Some funds will go even further and express retirement outcomes in terms of regular income, inflation protection, healthcare and bequests.

The “to” and “through” retirement phases will combine.

The new variants of target-date funds will shift the focus from asset maximization to liability matching, thus shedding the tyranny of market or peer benchmarks that cost investors dearly in the past.

Finally, plans are afoot to create exchange-traded funds (ETFs) based on lifestyle risk, with distinct tilts towards healthcare, life sciences, fuel, transportation and retirement communities. Thus, innovations are spilling over into the ETF space as well.

**Decumulation Phase**

In the decumulation phase, diversity will characterize the emerging line-up of new products. In fact, two sets of **generic retirement income funds** are already emerging alongside annuities.

The first set covers diversified-income funds that aim to deliver one or more of the following:

- **Regular income**
- **Inflation protection**
- **Low volatility**

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**FIGURE 1.2 The Evolution of Lifecycle Funds: 1990-2015**

*Source: Principal Global Investors / CREATE-Research Survey 2013*
Income funds will seek to minimize the “sequence of returns risk,” which diminishes the ability of retirees or near-retirees to catch up after big market losses such as those that were experienced throughout the global financial crisis.

The second set focuses on managed drawdown accounts. Some seek to pay a percent of principal to the retiree each year, ranging from 3% to 7%. Some seek to distribute principal over a pre-defined period, typically 10 to 30 years.

The emerging product line-up will prevail alongside fixed and variable annuities. For many retirees, annuities do not provide the flexibility to achieve other goals such as bequests and long-term healthcare.

Insurers already have a blended offering, mixing annuities with healthcare, life insurance and disability benefits to allay the fear of losing it all in the event of the premature death of the annuitant.

2. Nudge economics alone cannot deliver better outcomes

Key Challenges

The “set-it/forget-it” features of the autopilot version of the 401(k) plans create the context for the right behaviors, when faced with inertia and procrastination on the part of plan participants. But the necessary behavioral change needs to be reinforced and sustained throughout the retirement planning phase.

Key decisions are not single events like buying a house. New decisions are often forced by changes in job, family, health or market situations.

Retirement planning is a marathon, not a sprint.

There are four stakeholder groups in the retirement value chain. They have identified constraints that currently conspire against optimal outcomes.

Asset Managers

From asset managers’ standpoint, the four key participant-related constraints are:

- Low level of financial education consistent with long-term investing - 65%
- Low engagement of plan sponsors - 62%
- Inadequate deferral rate - 62%
- Herd instinct that makes participants act contrary to their best interests - 52%

The traditional model of 401(k) envisions the employee as a planner: a proactively engaged individual capable of accessing the right information and making informed decisions.

This ideal is at odds with reality. Plan participants often stick to their initial asset allocation, even when circumstances change. They over-rate their own ability, yet blindly rely on the wisdom of the crowd. Overall, they follow the path of least resistance, display strong inertia, dislike choice overload and find it hard to cut their losses.

Plan Participants

From plan participants’ standpoint, 63% are “very concerned” about their own long-term financial future, according to the first quarter 2013 Principal Financial Well-Being Index. Only 37% believe that they will be financially prepared for retirement.

More concerning is the fact that only a third of them agree with the statement that “my company is concerned about my long-term financial future.” This number has remained virtually static since 2004. Notably, the number has registered an improvement in the previous four years.

Currently, plan participants’ retirement narrative is one of high expectations and low preparation.

Financial Advisors

From financial advisors’ perspective, things are no better. They identified five constraints that conspire against retirement preparedness:

- Participants not saving enough - 74%
- Participants not starting to save early enough - 70%
- Participants living beyond their means - 69%
- Participants over-estimating their ability to plan ahead - 66%
- Participants putting off creating a financial plan - 62%

Plan Sponsors

They corroborate advisors’ assessment. Plan sponsors highlight five key constraints:

- Participants not giving high priority to retirement readiness - 68%
- Participants not receiving the necessary education and guidance - 66%
- Participants not offered “retirement readiness check-ups” - 63%
- Participants not offered advice about how to get back on track - 60%
- Plan sponsors putting more emphasis on input rather than outcome measures when assessing the success of their plan - 58%

Only 4% of sponsors use income replacement ratio or income projections as the metric to track retirement readiness. Thus, design features have mattered more than outcomes.
EXECUTIVE SUMMARY continued

3. Enhancing retirement preparedness requires like-minded thinking from all stakeholders

Key Imperatives
Since the 2008 crisis, the media headlines have graphically exposed the deteriorating funding levels in defined benefits (DB) plans. Defined contribution (DC) plans, in contrast, have remained the silent victim.

Going forward, the answer may be the creation of a system that provides participants with the benefits of the DB system without burdening the sponsor with risks — for example, investment, inflation, interest rate and longevity — that have undermined DB plans in the past.

It requires a 360 degree approach that extends beyond decent products and viable autopilot architectures.

The approach calls for two sets of solutions: one product-based and one guidance-based (Figure 1.3).

Product-Based Solutions

ASSET MANAGERS
They need to: understand the needs and risk tolerances of their end-clients; develop investment capabilities that can capitalize on the current debt dynamics in the West; promote innovation and create products that are fit-for-purpose; work closely with financial advisors in matters of asset allocation and risk management; and promote greater alignment interests as part of a win-win solution.

Above all, they need to be proactive with respect to innovation, seeking better ways of investing in preparation for the new wall of money that’s coming into lifecycle funds.

Guidance-Based Solutions
These involve the remaining three stakeholders.

PLAN PARTICIPANTS
They constantly need to: push for autopilot features; develop personal retirement plans with the help of their advisors; and adopt a deferral rate of around 17% or one that can deliver the targeted nest egg, minimize plan leakages (such as loans, hardship withdrawals and early distributions) and above all engage in educational activities. Such activities are vital in understanding retirement issues, making the best calls at key decision points in the retirement journey, developing a big picture understanding of financial planning over a longer horizon, and promoting a restless curiosity for better ways of managing personal finances.

In the industrial age, it was hard to get by without basic literacy: the ability to read and write. In this age of personal responsibility, it is just as hard to get by without financial literacy: the ability to plan and prioritize.

FINANCIAL ADVISORS
Financial advisors’ top priority must be to help plan participants craft a retirement strategy that: sets goals; does gap analysis; provides tips on how to save more; provides basic education on investing and its inherent risks; copes with unexpected contingencies like job loss, illness, family crisis or early retirement; and above all performs regular reality checks.

Overall, the advisors’ task is to help their clients visualize their retirement dreams and keep them on track towards achieving them.

PLAN SPONSORS
Plan sponsors need to take action to improve not only the plan design, but also its eventual deliverables.

On the design side, they need to adopt the so-called “90-10-90” strategy: a minimum plan enrollment of 90% via auto-enrollment, a minimum of 10% deferral rate via auto-escalation, and a minimum 90% of participants invested in QDIA, like target-date funds.

On the outcomes side, plan sponsors need to “stretch” their matching contributions, re-orient investment educational offerings, re-orient communication about getting “back-on-track,” initiate annual retirement readiness check-ups, offer advisory support to near-retirees, and ensure that plan accounts are portable in order to avoid undue leakages due to job changes.

It may be time for sponsors to promise less and do more to keep the promises they make.

Thus, the 360 degree approach requires purposive collaboration from all four stakeholders if the United States is to move the needle on retirement preparedness.

No longer can the nation rely on palliatives to what is now a major social problem.

The 401(k) system needs a big makeover before American workers feel that they can dream again about their golden years.
In 2012, the difference between what people saved for retirement and what they should have saved was $6.6 trillion.

- An Interview Quote

Source: Principal Global Investors / CREATE-Research Survey 2013
2 | PRODUCT-BASED SOLUTIONS

Retirement planning is a long stretch. - AN INTERVIEW QUOTE

WHICH INNOVATIONS WILL BE IMPROVING THE PRODUCT LINE UP?

OVERVIEW

Before the 2006 Act, the 401(k) participant-directed pension plans in the United States relied on voluntary “opt-in” architecture. Employees were responsible for making the key decisions about enrollment, deferral rate, deferral increases and investment choices.

This was premised on the belief that employees would adopt the right behaviors in each of these areas, once they had been given appropriate education and guidance. In hindsight, however, outcomes fell well short of expectations.

Hence, the 2006 Act gave birth to an autopilot version of 401(k) with an “opt-out” construct. Specifically, it created a context within which plan participants would adopt appropriate behaviors at the outset via various default options. This has resulted in major improvements, in plan design as well as the investment products that underpin it.
Against that background, this section explores three issues:

• Which innovations are being promoted by the autopilot version in the accumulation phase of retirement planning under 401(k)?

• How will these innovations affect the investment choices of plan participants in the accumulation phase?

• As a result, what product features will become critical in the decumulation phase?

These questions were pursued in the 2013 global edition of the CREATE-Research survey and resulting report entitled Investing in a Debt-Fuelled World. The report is part of the annual research series started by Principal Global Investors and CREATE-Research in 2009.

Key Findings

Innovations in the Accumulation Phase
So far, the autopilot version has delivered concrete benefits. Plan participation rates are up, as is the use of default options.

As a result, a number of new features are likely to be embraced by lifecycle funds during the accumulation phase.

These include a clear retirement income benchmark for participants at the outset, dynamic asset allocation, broad diversification and embedded advice. In particular, target-date funds are expected to morph into target-income funds over time.

As a result the “to” and “through” retirement phases will blend, potentially creating a better framework for managing four key risks: investment, inflation, interest rate and longevity.

Investment Choices of Plan Participants
Given the volatile nature of today’s markets, plan participants are likely to distinguish between medium-term asset allocation based on buy-and-hold investing and short-term opportunism based on temporary buying opportunities arising from periodic market dislocations.

Investment choices for asset allocation will include balanced funds, traditional cap-weighted indexed funds, target-date funds, actively managed equities and bonds, and target-income funds.

The ones likely to be chosen for opportunism include ETFs and actively managed equities and bonds.

Legacy assets, previously tied into active equities and bonds, will migrate over time to balanced funds, target-date funds and target-income funds. In the process, they will use active funds as well as passive funds covering traditional indexed funds and ETFs.

Product Diversity in the Decumulation Phase
Long dominated by annuities, the decumulation phase will witness a growing interest in other products as well.

Chief among them will be funds with one or more of the following features: high income, inflation protection, regular drawdown, capital protection and low volatility.

The growing trend towards lump sum distribution, as evidenced in DB plans, may likely spread to the DC space as well, driven by three imperatives: cost of annuities, bequest aspirations and healthcare needs.

Auto Features Alone Cannot Deliver Better Outcomes
Under 401(k), risk is being personalized. The re-engineering of DC products via autopilot is an important step. It puts plan participants on the right path at the outset, for sure.

However, they still have to make important decisions as they progress on the journey.

Improving retirement preparedness requires a 360 degree approach that goes well beyond creating better product solutions — as discussed in the Executive Summary.

Creating the right products is necessary but not sufficient.

- An Interview Quote
Nudge economics will transform DC products for the better

Participant-directed DC plans have become the cornerstone of the private sector retirement system in the United States.

The accelerated closure of DB plans since the 2008 financial crisis has provided powerful tailwinds.

But before then, the 2006 Act had created an autopilot version of 401(k) via three key innovations in plan design:

- Automatic enrollment of all eligible employees
- Automatic rises in deferral rates over time
- A selection of default investment choices

While plan participants retain the right to opt out of this arrangement, it is rare due to nudge economics implicit in the autopilot. Specifically, it makes a virtue of members’ two well-known behavioral traits, inertia and procrastination, both of which have historically ensured low enrollment rates and poor investment choices.

By also giving a safe harbor to lifecycle funds via QDIA, the 2006 Act promoted a “whole-of-life” approach to retirement planning.

According to the Employee Benefit Research Institute, employers offering a 401(k) plan have duly increased from 72% in 2007 to 82% in 2012. Additionally, 74% of sponsors have adopted QDIA.

Looking ahead, more than two of five respondents to the 2013 Principal Global Investors/CREATE-Research survey now expect new or better features to be embodied into lifecycle funds during the accumulation phase of retirement planning (Figure 2.1):

- A clear income benchmark during the retirement phase - 66%
- Dynamic asset allocation - 64%
- Broad diversification - 49%
- Embedded advice - 48%

As a result, the best features of DB plans will be emulated in the DC space over time.

**INTERVIEW QUOTES:**

“DC has gone from a supplemental savings plan to the primary retirement plan for the majority of Americans.”

“Plain vanilla DC products short-change investors. The target-date funds are a step in the right direction.”

“It is hard to imagine people retiring at 75, but it will happen.”

**FIGURE 2.1**

What features will become critical in the products used by participants in the accumulation phase of their DC plans?

Source: Principal Global Investors / CREATE-Research Survey 2013
Currently there are two types of lifecycle funds. The first of these are target-risk funds. They are customized to the participant’s risk profile — typically expressed as cautious, moderate and aggressive. The chosen profile is thus maintained over the accumulation phase.

The second form covers target-date funds. They have a glide path: a planned progression of asset allocation changes. The path starts out with an aggressive asset mix during a participant’s earlier years and gradually becomes more cautious on approach to retirement. Currently, these funds hold more than $500 billion, a figure that is expected to grow at a CAGR of around 15%. Indeed, under the weight of new money, target-date funds will increasingly morph into a retirement income product in two distinct forms.

One form will replace the traditional fixed income allocation with a pool of unallocated deferred annuities. Starting at 3% at the outset, the annuity income allocation will grow to around 55% by the target date. The second, and the more ambitious form, will see target-date funds adopt an explicit retirement income benchmark — typically the percentage of current income needed in retirement to maintain the current standard of living. This will shift emphasis from asset maximization to liability matching. It will also avoid peer benchmarks and express retirement outcomes in terms of income, inflation protection, healthcare and bequest motives.

Thus, accumulation products will be the main target of innovation over the rest of this decade. Under it, the “to” and “through” retirement phases will merge seamlessly.

### A VIEW FROM THE TOP...

The 401(k) participant-directed pension plans in the U.S. have long been based on an implicit model of the “employee as a planner,”: a proactively engaged individual capable of accessing the right information and making fully informed decisions about his/her financial future, with minimal help from the employer. Experience over the past 30 years, however, shows otherwise.

To start with, employees have been reluctant to pay for financial guidance, looking for “free” help from advisors who are often conflicted themselves. Furthermore, there is a low understanding of how much the participant will need in retirement, typically underestimating the impact of inflation, longevity and healthcare costs. Finally, there is also a tendency to invest in fads, without knowing their downside risks.

Our own research shows that, today, 58% of Americans have not figured out how much they need to save for retirement. 51% have not set aside a rainy day fund and 46% could not come up with $2,000 in 30 days, in case of emergency.

Only 30% of pre-retirees are fully prepared for retirement at age 65. Among the rest, another 30% feel confident about closing the savings gap by age 65. The remaining 40% are unlikely to achieve a reasonable standard of living when they retire.

Inadequate deferral rates are one factor. The other is the well documented behavioral biases that conspire against sensible investing. These include: anchoring effects that make members stick to their initial asset allocation decision even when circumstances change; over-confidence that makes the planner over-rate his/her own ability; and herd mentality that relies on the wisdom of the crowd.

As a result, in the eyes of many, DC pensions became connected with a bleak picture of poor investment choices, high charges and inadequate retirement savings. The 2006 Act has proved a watershed by exploiting inertia and procrastination.

By replacing the “opt-in” architecture with an “opt-out” construct, the new regime is turning the conventional planner model on its head. The planner is no longer solely in charge, since some of the key decisions are made on the basis of the advice embedded in the plan design. Likewise, the employer is no longer a bystander, since it has a fiduciary role in activities that go well beyond offering a worksite 401(k) plan.

On their part, asset managers are innovating around target-date funds. That is necessary but not sufficient because plan success also depends upon synergistic push-pull actions from plan participants and their sponsors. In particular, the success of investment default options critically depends upon the quality of worksite-based education, guidance and support.

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INTERVIEW QUOTES:

“Plan participants neither buy what they understand nor understand what they buy.”

“The advice-embedded feature of target-date funds is a major advance. It ensures that participants buy low and sell high.”

“Too much diversification is risky. There’s no need to carpet bomb every asset class in the glide path.”

— A LARGE 401(K) ASSET MANAGER
DC plan members will increasingly adopt new investment approaches while legacy assets are gradually unwound

Prior to the 2006 Act, 401(k) plan participants were left to their own devices when making investment choices. The majority tended to opt for top Morningstar funds — in initial investments and their periodic rebalancing. For example, many participants ended up overweight in tech stocks that crashed in the 2000-2002 bear market. In the subsequent recovery, the pursuit of the next rainbow was just as prevalent: the lessons of the technology debacle were soon forgotten. A minority went to the other extreme by being overweight in safe assets like bonds, insurance contracts and cash-plus products. By 2010, this pronounced diversity in investment behaviors delivered average plan balances of $60,000, according to the Investment Company Institute. Reform was overdue.

It received fresh impetus from the closures of DB plans in the face of two savage bear markets in a span of seven years in the last decade.

In hindsight, the 2006 Act proved a catalyst. By providing protection against potential liability to plan sponsors who default plan participants into a QDIA, the 2006 Act has ensured that the culture of chasing hot stocks will be a distant memory in the DC space before long.

Looking to the future, plan participants are likely to adopt a variety of approaches, according to our survey, duly distinguishing between medium-term asset allocation and short-term opportunism.

The approaches likely to be chosen for asset allocation include (Figure 2.2):
- Balanced funds - 68%
- Traditional cap-weighted indexed funds - 67%
- Target-date funds - 63%
- Actively managed equities and bonds - 55%
- Target-income funds - 46%

The ones likely to be chosen for opportunism include:
- ETFs - 41%
- Actively managed equities and bonds - 40%

Behind these numbers lie a new dynamic at work.

**INTERVIEW QUOTES:**

“In hindsight, we should have been using target-date funds when the DC plans took off in the 1990s.”

“Legacy funds will be gradually unwound as many of them have not met participants’ return expectations.”

“ETFs will gain traction in the DC space. Active ETFs may well offer distinct retirement offerings.”

**FIGURE 2.2**

Which asset classes and generic products are most likely to be chosen by DC plan participants for short-term opportunism and which ones are likely to be chosen for medium-term asset allocation over the next three years?

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**Source:** Principal Global Investors / CREATE-Research Survey 2013
There is a gradual migration of legacy assets, as they have not met plan participants’ return expectations. The migration is heading towards balanced funds and the two key components of lifecycle funds: target-date funds and target-income funds. In all these cases, some investors will use actively managed funds because that’s what they have always done. And some investors will use traditional indexed funds and ETFs — the former in buy-and-hold strategies, and the latter in opportunistic forays.

Indeed, familiarity with active funds will ensure that they will feature in both buy-and-hold investing as well as opportunistic investing.

The use of ETFs is nascent. Only 2.5% of DC assets in the U.S. is invested in them. More and more financial advisors are likely to channel assets into them such that the total ETF assets will top $9.5 trillion by 2020, from the current level of $1.7 trillion. As their registration process becomes less onerous, active ETFs in particular are likely to proliferate and drive this growth. Indeed, plans are afoot to create ETFs based on lifestyle risk, with distinct tilts towards healthcare, life sciences, fuel, and retirement communities backed by simple hedges.

Two other developments are in the works.

First, new participants’ choices will favor target-date and target-risk funds, in view of their safe harbor status. Indeed, these funds will also become popular among employees who are re-enrolled, after having opted out in the past.

Second, as legacy assets migrate towards balanced and lifecycle funds, the DC space will be characterized ever more by buy-and-hold investing, with a more even balance between active and passive funds.

**INTERVIEW QUOTES:**

“Lifecycle investing is overriding the long-entrenched feast and famine mentality among plan participants.”

“Target-date funds will morph into target-income funds for those who need them.”

“Lifecycle investing will jettison short-term returns in preference for long-term liability benchmarks.”

**A VIEW FROM THE TOP…**

For DC investors, there is an implicit disconnect in the brand of target-date funds. They are perceived as providing a path “to” retirement as well as “through” retirement. In reality, most investors cash out within three years after retiring, as these funds target an asset pot instead of a retirement income. It is like an airplane that takes off, crosses the ocean and finds that it has no landing gear as it get close to its destination. This is not to detract from their worth as an accumulation device. But we’ve discovered that they also lend themselves to innovation that enables them to incorporate a number of desirable features of a DB plan.

Our target-income fund does just that. It has a liability benchmark expressed in terms of two outcomes that are meant to last over the retirement phase: sufficient income to maintain our clients’ standard of living and inflation protection. Typically linked to the replacement ratio based on final year salary, the benchmark is also capable of accommodating healthcare needs and bequest aspirations.

It avoids a one-size-fits-all approach via a customized plan that integrates other known sources of retirement income like government benefits, DB plan entitlements, current plan balance and future contributions.

The underlying investment strategy has two goals: desired income and the minimization of risk in achieving it. The latter is secured by allocating a sufficient portion of a client’s assets (plus future contributions) to an index-linked fixed income portfolio that is as duration-matched as possible. The rest of the assets are managed to improve the estimated probability of achieving the desired income goals — with a dedicated sleeve for alpha. Once the estimated probability exceeds a predetermined level, assets are gradually shifted from equities to fixed income.

This liability-driven investment (LDI)-lite approach is one way in which the target-income approach seeks to mimic the best features of today’s DB plans. There are others, too. It aims to provide inflation protection. It manages the estimated risk of failure to achieve the targeted goals and takes pre-emptive actions. It does not require members to make investment choices, nor does it expect them to be engaged or possess a high degree of financial literacy. Above all, as with a car, it leaves complexity under the hood.

Our target-income fund has one over-riding merit. It aims to manage savings explicitly over a lifecycle rather than a defined period. All too often, the asset industry gets fixated on short-term or peer-based measures of performance without due regard to how today’s assets can be converted into tomorrow’s consumption.

— A U.S. ASSET MANAGER
Diversity will characterize the emerging line-up of products in the decumulation phase

Around 10,000 Americans join the ranks of retirees everyday. As more and more post-War baby boomers transition into their golden years, personal circumstances as much as market conditions will determine the key features of retirement products.

Long centered on annuities, the traditional one-size-fits-all approach has been giving way to diversity since the 2008 financial crisis.

More than a third of our respondents cited six features that will become critical to plan participants as they enter the decumulation phase (Figure 2.3): high income (cited by 55%); inflation protection (48%); a hybrid portfolio blending an annuity with a separate drawdown facility (48%); capital protection (41%); low volatility products (37%); and an annuity (35%).

This diversity, in turn, is indicative of a three-layered hierarchy implicit in retirees’ choices.

At the bottom of the pyramid are basic needs: food, shelter, clothing, fuel, transportation and healthcare. These rely on guaranteed sources of income such as social security, annuities and interest payments from bonds and cash products.

At the middle of the pyramid are wants: vacations, hobbies, eating out — consistent with a comfortable living standard.

Generally, this layer favors a hybrid portfolio that combines an annuity with a drawdown facility based on high income equities and bonds.

At the top of the pyramid is legacy: bequests for family, friends and charities. This layer favors high income assets with longer time horizons.

Our post-survey interviews showed that plan balances are a major factor in the operation of this hierarchy. The lower the balances, the greater the emphasis on basic needs and inflation protection. The higher the balances, the greater the emphasis on legacy needs and illiquid assets.

The interviews also showed that, apart from personal circumstances, retirees’ investment choices are likely to be influenced by conditions in the financial markets. Interest rates are expected to remain low for the foreseeable future. This will render annuities less attractive. It will also intensify the search for high yield via managed drawdown accounts that now come in two forms.

**INTERVIEW QUOTES:**

“Needs must always come before wants. That’s the mantra of retirement planning.”

“Over the past 120 years, life expectancy has gone up by one year every four years. Retirement is a costly game.”

“Size of plan balances will have a big influence on the choice of the drawdown products.”

**FIGURE 2.3**

What features will become critical in the products used by members in the decumulation phase of their DC plans?

Source: Principal Global Investors / CREATE-Research Survey 2013
One form pays a percent of principal to the retiree each year, ranging from 3% to 7%. The higher the percent, the greater the risk in the underlying portfolio. The second form of drawdown account aims to rundown principal over a pre-defined period — typically 10 to 30 years. While both forms enable a retiree to turn residual savings as bequests, neither provides any guarantees.

To partly compensate for that, the current innovation effort is centered on products that deliver regular income, inflation protection and low volatility within a single package. It is underpinned by a broad basket of assets such as high-yield bonds, global value securities, global real estate securities, preferred securities, emerging market debt, commercial mortgage-backed debt and infrastructure. Some use call-option programs to reduce the volatility of the underlying equity investments.

In the process, they also seek to minimize the “sequence of returns risk” arising from volatility. For retirees or near-retirees, market losses can greatly diminish the ability to catch-up during subsequent years, thereby increasing the longevity risk: retirees outliving their savings.

Thus, retirement products will morph for the better.

**INTERVIEW QUOTES:**

“People would rather have an apple today than wait for two tomorrow.”

“In the decumulation phase, one size does not fit all.”

“The decision to annuitize rests on a host of personal factors that go beyond the need to have a regular income.”

**A VIEW FROM THE TOP...**

America’s population is aging, as elsewhere in the West. Hence, plan participants have to factor in morbidity, longevity, inflation and market volatility in their investment choices during the accumulation phase of retirement planning.

That’s a tough call. How can we persuade our 401(k) participants to set aside scarce cash for some distant age that they may or many not reach, for pay-offs that may or may not materialize, at a price that may or may not deliver value?

Annuities make a lot of sense. That’s what made DB plans so attractive: members didn’t have to worry about a thing. Until recently, people seeking guaranteed retirement income had to wait until retirement to buy single premium annuities. In the last five years, we have seen the arrival of deferred fixed income annuities that lock into a stream of guaranteed income years before retirement. Both are good devices for people who worry about out-living their retirement savings.

Yet annuitization is no longer the first choice and lump-sum distributions (LSD) are on the increase. For example, data from the Employee Benefit Research Institute shows that, in 2010, of DB plan members who had a choice between annuitization and LSD, only 44% choose to annuitize. The members who chose cash balance plans was even lower, at 22%. Lately, members opting for LSD has increased to 75% in many DB plans. This shift reflects a desire on the part of plan members to balance the longevity risk with investment risk.

It may be that members are poorly informed regarding their remaining life expectancies. But there are some rational forces at work, too.

Some retirees have strong bequest aspirations: they worry about potential losses to heirs in the event that they die early, since annuitization eliminates the possibility of a refund on unused expected benefits.

Some retirees worry about having to pay for long-term healthcare: a longer life does not mean a healthier life.

Some retirees worry about locking their savings into current low yields as an irreversible decision.

Some retirees see charges on annuities being too high compared to the indexed funds due to loads levied by some providers.

Some retirees see LSD as especially attractive as regulations permit them to take a relatively large sum computed on the basis of a low discount rate that currently prevails.

Some insurers now have a blended offering: mixing annuity with healthcare, life insurance and disability benefits to allay the fear of losing it all in the event of premature death.

That does not detract from an important fact: the decumulation market will be characterized by diversity: income-oriented products will co-exist with annuities. Investment products in the accumulation phase will roll over seamlessly into drawdown devices in the distribution phase.”

— A SPONSOR OF DB AND 401(K) PLANS
3 | GUIDANCE-BASED SOLUTIONS

“People will have to spend less, save more, save early and work longer.”
- AN INTERVIEW QUOTE

WHAT DO THE VARIOUS STAKEHOLDERS NEED TO DO?

OVERVIEW
Section 2 argued for a 360 degree approach that is highly conducive to enhancing employees’ retirement preparedness in the U.S. in this decade.

This section extends the analysis to cover the respective roles of four stakeholder groups in the retirement value chain:

- Asset managers
- Plan participants
- Plan sponsors
- Financial advisors

After all, it is one thing to provide a worksite retirement plan. It is quite another to ensure that employees make the right calls at critical junctures in their retirement planning.
Specifically, it requires employees to have four sets of capabilities:

- **Know-what**: formal cognitive knowledge derived from education, training and guidance on retirement issues
- **Know-how**: skills that apply this knowledge when faced with decisions at different milestones as the plan progresses
- **Know-why**: trained intuition to deal with more complex decisions
- **Care-why**: self-motivated curiosity for knowledge renewal as and when new issues arise

Thus, while the autopilot features set the context for the right behaviors at the outset, these capabilities are essential for ensuring that such behaviors are sustained throughout the retirement planning journey.

**ISSUES**

Accordingly, this section addresses four issues:

- With better retirement products, what remaining impediments do asset managers perceive?
- With the personalization of risks, what do plan participants need to do to equip themselves with capabilities conducive to good eventual retirement outcomes?
- With the importance of planning, how can financial advisors help plan participants craft a retirement strategy and perform regular reality checks?
- Being the primary source of information on retirement planning, how can employers up the ante?

**Key Findings**

**Asset Managers’ Views**

Asset managers have identified a number of constraints that work against a continuous improvement in retirement preparedness of plan participants.

Chief among them are: low level of financial education on the part of plan participants, inadequate deferral rates, low engagement of plan sponsors and low awareness of client needs on the part of asset managers themselves.

**Plan Participants’ Views**

These views have emerged from the Principal Financial Well-Being Index™, a quarterly survey of American workers since 2000.

It reveals that around 70% of workers are very worried about their long-term financial future. They also do not think that their company is concerned about their long-term financial future.

Best practices suggest that plan participants need to engage in a push-pull strategy, involving their sponsors as well.

Specifically, participants need to push for autopilot features and the associated educational support. In addition, they need to develop a retirement plan, adopt a deferral rate that can deliver the targeted savings pot, and minimize plan leakages.

On their part, sponsors need to pull the participants onto the retirement journey at the earliest opportune moment.

**Financial Advisors’ Views**

Financial advisors report that participants are not saving enough, not starting retirement savings early enough, living beyond their means and over-estimating their ability to plan ahead.

Hence, advisors’ key task is to help plan participants craft a retirement strategy backed by regular reality checks, with deeper engagement during contingencies like job losses, illness, family crisis and early retirement.

**Plan Sponsors’ Views**

Plan sponsors report that participants are not giving high priority to retirement preparedness, not receiving the necessary education and guidance, not being offered “retirement readiness check-ups,” and not being given advice on how to get back on track.

Accordingly, sponsors need to take action to improve not only the plan design but also its eventual outcomes. On the design side, they need to adopt the so-called “90-10-90” strategy.

On the outcomes side, sponsors need to stretch their matching contributions, re-orient educational offerings, turn the spotlight on how to get “back on track” in their regular communication, establish an annual retirement readiness check-up, offer special advisory support to near-retirees and ensure that plan accounts are portable.

In sum, complementing what asset managers do, the actions proposed here for the other three stakeholders are an essential part of a 360 degree program to enhance retirement readiness in America.

*The best metric of plan success is the projected retirement income replacement ratio not the enrollment rate* - AN INTERVIEW QUOTE
Nudge economics alone can’t deliver better outcomes

In the West, governments are looking to reduce the cost of long-term retirement benefits. Employers, too, are de-risking their balance sheets by shedding volatile liabilities related to final-salary pension plans. Insurance companies are pulling out of the annuity markets as low rates have hit their balance sheets. Risk is being personalized. Individuals are obliged to bear the brunt of four key risks in retirement planning: investment, inflation, interest rate and longevity.

Everywhere, risk is being transferred from those who were unable to manage it to those who are ill-equipped to bear it. So, in the United States, re-engineering the DC products via autopilots is a step in the right direction. It sets participants on the right path.

Its “set-it/forget-it” features create the context for right behaviors, when faced with inertia and procrastination.

But the necessary behavioral change needs to be reinforced and sustained. Participants have to make new decisions as they progress on the journey.

Retirement decisions are not single events like buying a house. New decisions may be forced by change of job, change of personal circumstances or change of market conditions.

In this age of rampant consumerism, it is easy for participants to get side-tracked and ignore the challenges that lie over the distant horizon.

When asked to identify the constraints that would prevent asset managers from meeting the needs of plan participants in the accumulation and decumulation phases, our respondents identified two sets of factors: participant-related and asset manager-related (upper and lower panels in Figure 3.1).

**INTERVIEW QUOTES:**

“The elephant in the room is the insanely low deferral rates of participants. The going rate of 3% is woefully inadequate.”

“Day-to-day pressures for an average worker leave little bandwidth to think about the future.”

“50% of plan participants don’t know what 50% means.”

**FIGURE 3.1**

What factors constrain asset managers from meeting the needs of their end-clients?

- **PARTICIPANT-RELATED CONSTRAINTS**
  - Low level of long-term investing education
  - Low engagement of plan sponsors
  - Inadequate deferral levels
  - Herd instinct leading to ‘wrong time’ risk
  - Overly cautious/aggressive investment choices
  - Overly influenced by the 24-hour news cycle
  - Periodic borrowing from plan balances
  - Overly influenced by friends and relatives

- **MANAGER-RELATED CONSTRAINTS**
  - Low awareness of client needs disintermediation by fund advisors/wholesale fund buyers
  - High costs of solutions-based products that do not scale easily
  - Lack of scale and multi-asset class capabilities
  - Lack of asset allocation capabilities
  - Lack of track record on solutions-based products
  - Lack of flexibility in accumulation/decumulation products
  - Lack of specialist capabilities in component strategies

*Source: Principal Global Investors / CREATE-Research Survey 2013*
More than half the respondents cited four constraints: low level of financial education consistent with long-term investing (65%), low engagement of plan sponsors (62%), inadequate deferral rates (62%) and herd instincts that make participants act contrary to their best interests (52%).

Turning to manager-related constraints, two were cited by more than half the respondents: low awareness of participant needs due to disintermediation by fund advisors and wholesalers (65%) and high costs of customized products that do not scale (52%).

Three areas were identified where further progress is vital. The first is financial education. Life expectancy in America has increased by around 30 years in the last century. Today's Generation Y will spend as many years in retirement as in employment if the official retirement age remains at 65. With the median job tenure of five years, they will also have around eight job changes. Without financial education, personalization of risk faces an Everest of a task.

The second area is low deferral rates. A staggering 74% of 401(k) plans with auto-enrollment default their participants to 3% or less; only 26% set the rate at 4% or above, according to the Profit Sharing Council of America. It also shows that only 16% of plans have auto-escalation as well as auto-enrollment.

The third area is sponsor engagement in participant education and autopilot activities. Sponsors have stepped up to the plate since the 2006 Act, but they have a long way to go to raise the retirement preparedness of plan participants.

**INTERVIEW QUOTES:**

“Nudge economics has its limits. People have to be prepared to make decisions at various milestones in retirement planning.”

“Auto features and advice are two sides of the same coin: one defines the other.”

“Participants need to take ownership of retirement planning in much the same way as their career planning.”

**A VIEW FROM THE TOP…**

Since the 2008 financial crisis, the media headlines have concentrated on the worsening funding levels in DB plans. DC plans, in contrast, have remained the silent victims. While DC plan sponsors have been spared huge financial pain, their members have seen their plan balances take a big knock.

While the concept of employer-sponsored retirement benefits is a sound one, it was never intended to turn into something that can cripple the sponsoring businesses or undermine their long-term viability. Hence, the switch from DB to DC plans means that it is time for companies to promise less.

The answer is in creating a system that provides the individual with some of the benefits of the DB system without burdening the sponsor with risks that have undermined the DB plans. It's time for a new implicit contract that sets out clearly what a successful DC plan looks like and what its delivery requires from the participant, the sponsor and service providers like asset managers and financial advisors.

While DB plans have suffered from over-promising, DC plans have suffered from low participation, low contribution, poor investment choices and ill-defined retirement goals. There is a need to redefine the goals and rethink their delivery mechanisms.

In the beginning, DC plans were meant to be supplemental savings vehicles. As they became mainstream, their name changed to “participant-directed retirement plans.” The idea was to drive a behavioral change on the part of the individual by putting him/her in the driver's seat. No wonder only about 40% of working Americans put money into workplace plans.

The Pension Protection 2006 Act has the potential to drive that much needed change. Its provisions on auto-enrollment and auto-escalation are constructive, as is the Department of Labor's subsequent ruling that treated target-date funds as Qualified Default Investment Alternatives.

These changes do not mean that the new DC has to be more expensive than a first generation DC. But they do enjoin plan sponsors to retain responsibility in four critical areas: enrollment, deferral rate, investment choices and financial education.

As such, the new implicit contract is about ensuring that plan participants adopt the right behaviors at the outset within a new context created by the auto features — even before they embark on financial education. Education can then play a reinforcing role in explaining the defaults and future milestones that merit new decisions. This is in marked contrast to the traditional practice that relied on education to drive the right behavioral change at the outset.

Education remains essential, of course. But plan members have to be guided to the right path to start with, via a context that enshrines best practices. Education can then help navigate different milestones on the retirement journey. Without greater sponsor engagement, the pension community will miss the lifeline thrown by the 2006 Act.

— A GLOBAL PENSION CONSULTANCY
As we saw in Figure 1.1 in the Executive Summary, at least three of five 401(k) plan members have remained worried about their financial future according to the Principal Financial Well-Being Index℠.

Tracking the views of workers at small- to medium-sized U.S. businesses on a quarterly basis, the survey also highlights their concerns about retirement preparedness. For example, data from the first quarter 2013 survey shows that:

- Only 37% believe that they will be financially prepared for retirement
- One in five employees (21%) say it is either very difficult or extremely difficult to plan and save for their retirement

On the upside, the survey respondents harbor positive attitudes towards retirement plans, as reported in the fourth quarter 2012 Principal Financial Well-Being Index℠:

- 68% indicate that a DC plan is very important to them
- 69% report that a good benefits plan encourages them to work harder and perform better

But behind the less-positive numbers lies the bigger worry: only a third of respondents agree with the statement that “my company is concerned about my long-term financial future.”

Doubtless, this is the legacy of the pre-2006 arrangement, under which the sponsors’ main responsibility was to provide administrative and educational support, leaving members to make the key decisions on enrollment, deferral rates and investment choices. Since the 2006 Act, perceptions of whether “my company is concerned about my long-term financial future” have improved somewhat but they have yet to exceed the previous high of 33% recorded by the Principal Financial Well-Being Index℠ in 2004.

It is unrealistic to lay the responsibility for this seemingly low level squarely on the shoulders of sponsors. If there is one lesson to be learned from the examples of best practices in the United States and elsewhere, it is that retirement preparedness involves a push-pull synergy.

Plan members need to proactively push for auto features and the educational support associated with the key decisions at every milestone on the retirement journey. On their part, sponsors need to proactively pull the members into the journey at the earliest possible moment by stimulating interest in retirement issues.

**FIGURE 3.2**

Percentage of workers agreeing with the statement “My company is concerned about my long-term financial future.”

![Chart showing percentage of workers agreeing with the statement over time]

Source: Principal Financial Well-Being Index℠
For plan participants, being proactive means they must first develop a retirement plan outline that factors in likely living expenses, healthcare needs, government benefits and bequest aspirations. Then they should determine the size of the asset pot required to meet these outlays. Next, they should link the deferral rates to the target nest egg and ensure that it is at least 17% of annual salary, as widely recommended by industry experts, including employer match if available. Participants should participate in education about the basics of retirement investing and seek advice when making big decisions at every milestone on the retirement journey, being mindful of minimizing leakages from the account in the form of loans, hardship withdrawals and early distributions.

The story of retirement preparedness in the DC space is one of high expectations and low preparations. The bulging baby boomer generation is on the cusp of retirement. Yet the majority of them only start planning when they get close to the retirement date. Not only do they begin late, some also aspire to retire when they are either 60 or 65, despite rising life expectancy.

With the shift from DB to DC plans, risk has been personalized — with the responsibility falling to retirees. Paradoxically, it has been passed from those who could not manage it, despite access to the best expertise, to those who do not understand it, with minimal access to expertise.

This shift can only work under a viable 360 degree approach that involves four groups of stakeholders: plan participants, plan sponsors, financial advisers and asset managers. The approach recognizes that retirement planning is about catering for an unknown future. Each stakeholder needs to be effective in its own area.

For plan members, the new autopilots are a major step forward. They make the member’s world easier. Being part of the plan design, they ensure that a “do-nothing option” at the outset is itself financially savvy.

However, this does not absolve responsibility on the part of participants, if we are serious about personalization of risk. These auto features put plan participants on the right path. They do not have to understand technical investment stuff. But participants still have to make decisions periodically on matters around plan balances, investment performance, retirement date and retirement income — duly taking into account their family and health circumstances. Only participants know what their long-term needs are likely to be. One size will never fit all. Hence, they need to do two complementary things.

INTERVIEW QUOTES:

“Congress will never mandate U.S. citizens to save for retirement.”

“A whole raft of DIY tools on retirement planning is now available.”

“Financial literacy is about acquiring the right information and knowing how to use it when making big decisions.”

A VIEW FROM THE TOP...

The story of retirement preparedness in the DC space is one of high expectations and low preparations. The bulging baby boomer generation is on the cusp of retirement. Yet the majority of them only start planning when they get close to the retirement date. Not only do they begin late, some also aspire to retire when they are either 60 or 65, despite rising life expectancy.

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First, they need to outline a retirement strategy that sketches out long-term goals reflecting living expenses, healthcare needs, long-term care, government benefits and other entitlements. Only 14% of individuals nearing retirement actually have created a plan for how they will convert their retirement savings into an income stream. There are numerous personalized do-it-yourself (DIY) tools available that can generate numbers that are indicative, not definitive. But they are good enough to suggest the approximate amount that a participant must put aside for retirement needs. Some tools also allow participants to construct a “pension forecast.” If the retirement outlook appears cloudy, they are told what to do.

Second, members must engage in financial education that enables them to ask the right questions, seek appropriate advice, have an informed discussion and then make decisions in the light of the regular forecasts. Education needs to focus on simple concepts such as household budgets, compound interest, dollar-cost-averaging, risk-return trade-offs, asset diversification, market cycles and time preference rate — to mention a few. Education also needs to simplify various key risks, why they arise and how to deal with them. They include market risk, stock-specific risk, wrong time risk, regret risk, sequence of returns risk and longevity risk. Overall, education has to get across the idea that the promise of pleasure tomorrow means some pain today: there is no gain without pain.

In the industrial age, it was hard to get by without basic literacy — the ability to read and write. Likewise, in this age of personal responsibility, it is hard to get by without financial literacy.

– A GLOBAL ASSET MANAGER
Plan sponsors are far more satisfied with the “input” aspects of retirement planning than the “outcome” aspects

When asked to identify the factors that are currently constraining plan participants from enhancing their retirement preparedness, a host of factors were singled out by two groups closest to them (Figure 3.3): financial advisors and plan sponsors.

The five top constraints identified by financial advisors are:
- Participants not saving enough - 74%
- Not starting savings early enough - 70%
- Living beyond their means - 69%
- Over-estimating their ability to plan ahead - 66%
- Putting off having a financial plan - 62%

As to how much plan participants should save, financial advisors recommend 17%. Although higher than the current average across the United States, the level falls short of the 23% average for defined benefit plans, according to DB sponsors in our research.

For advisors, therefore, the most important task is to help plan participants create a retirement strategy that includes goal setting, a gap analysis, tips on how to save more, education on investing and its inherent risks, and planning for contingencies like job loss, illness, family crisis or early retirement.

The immediate purpose is to raise awareness about retirement planning and provide tools in implementing it. The basic premise is to build a savings culture in which plan members are financially savvy, have the tools to meet their goals, and develop the will to live within their means while saving for rainy days and retirement.

The top five constraints identified by plan sponsors are (Figure 3.3, lower panel):
- Participants not giving retirement preparedness a high priority - 68%
- Inadequate education, guidance and support at the workplace - 66%
- Lack of “retirement readiness check-ups” at the workplace - 63%
- Lack of advice on how to get back on track - 60%
- Sponsors putting more emphasis on input rather than outcome measures of plan success - 58%

An over-emphasis on plan design is the product of history: until the 2006 Act, plan sponsors steered away from issues that impacted outcomes for fear of litigation.

**INTERVIEW QUOTES:**

“The participation rate is important. But it is a gateway, not a path, to savings accumulation.”

“Plan participants need a clear line of sight between contributions and outcomes.”

“The risk of litigation in the event of anything going wrong is always lurking in the background.”

**FIGURE 3.3**
What factors are currently constraining plan participants from enhancing their retirement preparedness?

*Source: Principal Global Investors / CREATE-Research Survey 2013*
But the winds of change are evident. A growing proportion of sponsors now believe that more education should be available, duly highlighting the role of plan providers such as financial advisors and asset managers.

Sponsors also accept that they need to put as much emphasis on outcomes as on inputs.

On the input side, they need to adopt the so-called “90-10-90” strategy: a minimum plan participation rate of 90% via auto-enrollment; a minimum 10% deferral rate via auto-escalation; and a minimum 90% of participants invested in qualified default investment alternatives, such as target-date or target-income funds. The aim is two-fold: to achieve capital growth in the accumulation phase while targeting a retirement benchmark for the decumulation phase.

On the outcome side, sponsors need to “stretch” their matching contribution at no extra cost to them. This incents the employee to contribute more for every dollar of sponsor contribution within a set formula. In addition, sponsors need to: first, reassess their educational offerings to ensure it meets the needs of all employees, especially those who find the retirement math and its concepts difficult to grasp; second, reposition communication with messaging about the importance of getting “back on track” in pursuit of their retirement goals; third, establish an annual 401(k) retirement readiness check-up at the same time of year as healthcare enrollment; fourth, offer pre-retirees extra support in planning their transition into retirement; fifth, ensure that plan accounts are portable so they can accompany members when they change jobs to prevent cashing out or premature withdrawals; and finally, deliver information and education via social media, mobile apps and mobile websites.

Indeed, such actions are already part of best practices among large 401(k) sponsors across the United States. They have done a lot to improve the retirement preparedness of their employees within a 360 degree framework. The challenge is to spread such practices to benefit all American workers.

INTERVIEW QUOTES:

“Our educational effort has been hampered by the natural resistance people show towards investing for an uncertain future.”

“Employers are participants’ single most important source of information about retirement planning.”

“It may be time for companies to promise less but at the same time do more to meet the promises they make.”

--- A GLOBAL ASSET MANAGER

A VIEW FROM THE TOP...

Around 40% of working Americans put money into a workplace plan. And their deferral rate averages at 6%, which falls short of the 17% consistent with a decent pension. This is the legacy of the “employee as a planner” model that long prevailed in the DC space.

Hitherto, the education model that has underpinned these numbers typically had limited aims: promote the concept of retirement savings, highlight the enrollment process and minimize the fiduciary liability of the sponsors. Participants were also told that enrollment was optional as was the deferral escalator. Investment advice was minimal and emphasized the importance of capital conservation, irrespective of members’ age and risk appetite. Everything seemed one-size-fits-all. The key metric of plan success, from a plan sponsor standpoint, was the enrollment rate.

The 2006 Act has changed all that. Now the best metric of success is the projected retirement income replacement ratio. The aim is to replace 85% of the pre-retirement income when an employee stops working. Only 4% of sponsors have so far adopted this metric to track retirement readiness. More will follow suit.

In the past, DC communication concentrated on contributions made, returns achieved and capital accumulated. The next step is to communicate data on potential retirement income and any shortfalls – duly taking into account government pension and other sources of income. Communication, thus, has to be an “on-track” report, duly flagging potential shortfalls. Finally, it needs to factor in flexible working options past the retirement age.

On the education side, they need basic understanding of how their default or chosen investment options work, what risks are embedded into their portfolios, the virtues of buy-and-hold investing, the perils of panic buying and panic selling, the futility of chasing the next rainbow created by regular fund ratings, and the awesome power of compound interest rates and dollar-cost-averaging. The aim of such an educational effort is not to produce investment experts. Rather, it is to promote a basic understanding of what their portfolio aims to do and cognitive capabilities to ask intelligent questions, seek advice and make decisions.

Employers can play a key role in their employees’ retirement planning process. Large employers already do this as a part of their fiduciary duties and huge buying power. The challenge for corporate America is to spread these best practices to small and medium-sized enterprises who have felt constrained in the past due to litigation worries. The safe harbor provision of the 2006 Act is a great help. But, for many sponsors, the risk of litigation in the event of anything going wrong is always lurking in the background.

--- A GLOBAL ASSET MANAGER
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Target date portfolios are managed toward a particular target date, or the approximate date the investor is expected to start withdrawing money from the portfolio. As each target date portfolio approaches its target date, the investment mix becomes more conservative by increasing exposure to generally more conservative investments and reducing exposure to typically more aggressive investments. Neither the principal nor the underlying assets of target date portfolios are guaranteed at any time, including the target date. Investment risk remains at all times. Neither asset allocation nor diversification can assure a profit or protect against a loss in down markets. Be sure to see the relevant prospectus or offering document for full discussion of a target date investment option including determination of when the portfolio achieves its most conservative allocation.

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