



NEW

RULES

WITH SOCIAL SECURITY TEETERING PRECARIOUSLY, ASSET MANAGERS, EMPLOYEE ADVOCATES AND REGULATORS ARE SEARCHING FOR A BETTER WAY TO PROVIDE RETIREMENT INCOME FOR MILLIONS OF AMERICANS.

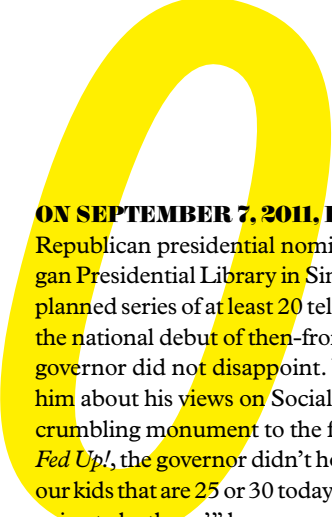
FOR

RETIRE

By Frances Denmark

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ILLUSTRATION BY MAXWELL HOLYOKE-HIRSCH



ON SEPTEMBER 7, 2011, EIGHT CANDIDATES FOR THE Republican presidential nomination gathered at the Ronald Reagan Presidential Library in Simi Valley, California, for the fifth in a planned series of at least 20 televised debates. The evening marked the national debut of then-front-runner Rick Perry, and the Texas governor did not disappoint. When one of the moderators asked him about his views on Social Security, which Perry had called “a crumbling monument to the failure of the New Deal” in his book *Fed Up!*, the governor didn’t hold back. “It is a Ponzi scheme to tell our kids that are 25 or 30 today, ‘You’re paying into a program that’s going to be there,’” he answered.

Perry’s characterization of Social Security as a Ponzi scheme — a term that will be forever linked in the American consciousness to fraudster Bernard Madoff — set off a heated exchange with fellow candidate Mitt Romney during the September debate. The real issue, said the former Massachusetts governor, is not about funding Social Security but saving it.

Few people, including Romney, should have been surprised by Perry’s statement. The Texas governor is one in a long line of politicians who have sought to dismantle Social Security since it was established close to 80 years ago, at the height of the Great Depression. In 1964, Republican presidential candidate Barry Goldwater established his conservative credentials by recommending that the federal program become voluntary. In 1981 president Ronald Reagan met with resistance over his proposed cuts to Social Security, leading him to appoint a commission to resolve funding issues. More recently, president George W. Bush promoted a plan to convert part of Social Security to individual investment accounts.

Now, as a result of the latest financial crisis, the Social Security promise made to millions of workers who are paying into the system has become hostage to the much larger debate that has been raging for months in Washington: how to shrink the \$15 trillion U.S. federal debt load. With Congress paralyzed by dissension, the retirement security of 150 million U.S. workers hangs in the balance. In the midst of the Sturm und Drang, however, there is some certainty. The one group that’s guaranteed to benefit from the lack of certainty of future Social Security benefits — Rick Perry’s “Ponzi scheme” — is the asset management industry.

With the notable exception of Social Security, U.S. pension and retirement plan sponsors and participants have long depended on asset managers to invest what has grown to be many trillions of their dollars in collective trusts and mutual funds. President Bush’s faith in the industry led him to call for an enormous new system of individually managed retirement accounts as a replacement for at least part of Social Security; this would have added trillions more in assets for financial firms to manage. Although that idea was tabled, most policymakers agree that Social Security will need a fix that will result in fewer benefits for future generations of Americans.

The retirement system in the U.S. is at a critical point. Even if Social Security benefits remain untouched, the looming gap in retirement income security and the promise of a flood of new assets into the system are fueling a race among asset managers to create, structure, sell and manage new products. Longtime defined benefit pension plan managers like Goldman Sachs Asset Management, Northern Trust Investments and State Street Global Advisors are gearing up to gain assets in the burgeoning defined contribution

arena. Fund managers that have long specialized in 401(k) and other defined contribution plans, like Fidelity Investments, T. Rowe Price Associates and Vanguard Group, are looking for new instruments that will allow them to keep their lead.

If money managers can’t deliver a rational retirement system, there are plenty of people at their heels ready to step in with new solutions. Organizations as diverse as the National Conference on Public Employee Retirement Systems and global consulting firm Mercer have recently designed pension schemes and want a wholesale change to the U.S. retirement system. At the same time, retirement industry regulators and congressional committees have been holding hearings to determine how to make the 401(k) plan look and act more like a traditional pension.

Thirty years of data have proven that defined contribution plans do not provide the retirement benefits of a traditional pension. When the 2008–’09 market crisis exposed 401(k) investors’ vulnerability, criticism of the current retirement savings system and asset managers’ role in it became louder. In February 2009, John Bogle, founder and former CEO of Vanguard Group and an outspoken critic of the fund industry he helped found, pointedly told the Educa-

FUNDS WITH BENEFITS

THE QUEST TO PROVIDE A LIFETIME INCOME STREAM

Turning working folks into professional investors has been a challenge for the asset management industry in the U.S. for nearly three decades. Trillions of dollars and 23 million defined contribution investors later, progress has clearly been made. Now comes the next challenge: decumulation. The term of art coined for postretirement annuitized payouts that mimic Social Security and traditional pensions has been proving even more challenging than accumulation, says Mark Warshawsky, Washington-based head of retirement research for consulting firm Towers Watson. For one thing, he explains, there are a lot of moving parts and more confusion.

“There are ideas out there and the beginning of the process,” Warshawsky adds. “I think that there will be a lot of products.”

High cost is a major obstacle in selling annuities. Products that address pretty much everything people want — a minimum

monthly payment, a fund balance, income flow and the ability to grow with the stock market — can cost close to 350 basis points a year. That’s a hefty fee for most defined contribution participants, and employers have not been signing on.

Another problem has been the lack of a clear regulatory nod. Last year the U.S. Internal Revenue Service and the Department of Labor’s Employee Benefits Security Administration requested information from the public on these products and held two days of hearings. The findings were inconclusive, but that has not stopped the asset management industry from continuing to build products in anticipation of plan sponsors signing on.

“I think an annuity is something people can’t afford not to do,” says Kristi Mitchem, head of defined contribution at State Street Global Advisors.

Consultants look at the post-retirement asset chase with more of a jaundiced eye. “The industry is all about how do you get the money when they [participants] terminate,” says Pamela Hess, director of retirement research at consulting group Aon Hewitt in Lincolnshire,

tion and Labor Committee of the U.S. House of Representatives, “Our existing [defined contribution] system is failing investors.” Bogle called for systemwide changes, identifying high fees that engender mediocre or poor returns as a key problem.

“On the DC side investors are getting retail mutual funds,” Bogle recently told *Institutional Investor*. “The industry is guilty of charging grossly excessive costs. We charge large investors much less.”

A three-way race is building among asset managers and insurance companies, regulators and policymakers, and industry activists to solve the retirement crisis. Overwhelming evidence in favor of key elements of defined benefit pensions — professional investment management with lower fees and greater portfolio diversification, large collective pools of participants and a lifetime payout — has asset managers working overtime to come up with new schemes to prevent a scenario in which massive numbers of elderly people become wards of the state.

The retirement system, such as it was, once consisted of a chaotic web of haphazard arrangements ranging from family support and mutual aid societies to almshouses and early death. The 20th century saw the creation of a government-sanctioned safety net — Social Security — and a law meant to safeguard employer-sponsored pensions: the Employee Retirement Income Security Act of 1974.

Despite these changes, the U.S. retirement structure, often referred to as a three-legged stool, has become very wobbly.

The first leg of the stool, defined benefit pensions, peaked at coverage for 30 percent of Americans in the 1970s and ’80s following the passage of ERISA. Today that number is down to 20 percent and shrinking fast as workplace savings plans replace traditional pensions in the private sector. The second leg, personal savings — which includes savings plans like the 401(k) — is also in decline. In June 2010 the U.S. Department of Commerce reported that the personal savings rate had fallen to zero, closing in on the last low, reached during the depths of the Great Depression, when the savings rate turned negative. That leaves the last leg, Social Security, as the only guaranteed retirement income source, and the only source for a full one third of American retirees.

The vast majority of employers believe their workforce is ill prepared for retirement. According to consulting firm Deloitte’s 2011 annual 401(k) survey on retirement readiness, only 15 percent of 653 private employers surveyed — which were fairly evenly distributed across geography, industry sector and size — believe their employees will be financially ready to retire. That paltry number hasn’t budged in 14 years, says Scott Cole, a senior consultant who led the project from Deloitte’s Wilton, Connecticut, office.

“It’s a matter of where you place the responsibility,” says Cole,

Illinois. Currently, rolling over participant assets to retail platforms at retirement has been very profitable for recordkeepers like Fidelity Investments and Vanguard Group that started providing bundled plan packages in the 1990s. That has been the default retirement solution pending a new way of distributing participants’ assets.

“There’s a strong argument for putting some portion of personal savings into an annuity for basic requirements,” says Alicia Munnell, Peter F. Drucker Professor of Management Sciences at Boston College’s Carroll School of Management. “Social Security is special,” she continues. “We’re losing a particular type of retirement income.” Munnell, who also directs the college’s Center for Retirement Research, adds, “We’ve been used to having some annuitized income through Social Security.”

But building annuitized products will not be a cakewalk. The insurance industry owns the franchise on guaranteed lifetime income, explains Thomas Streiff, retirement product manager at Pacific Investment Management Co. When the asset management and insurance industries work together, there

are challenges with both delivery and education. Pimco has partnered with MetLife to offer an annuity product tied to one of its mutual funds that is only being offered on the retail level, not through workplace retirement plans. “We’ve made progress, but not enough,” Streiff complains.

There are several practical concerns about the benefits of annuity products. Dean Takahashi, senior director of investments at the Yale University Investments Office, has started to look at the retirement issue on behalf of the university’s professors and others. Takahashi, who has worked alongside endowment head David Swensen for 25 years, believes future retirees face a number of challenges.

“It is difficult to find simple, straightforward advice on how much people need to save,” Takahashi explains. “And once they have retired, they get little guidance on how much of their savings they can draw each year as they budget their resources over an uncertain life span. Life annuities can help deal with the risk of outliving one’s savings; however, annuities usually don’t address inflation risk.”

The Yale investments director says many retirees avoid annuities because their terms and pricing are difficult to understand. They also worry about losing their money, leaving less for their heirs, if they die soon after retiring.

Asset managers’ awareness of these pitfalls and their eagerness to make sales are driving new-product research and development. At BlackRock’s San Francisco offices, home to the former Barclays Global Investors team that created the first target date fund in 1993, Chip Castille, head of the U.S. and Canadian defined contribution group, explains the firm’s next-generation product. Advances in technology have enabled BlackRock, which bought BGI in 2009 and manages \$325 billion in defined contribution assets in North America, to create a new series of target date funds that replace the fixed-income portion of these multifund portfolios with an annuity. A separate account with MetLife and interest rate averaging allow the funds to charge about half of what a typical guaranteed minimum withdrawal benefit wrapped around a target date fund would cost.

AllianceBernstein Investments has advanced the cause by bundling multiple insurers in its guaranteed withdrawal benefit. The company delivers the annuity inside a target date fund structure for one third the price of a stand-alone annuity. It begins phasing in at age 50 and is fully established within the participants’ accounts by age 60. “Portability is key,” says Thomas Fontaine, head of defined contribution investments. “It had to be able to change insurers and recordkeepers and preserve the benefit.” But David Bauer, a partner with Casey, Quirk & Associates, cautions, “There isn’t enough balance sheet in all the insurance companies in the country to annuitize everyone’s retirement income.”

For those who want a distribution vehicle without an insurance component, Fidelity offers a series of income replacement funds that work as a sort of reverse target date fund. Investors select the date they want their fund to liquidate, and the fund pays out until that date. According to Fidelity, annuity products have not been widely used because many people do not want to confront their own mortality. — F.D.

who was surprised by the long-term nature of these findings. He points to actively managed funds that can cost 20 times more than index funds: “In my view, the responsibility falls on the plan sponsor to be pushing the asset managers to come up with the right products.”

Money managers like to boast that mutual fund fees have come down. In 1990, when mutual fund assets were a mere 9 percent of the \$35 billion in 401(k) plans, average fees and expenses paid by investors were a whopping 198 basis points, or close to 2 percent. By the end of 2010, when mutual funds had captured more than half of the \$4.7 trillion in all defined contribution plans — 401(k), 403(b) and 457 — the average fees and expenses for all funds had dropped to less than 1 percent, and to 1.3 percent for actively managed equity funds. That’s still not good enough, says Vanguard’s Bogle, who has long championed index funds, whose fees can be as low as 10 basis points.

“Much more broadly, we need money managers to behave as fiduciaries,” says Bogle. “It’s a great big asset-gathering business. Money managers should put investors’ interests ahead of their own. Fiduciary duty — where is it?”

The U.S. is heading toward a massive national retirement crisis. The Employee Benefit Research Institute in Washington recently calculated the aggregate savings shortfall to be close to \$4.6 trillion. Without Social Security, the figure would rocket to \$8.5 trillion. If these gaps were filled, the asset management industry would stand to reap a bonanza that would build on the \$4.7 trillion in 401(k) assets and \$6.8 trillion in corporate and public defined benefit pensions that it already manages.

“Now is the time to fix Social Security,” says Putnam Investments CEO Robert Reynolds. “But we don’t have the political courage to go after anything.”

There is some good news. Reynolds estimates that, partly as a result of the Pension Protection Act of 2006, even without a new solution to plug the income gap predicted for retirees, workplace

“Fidelity noticed a long time ago that people might want to discount Social Security as a source of income.”

— Boyce Greer, Fidelity Investments

savings will grow by nearly 70 percent, to more than \$6 trillion in the next five years. Looking further out to 2020, Darien, Connecticut-based investment management consulting firm Casey, Quirk & Associates predicts that there will be \$7.7 trillion in defined-contribution-plan assets. A key reason for the projected growth in plan assets is the three “auto” additions sanctioned by the PPA: automatic enrollment, automatic deferral into qualified default investment alternatives like target date funds and automatic escalation of participants’ contributions. The percentage of plans that automatically enroll employees has risen dramatically, from 19 percent in 2005 to 56 percent in 2010, according to consulting firm Aon Hewitt in Lincolnshire, Illinois.

Reynolds, who takes pride in the fact that the mutual fund was invented in Boston, a city that is now home to 20 percent of all fund

assets, believes that if all three automatic features were implemented for all employees and combined with Social Security benefits, middle-income workers would retire with 125 percent of their annual income at retirement available on an annual basis. But, laments Reynolds, who left his role as vice chairman and COO at Fidelity to join Putnam in 2008, “The 401(k) system in this country only covers half of working Americans.”

Adds Damon Silvers, policy director and general counsel at the AFL-CIO in Washington: “The real, fundamental problem is, there isn’t enough money in the system in relation to the retirement needs of employees. Employers don’t put enough in.”

Even if both employers and employees contributed more money to 401(k) plans, the discrepancy in investment returns between those plans and old-fashioned pensions is enormous. A joint survey by the National Institute on Retirement Security and consulting firm Milliman released in October found that defined benefit plans produce an almost 25 percent greater return to participants over a 30-year period than defined contribution plans. On a per annum basis, the defined benefit plans outperformed defined contribution plans by 80 to 270 basis points. In a separate study, published in March 2011, Towers Watson found that from 1995 through 2008 the yearly asset-weighted median rates of return of traditional pensions were 100 basis points higher than for 401(k)-type plans.

At a September 15 hearing on promoting retirement security, held by the U.S. Senate Finance Committee, Karen Friedman, policy director of the Pension Rights Center in Washington, talked about proposals for some of the new retirement plan models. “These are not unreachable ideals,” said Friedman. “While encouraging savings is a worthy goal, 401(k) plans are not a substitute for good, secure pensions.”

To get employees where they need to be, the asset management industry is pinning its hopes on two products that mimic critical features of traditional pensions: target date funds to diversify investors’ asset allocation, and annuities or lifetime income vehicles. Target date funds, also called lifestyle or life-cycle funds, suffered a big setback during the 2008–’09 financial crisis, when funds across all age cohorts dropped by 32 percent, according to the Employee Benefit Research Institute. Even worse was the discovery that many fund families had allocated outsize equity investments to preretirees in 2010 funds that suffered losses of more than 40 percent.

Managers have learned a hard lesson. They are now working feverishly to make changes to target date funds. Even staunch active managers like Fidelity have added index options to their fund line-ups. Fund managers and insurance companies are also looking to create a new product to deliver postretirement benefits, meant to replace the annuitized portion of Social Security and traditional pensions (see “Funds with Benefits,” page 32). “There’s not an insurance company or asset management company that’s not trying to find a retirement income solution,” says Thomas Streiff, manager of retirement solutions at Pacific Investment Management Co. in Newport Beach, California. “We view this market as an important part of our future.”

“It’s an arms race to come up with a lifetime income solution,” agrees Putnam’s Reynolds.

The pressure to provide better retirement answers is forcing

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NEW RULES FOR RETIREMENT

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asset managers to think differently. “The primary vehicle is doing the lifting it wasn’t designed for,” says Winfield Evens, director of investment strategy for Aon Hewitt’s outsourcing business, speaking of the 401(k) plan. “The ramifications of getting it wrong are enormous. Are the asset managers up to the task? So far, it’s been a savings discussion, not a retirement discussion.”

Asset managers must balance their own agendas with those of millions of individuals in need of retirement security. If the asset management industry cannot produce viable solutions that provide that balance, it will fall to policymakers, regulators and others to dictate pension reform.

SOCIAL SECURITY HAS BEEN embroiled in controversy for its entire 76-year history. Since president Franklin Roosevelt signed the Social Security Act on August 14, 1935, a cavalcade of politicians, presidents and pundits have threatened it and even questioned its very existence.

“It’s only IOUs, and the government needs to come up with the money to pay it,” explains Olivia Mitchell, professor of insurance and risk management at the University of Pennsylvania’s Wharton School and director of both the Boettner Center for Pensions and Retirement Research and the Pension Research Council in Philadelphia.

Social Security is real, counters Virginia Reno, vice president for income security at the National Academy of Social Insurance in Washington. “People say the interest the government owes Social Security doesn’t count because it’s off-budget,” Reno says. “But it’s owed.”

In 1994, during the Clinton administration, to support the case for there being real Treasury bonds backing Social Security,

Congress legislated a requirement that each security issued be physically presented in paper form. The Trust Fund Management branch of the Bureau of the Public Debt was chosen to house the documents. Inside a locked room in a four-story office building in Parkersburg, the third-largest city in West Virginia, sits a locked, four-drawer, white filing cabinet filled with three-ring binders. Inside the binders are 8-inch-by-11-inch paper representations of the now \$2.6 trillion in special Treasury bonds the U.S. government promises to redeem when the trust fund runs short of current tax revenues.

The filing cabinet gained notoriety during Bush’s campaign for his scheme to convert Social Security to nonannuitized individual accounts. On April 5, 2005, during a photo-op visit to Parkersburg, the president held up one of the binders, pointing out, “There is no trust fund, just IOUs.”

The U.S. Treasury collects Social Security revenue through payroll taxes. Some of this revenue is used to pay current benefits; when it exceeds payout needs, the Treasury issues special bonds to the Social Security Trust Fund. But the fact that Congress can use the extra revenue to fund any program it wishes — to build a bridge to nowhere or help pay down U.S. debt, for example — was behind President Obama’s warning this summer that \$20 billion in Social Security checks might not be mailed. (They were.)

Charles Blahous, one of two public trustees for the Social Security and Medicare programs, and a research fellow with Stanford University’s Hoover Institution, framed the basic argument in his May keynote address at Mitchell’s annual Pension Research Council conference at Wharton. Blahous, former executive director of president Bush’s 2001 Commission to Strengthen Social Security (Mitchell was one of the 13 commission members), asked where the money would come from to pay off the trust fund bonds. “We can choose to issue more bonds to Social Security at any time,” he explained. “But doing so doesn’t create the resources to pay Social Security benefits.”

The future uncertainty of Social Security benefits is providing the asset management industry with a huge opportunity. Despite the failure of Bush’s push to divert trillions in Social Security payroll taxes into individually managed accounts, dreams of new money pouring into their coffers has had asset man-

agers salivating. Such a plan could still come about one day.

“When you look at the original promise of Social Security, there are those who argue the promise shouldn’t be broken,” says Pimco’s Streiff. “We note that the promise has already been broken numerous times. We expect it could change significantly again.”

The last major change to Social Security was made in 1983, at a time when the program was nearing insolvency. A bipartisan commission appointed by Reagan and led by Alan Greenspan (before his 1987 nomination as Federal Reserve chairman) reached a solution that Congress and the president agreed on. The retirement age was stepped up to 67, and the tax-rate schedule was altered so that higher-income retirees would begin to pay taxes on as much as 80 percent of their benefits. The June 1988 Social Security trustees’ report announced that the program would be able to pay benefits for the next 75 years — but the surplus only lasted until 2009. Social Security inflows were reduced this year when the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 cut the program’s federal payroll tax from 6.2 percent to 4.2 percent.

JUST A FEW WEEKS BEFORE HIS untimely death in a kayaking accident in Idaho this past August, Boyce Greer, head of institutional investments at Fidelity in Boston, spoke to *Institutional Investor* about the first time the idea of a reduction in Social Security benefits entered the product development conversation at his firm. “Fidelity noticed a long time ago, right at the beginning of when we started to look at how people should be saving for retirement, that people might want to discount Social Security as a source of income,” he explained of his firm’s life-cycle fund planning during 1994 and 1995. “The same question is still being asked of asset managers like Fidelity,” Greer added. “What else can be done?”

The asset management industry has been trying to get the U.S. workforce to save more for retirement since the early 1980s. It hasn’t been easy. From the 1981 inception of workplace savings plans following the addition of paragraph “k” to Internal Revenue Code Section 401 in 1978, through the mid-1990s, Congress did little to nurture the growth of what came to be called

defined contribution plans. In fact, fearing that employees would lose their pension benefits, in 1984 the Treasury Department proposed to eliminate section 401(k) entirely. Instead, in 1986 the Treasury merely revised some of the guidelines. That same year the Senate Finance Committee issued a warning that “excessive reliance on individual retirement savings (relative to employer-provided retirement savings) can result in inadequate retirement income security for many rank-and-file employees.” The committee further warned that workplace savings plans should be supplementary: “Such arrangements should not be the primary employer-maintained retirement plan.”

Yet that is precisely what happened.

In the 1980s and early 1990s, Congress passed a series of acts to amend ERISA to provide more revenue to federal coffers. Those amendments effectively penalized defined benefit pension overfunding and curbed the amount of money corporate employers could squirrel away for their employees. At the same time it was becoming

more costly to sponsor a pension, the stock and bond market boom of the 1980s was giving rise to the growth in mutual funds and the birth of the individual investor. Early in the decade 401(k) plans were mostly managed through banks and insurance company private-label funds. As equity and bond markets continued to grow in the 1990s, employees who enjoyed the perceived panache of brand names and the ability to keep an eye on their funds in the daily newspaper began to ask for mutual funds as their primary workplace savings plan vehicle.

Barclays Global Investors, now part of BlackRock, brought out the first target date funds in 1993, a few years ahead of Fidelity’s Freedom Fund series. Whereas BGI packaged the funds in collective trusts, Fidelity launched theirs via mutual funds, quickly growing assets in those vehicles. By the late 2000s, in their ongoing quest to find a better way to help workers save, employers started to abandon unsuccessful employee edu-

cation programs in favor of prepackaged, age-appropriate asset allocation funds, variously called lifestyle, life-cycle and target date funds. Today there is \$346 billion in prepackaged versions of these funds offered by 48 different fund families; 75 percent of these assets are managed by Fidelity, T. Rowe Price and Vanguard. A further \$200 billion or so resides in customized separate account versions of these asset allocation portfolios, for a total of 11.6 percent of the overall \$4.7 trillion U.S. defined contribution market.

Target date funds are a particularly ripe target for improvement right now, as asset flows are predicted to explode. Casey Quirk estimates that by 2020 they will have swollen to about \$3.7 trillion, or 48 percent of the overall 401(k) market, and will look more like defined benefit portfolios. To get there, managers will have to do more of the heavy lifting for participants, including risk management and better asset selection and allocation. Not surprisingly, the largest plan sponsors are leading the charge

into customized target date funds. About half of the 30 companies in the Dow Jones Industrial Average have stopped using off-the-shelf products. They hope to better control fund lineups, limit costs through economies of scale and select the top managers rather than accept a full array from one fund family.

The need for increased diversification of target date funds is drawing specialty managers into the 401(k) world. Known for their expertise in providing diversification with hedge fund, real estate and commodity funds, smaller managers are starting to get subadvisory mandates within customized target date funds. There is a lot of discussion about downside protection in these portfolios, says Derek Young, president of Fidelity’s asset allocation division. That will involve managers adding derivative strategy overlays to hedge downside risks, as well as alternative assets like commodities, real estate, Treasury Inflation-Protected Securi-

ties and even absolute-return, market-neutral and liquid hedge fund vehicles. Tactical asset allocation and lifetime income features are being built into target date funds as well.

“The movement to custom target date funds is probably a good thing for managers,” says Thomas Idzorek, global chief investment officer at Morningstar. “It’s a fight most money managers are familiar with and comfortable with.”

Idzorek points to the different ways managers are repackaging their target date series. Goldman Sachs Asset Management, for example, is creating what William McDermott, head of the defined contribution business, calls a fourth-tier offering for 401(k) plans. Goldman wants to create a new definition of diversification in defined contribution plans, McDermott says. “Now that defined contribution plans are the primary retirement vehicle, we should give participants access to the same asset classes that professionals use to create optimal portfolios in the defined benefit space,” he explains. Dubbed the diversified opportunities strategy, the product aims for lower volatility, lower correlation among asset classes and passive implementation to keep fees reasonable and eliminate manager risk.

J.P. Morgan Asset Management intends to simplify its plan offerings in an effort to counter participants’ confusion with large fund menus, which currently average 18 choices. J.P. Morgan will offer just three core portfolios: one composed of diversified stock strategies, one of diversified bonds and a diversified cash portfolio. In another twist, longtime active manager Fidelity created a new indexed target date series in 2009.

AllianceBernstein Investments’ custom fund program represents half of its \$30 billion in retirement assets under management. The firm launched the initiative in 2006 after Thomas Fontaine, head of defined contribution investments, spoke with large defined benefit sponsors who asked for more defined-benefit-like components in their defined contribution plans. “No large defined-benefit-plan sponsor would invest all its assets in one manager,” asserts Fontaine. “It was a hard conversation to have back then because plan sponsors didn’t understand why they should take the target date funds from their recordkeeper.” AllianceBernstein’s custom funds are completely unbundled: They use a variety of out-

“The real problem is, there isn’t enough money in the system in relation to the retirement needs of employees.”

—Damon Silvers, AFL-CIO

side managers and are delivered in separate accounts. The firm also offers a guaranteed withdrawal benefit option in these funds, using multiple insurance companies.

The changes to target date funds were motivated at least in part by poor returns. Preretirees were especially ill served by their target date investments. According to a 2009 report by the U.S. Government Accountability Office, despite the similarity in fund names that describe a retirement year, the fund components and returns vary widely among the fund providers. Returns for 2010 target date funds ranged from -9.0 to -41 percent in 2008. When the markets recovered in 2009, the gains ranged from 7 to 31 percent.

It hasn't helped that employers as well as their befuddled employees struggle to decipher fee information. According to Deloitte's 2011 survey on retirement readiness, 55 percent of employers said they were not aware of their plans' overall asset-weighted expense ratios. "We think it's a critically important calculation that plan sponsors are missing, because it's the only way to truly understand

Bogle points to TIAA-CREF as a firm that offers reasonable fees. "One of the responsibilities of asset managers in retirement programs is to provide the asset management at appropriately low cost," explains Edward Moslander, senior managing director for institutional sales and services at New York-based TIAA-CREF, whose plans combine individual accounts with guaranteed lifetime income and annuitization.

"The question of fees is where most obviously something is wrong," says the AFL-CIO's Silvers. "The point about defined benefit plans is, you have highly professional managers at every level and you get leverage over the managers." He adds that "401(k) plans give people spurious choices and charge them for spurious choices."

THE TIME HAS COME TO CONSIDER

a new way of delivering retirement income benefits to the U.S. workforce — to move beyond the debate over whether defined benefit plans are better than defined contribution plans. Sufficient data has accumulated about what works for employers and

Any change to the system will affect asset managers differently. According to a working paper from the New School for Social Research published in July, "Wall Street's Stake in Pension Reform," economics professor Teresa Ghilarducci and research assistant David Stubbs found that firms like Fidelity and Vanguard would benefit from a new retirement plan system based on individual accounts, while BlackRock; Loomis, Sayles & Co.; Northern Trust and State Street would thrive in a system that emphasized pooled accounts.

Some managers understand that change is due. "It's going to involve being more nimble and thinking more holistically," says Fidelity's Young. Others, like Cynthia Egan, president of T. Rowe Price Retirement Plan Services, one of the largest 401(k) record-keepers and fund providers, are not keen on wholesale change. "When I think of the defined contribution system, it really is an elegant design in that we have government endorsement through ERISA, corporate fiduciary responsibility, individual responsibility for saving and competition among asset managers."

But even Egan, a former Fidelity executive, does not have to be pushed far to reveal her own gripe about the "elegant" system: "Can we do something to elevate the percentage of workers?" she asks. Participation in defined contribution plans leveled off between 2006 and 2009 after experiencing sharp growth through the 1990s and early 2000s, according to a report last month from the Employee Benefit Research Institute. In 2010 less than 40 percent of all workers participated in an employment-based retirement plan.

Despite their investment in the status quo, asset managers share a number of important goals with employee and employer advocates. The difficulty in getting employees to sign on to their company plans has the asset management industry and advocate groups alike calling for a mandatory retirement system with a higher contribution rate. "Any new model needs to move from a retail mind-set to an institutional mind-set," says Aon Hewitt's Evens.

Some managers agree that employees would benefit more from participating in a collective pool than from managing their own individual accounts. Ideally, some say, a 401(k)-type workplace savings account

"What scares me is, what are we going to do with people who won't have money? Are we going to put them in tents?"

— Angelien Kemna, APG

the cost of participants investing in the plan," says Deloitte's Cole. "They need numbers from recordkeepers and asset managers. It's not difficult to calculate, but you need fee transparency." After years of lobbying by employee advocacy groups, transparency is on the way, a result of the new 408(b)(2) fee disclosure rules that will arrive in 2012. But consultants warn that it is just the beginning of a rationalization of plan costs.

In his February 2009 testimony, Bogle told the House of Representatives that "excessive investment costs are the principal cause of the inadequate long-term returns earned by both stock funds and bond funds." In addition to high fees, he said, the costs reflect the rapid turnover of actively managed equity portfolios. In 2008 the average actively managed fund had a turnover rate of 96 percent, meaning that its manager bought and sold the value of almost the entire portfolio during the year.

employees in the early 21st century. There are now new, workable pension models that could be adopted or adapted. There are also several successful existing retirement systems from which to crib. It is time to craft a true next-generation retirement benefit.

Despite the current logjam in Washington, there is cause for optimism. That's because folks like Bogle, organizations like NCPERS and the ERISA Industry Committee, and other dedicated retirement experts and organizations have worked hard to develop plans that would work in today's global economy.

But it is also time for the asset management industry to join the effort to rationalize the pension and retirement system rather than keeping its vision narrowed to a status quo that is not providing many U.S. retirees with adequate benefits. With a few exceptions, asset managers have been notably absent from the public dialogue on building a new system to deliver retirement security.

would supplement a mandatory, collective hybrid pension system — as it was originally designed to do.

Gordon Latter, head of risk-based solutions for RBC Global Asset Management (U.S.) in Minneapolis, and the AFL-CIO's Silvers point to Australia's superannuation fund as an example of a well-constructed retirement plan. It's made up of individual accounts but with a collective entity set up to act in participants' interest and manage their savings across all asset classes. It also defers a mandatory 9 percent of salary (soon to be 12 percent). "You're not going to get that in a DC plan," says Silvers. "Collective asset management is critical." Of course, in the U.S., where Social Security is the only mandatory retirement system, the very fact of its universality has whipped up controversy since its inception among those who fear creeping socialism.

Greater contributions from both employers and employees are essential; both employees and managers would benefit. "Three percent is not going to get people where they want to go," warns Pamela Hess, head of retirement research at Aon Hewitt, referring to the automatic enrollment number that most companies use. Hess would start employees at 6 percent and escalate to 15 percent. But that would still be small change compared with the Netherlands, which placed first again in the 2011 Melbourne Mercer Global Pension Index: Dutch employees in all industries have 20 percent or more of their paychecks deducted.

Angelien Kemna, CIO of APG, the investment subsidiary of the \$280 billion Dutch pension system, which covers a third of her country's workforce, joined APG in 2009 to ensure that her countrymen would have an adequate retirement. Kemna, former CEO of ING Investment Management Europe, fears that the movement in the U.S. to individually managed accounts will reap disaster. "What scares me is, ultimately, what are we going to do with people who won't have the money?" she asks. "Are we going to put them all in tents?" Her message to the U.S.: "Do it collectively, and make it mandatory."

"Pooling is something we need to get into defined contribution structures and make cost-effective for participants," agrees Kristi Mitchem, head of the defined contribution business at State Street.

Although U.S. lawmakers may not be

ready to make higher contribution levels, or any contribution, mandatory, employers with at least \$300 million in their defined contribution plans are returning to collective trusts and separate accounts as a way to mitigate participants' asset erosion from high fees and expenses. According to Hess, some plan sponsors are reconsidering mutual funds and many large sponsors have already given up on them. "The recordkeepers are just starting to lose their grip," she observes. About two thirds of defined contribution assets in the largest plans — those with \$50 billion or more in assets — are already in collective trusts and separate accounts; a little less than half of all plans are in pooled vehicles. By offering their lower-cost defined benefit managers' funds, as International Paper Co. and General Motors Co. have done, or just pooling assets that are privately traded, annual costs can drop from 60 basis points to 40, says Hess.

Pooling is a critical part of one of the most successful U.S. defined contribution programs, the \$287 billion Thrift Savings Plan that covers nearly 4.5 million federal government employees and the military. Often held up as an example of a low-cost, easy-to-use plan, the TSP, which supplements a defined benefit plan, has only five generic funds and net fees of about 3 basis points a year for participants. "The Thrift Savings Plan is the best retirement plan in the country because of its fees and performance," observes Edward Siedle, a former Securities and Exchange Commission attorney and owner of Benchmark Financial Services, a forensic pension investigator in Ocean Ridge, Florida. He also praises the lack of marketing machinery and conflicts of interest in the giant plan.

Next year a brand-new, giant defined contribution plan modeled on the TSP will be coming on line in the U.K. Called the National Employment Savings Trust, or NEST, it's designed for millions of middle-income workers without access to a retirement plan. NEST staff consulted with both TSP and Dutch pension officials, then developed their own variation on the theme. Employers must automatically enroll their workers, and transfers in and out of the fund are prohibited. BlackRock, HSBC Holdings, State Street, UBS and F&C Investments in London have each won a piece of this new

mandate expected to bring in 4 million to 5 million new investors.

In response to pension plan sponsors' continual complaints that the system is broken, Mercer designed a new, global prototype pension model. Mercer's model calls for the best of defined benefit and defined contribution schemes: fixed costs, predictable outcomes, strong risk management, a 10 percent contribution and lifetime income. Instead of one stakeholder — employers or employees — taking all the risk, it would be shared. Robert Moreen, primary author of the Mercer model and a leader in the firm's global work in formulating its position on retirement reform policies, wants everybody to have a stake in what he envisions as a mandatory system. The cap-on-contributions threshold would be much higher than the \$106,000 wage limit in the Social Security system. The basic fund accumulation mechanism would be "a next generation of life-cycle funds with a real twist on the payout end," says Moreen.

Bogle also has a vision for a new retirement savings system in which both investment and longevity risk would be pooled. Run by a newly created, private sector, nonprofit federal retirement board to oversee both employer-sponsors and plan providers, the system would consolidate the current array of defined contribution plans, IRAs and Roth IRAs, and the federal employee Thrift Savings Plan. Asset managers and recordkeepers would continue to compete for the many trillions of dollars to be invested.

NCPERS announced another viable hybrid pension plan for the corporate sector in September. "We need to be involved in this issue or it will overwhelm all of America," says executive director Hank Kim. Dubbed the Secure Pension Choice, the proposal includes a pooling of investment risk, economies of scale in investment management and the potential to include all employees. It would be a multiemployer plan run with modifications by each of the 50 states.

Although the prospects for Social Security, like those of the presidential candidate who called it a Ponzi scheme, are cloudy, there is hope for a better retirement system because asset managers and policymakers have one major aligned interest: Both want people to save more. ●●