QDIA

What's New

Design trends in Qualified Default Investment Alternatives

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The passage of the Pension Protection Act (PPA) of 2006 led to the creation of the qualified default investment alternatives (QDIA) and the expansion of 404(c) "safe harbor" protections for plan sponsors. QDIA's include target date funds, target risk funds, balanced accounts, managed accounts and grandfathered stable value funds.

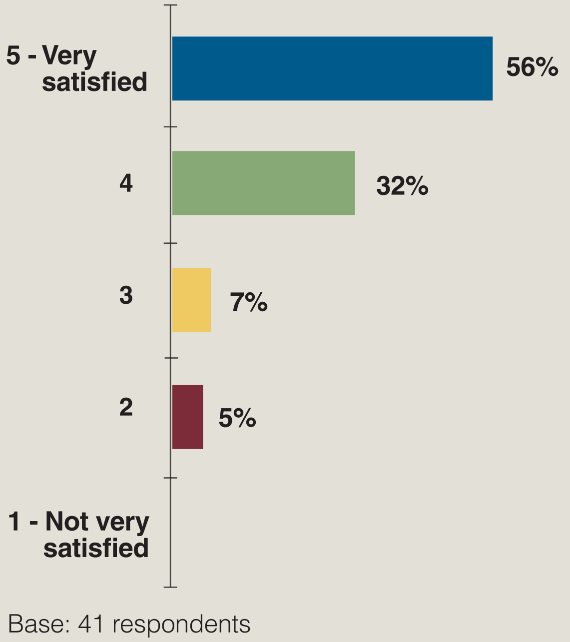
Many plan sponsors have taken meaningful steps to improve their organizations' retirement plans in the wake of the PPA. Yet the continuing onslaught of legislative and regulatory measures expected in 2012 suggest that it may be time to rethink their 401(k) plan design, educational programs and investment offerings. Roth 401(k) and conversion rules have increased participant choices, but they also complicated the educational programs offered by plan sponsors.

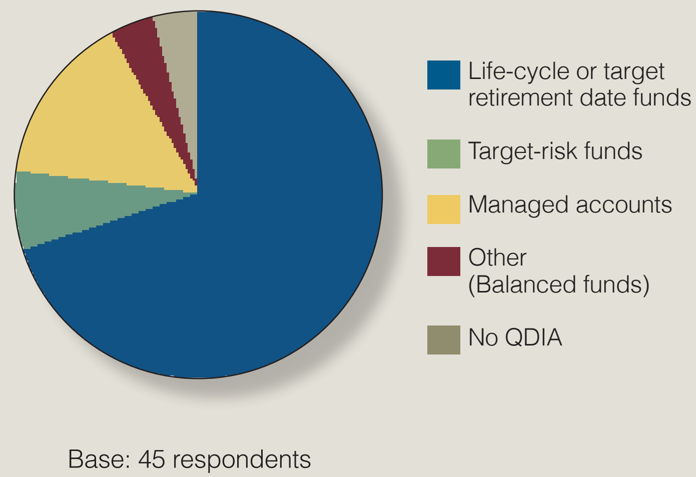
The rapid adoption of QDIAs by plan sponsors and lessons learned from the 2008 financial crisis have prompted many changes to these ever-evolving investment vehicles and strategies. Many investment managers have sought to add asset classes to their allocations in an effort to reduce correlation between assets and combat volatility.

Target date and risk funds

By far the most widely adopted QDIA by plan sponsors—target date funds—continue to attract the majority of plan assets. In recent years, the use of target date funds in 401(k) plans surged. They are most popular with new hires and younger participants according to the Profit Sharing/401(k) Council of America. Many plan sponsors have replaced balanced funds that have a fixed asset allocation and may not be suitable for all participants with target date funds whose asset allocations vary by age and change over time.

Most plan sponsors had relied solely on their record keeper's proprietary target date fund recommendation without clearly understanding the extent to which the underlying funds and asset



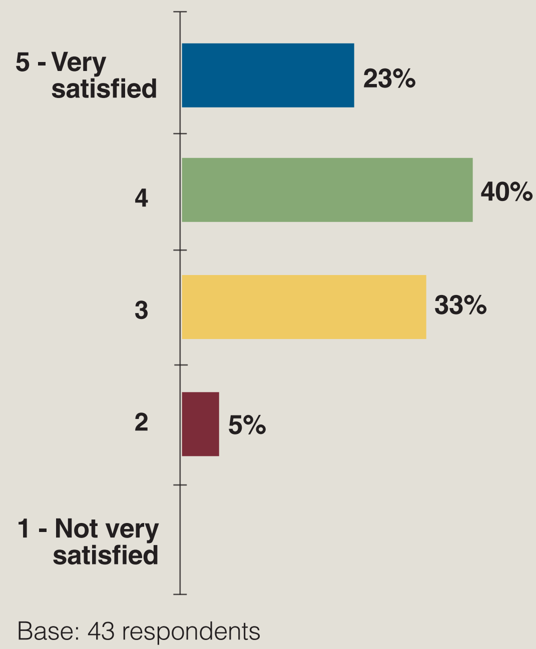


classes deviate from the risk profile of their core menu of funds. The financial crisis demonstrated that the performance differences between target date funds could be attributed to high allocations to equities and other volatile asset classes. Significantly different "glide paths" lead to dramatically different results, forcing plan sponsors to realize that a much more thorough evaluation of their target date funds, the underlying asset classes, and allocation assumptions is required.

In response to the financial crisis, many target date managers have changed their investment strategies and underlying assets. Some changes were implemented to increase diversification, mitigate downside risks, and add uncorrelated assets. The most common changes include the introduction of inflation hedges, including TIPS (Treasury inflation-protected securities), REITs (real estate investment trusts), natural resource and commodity linked instruments, derivatives, currency swaps, emerging markets, and high-yield bonds.

These changes have been marketed as being consistent with the previous asset allocation, yet they constitute a significant shift that should be evaluated and understood by the plan sponsor. Additionally, the DOL recently pronounced that target date fund investment managers are not fiduciaries to the plan, yet they are permitted to make decisions that impact participant returns without consulting plan fiduciaries.

Plan sponsor perceptions of QDIAs have shifted since the passage of the PPA when they focused on the fiduciary relief of QDIAs and viewed them as a quick fix to educating participants on asset allocation. Many rushed to add the recordkeeper's proprietary funds without further evaluation. Participants view target date funds as a one-stop shop retirement solution so it is important that the target



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date funds be best-in-class. The financial crisis reminded plan sponsors that they still retain fiduciary liability in the selection and monitoring of the QDIA option.

"The same principles that apply to a multi billion-dollar plan can be applied to medium and small plans," said Janice Phan, CCM, treasurer for Dolby Laboratories Inc. "Our human resources department combined their expertise in benefits and regulatory compliance with the in-house investment expertise provided by our treasury department. Engaging our treasury professionals when selecting, evaluating, and monitoring QDIA investments definitely improved the plan."

Guaranteed retirement income

Some investment firms are introducing target-date funds with a guaranteed retirement income feature that would provide an annuity stream of income during the participant's retirement. Some plans offer multi-insurer programs intended to diversify the exposure.

Acceptance has been slow in adopting retirement income solutions. Some plan sponsors cite fiduciary liability in the selection of annuities or individual insurance in-plan solutions. Some believe that there would be low expected usage while others believe that the products are still evolving.

Managed accounts

Managed accounts are a full fiduciary service provided by third-party investment advisers. Some act as a discretionary, investment manager under ERISA 3(38), meaning that they have exclusive authority over investment decisions and accept full fiduciary responsibility for their discretionary investment decisions. These managers provide a custom asset allocation for the participant and rebalance the portfolio periodically.

This type of vehicle is most popular with participants with high account balances and outside resources. Managed accounts replace online advice and risk-based asset allocation with customized asset allocation, longevity assumptions, and risk appetite of the participant.

Monitoring managed accounts from a fiduciary perspective is based on reviewing the service provider, methodology of the model, integrity of the asset allocator rather than on the portfolio performance, which is individualized. Managed accounts provide choice for participants and tools to better manage their money using the core menu of funds that have been carefully selected and monitored by the plan sponsor.

Stable value fund as QDIA

Stable value fund assets invested before December 24, 2007, are considered a "grandfathered" QDIA as well as capital preservation products (for the first 120 days of participation). Stable value funds were considered a conservative investment option, being a hybrid asset class that produced bond-like returns while seeking to maintain a stable principal value. They consist of a diversified portfolio of fixed income securities offered through commingled bond trusts and mutual funds. Synthetic GICs (guaranteed investment contracts) are comprised of a fixed-income portfolio with a wrap contract issued by a bank or insurance company that guarantees the principal.

The financial crisis revealed certain weaknesses in the structure of stable value funds arising from the accounting methodology and required wrap contract. The book value of a stable value fund relies on having well-capitalized and financially sound wrap providers, close tracking of the market-to-book value ratio, and reasonable cash flows to insure participant withdrawals.

During 2008, layoffs, company mergers, employer insolvencies and bankruptcies triggered "plan events." Wrap provider contracts include clauses that enable wrap providers to pay participants less than the book value at withdrawal or redemption when plan events or employer-initiated events occur.

Many wrap providers have exited the market because the margins are too thin or they lack sufficient capital or resources to maintain this exposure. Issuer downgrades, constraints on wrap capacity, and low fees are limiting the availability of stable value funds.

"Drawing upon the investment knowledge of the treasury group is an essential part of any 401(k) due diligence process," Phan said. "A detailed annual review of the target date funds is a prudent practice. An analysis should include a review of the glide path, sub-asset categories within the asset classes, underlying funds, fees, performance against benchmarks and third-party peer ratings."

Linda Ruiz-Zaiko, president of Bridgebay Financial Inc., and Janice Phan, CCM, for Dolby Laboratories Inc., discussed QDIAs at AFP's 2011 Annual Conference.