MERS®
Municipal Employees' Retirement System
2017 RETIREMENT CONFERENCE

Designing Your Defined Contribution Plan to Maximize Retirement Adequacy

Presented by John Waugh

What is a Defined Contribution Plan?

- Employer-sponsored savings account for employees
- Sometimes referred to as “participant directed accounts” because the participant controls how funds are invested
- As a result, many employers believe they have no responsibility for the plan
- In reality, when an employer offers a retirement plan, they become the Plan Sponsor and may have fiduciary responsibility for:
  - Plan compliance
  - Designing the plan structure
  - Choosing the investment lineup
  - Negotiating and monitoring investment and plan costs

How Defined Contribution Plans Evolved

- The Employee Retirement Income Security Act of 1974 (ERISA) provided tax-deferred savings for retirement
- Congress passed the Revenue Act of 1978—now known as IRC 401(k)—which allowed employees to avoid taxes by deferring compensation
- Started as supplemental plans to traditional pension plans
- First 401(k) was established by the Johnson Companies in 1981, and others followed, including governmental plans
- In 1986, tax law changes prohibited establishing new governmental 401(k) plans
- 401(a) and 457(b) have become the “go to” Defined Contribution plans for governmental employers

Defined Contribution Plans: Comparison

Plan Feature Comparison			
Plan Type	401(k)	401(a)	457(b)
Primary Purpose	Qualified Retirement Plan	Qualified Retirement Plan	Supplemental Savings Program
Available for Governmental Entities	No (post-1986)	Yes	Yes
Enrollment	Voluntary	Mandatory	Voluntary
Employee Contribution Flexibility	Complete Flexibility	Limited (Choice only at Enrollment)	Complete Flexibility
Required Contributions	No	Yes	No
Automatic Enrollment Feature (optional)	Yes	n/a	Yes
Automatic Contribution Escalation (optional)	Yes	No	Yes
Roth Option Available	Yes	No	Yes
Allows Employer Contribution	Yes	Yes	Yes (but included as employee earnings)
Allows Vesting	Yes	Yes	Varies

Plan Design

Considerations of Defined Contribution

Potential risks of not providing adequate retirement plan

Recruit

Decreased ability to compete with other employers to attract talented employees

Retain

Benefits keep talented employees engaged in their current position and future opportunities

Retire

Potential employer costs if employees have inadequate savings to retire:

- Higher health care costs than younger employees
- Higher absenteeism and lower productivity while at work
- Decreased engagement for other workers unable to advance career

Plan Design Considerations

Plan Type

- Is the plan intended solely for retirement income or is it supposed to cover retirement health care costs as well?
- Is its purpose to supplement a pension or to be the primary retirement plan?

Participation

- Is the plan mandatory or voluntary?
- Would automatic enrollment enhance the plan?

Contribution Structure

- Are employee contributions voluntary and flexible or fixed?
- What is the employer contribution budget?
- Do the employer contributions incentivize increased participation and/or contributions from the employee?
- Would automatic escalation of contributions enhance the plan?

Vesting Schedule

- Vesting schedules help retain employees
- Unvested dollars can return to employer and offset future contribution costs

Loans

- Will participants be allowed to take out loans?

Adequate Savings Rates

Defined Contribution Plan Trends

Increased life expectancy means retirees need larger retirement savings

Trend of employers no longer offering traditional pensions

Trend of employers no longer offering retiree health insurance

Defined Contribution Plans are growing in importance

What is an Adequate Saving Rate?

- Rather than aiming for a one-size-fits-all savings rate, it's important to look at how much income a person is likely to need in retirement
- **80% income replacement rate** is the recommended industry standard
- The contribution rate needed to achieve that income replacement rate varies from person to person and depends on several factors:
  - Current age
  - Expected age at retirement
  - Life expectancy
  - Health
  - Cost of health insurance
  - Investment risk tolerance
  - Social Security
  - Other income sources
  - Lifestyle in retirement
  - Debt
- Giving employees the flexibility to choose their savings rate enables them to make the best choices for their individual circumstances

Determining Adequacy *Example One*

Kira is 23 and just got her first full-time job making $35,000/year.

Because she's just starting out, she doesn't have anything saved yet.

With 39 years of compounding interest ahead of her, Kira will only need to save **7.5%** of her pay for retirement.

Assumes Kira retires at age 62 and lives to age 90.

Also assumes a 6% annual return on investment, 2% annual inflation and 2% wage increases during her remaining working years.

80% income replacement rate includes projected Social Security income.

Determining Adequacy *Example Two*

Mark is 35 and also makes $35,000/year.

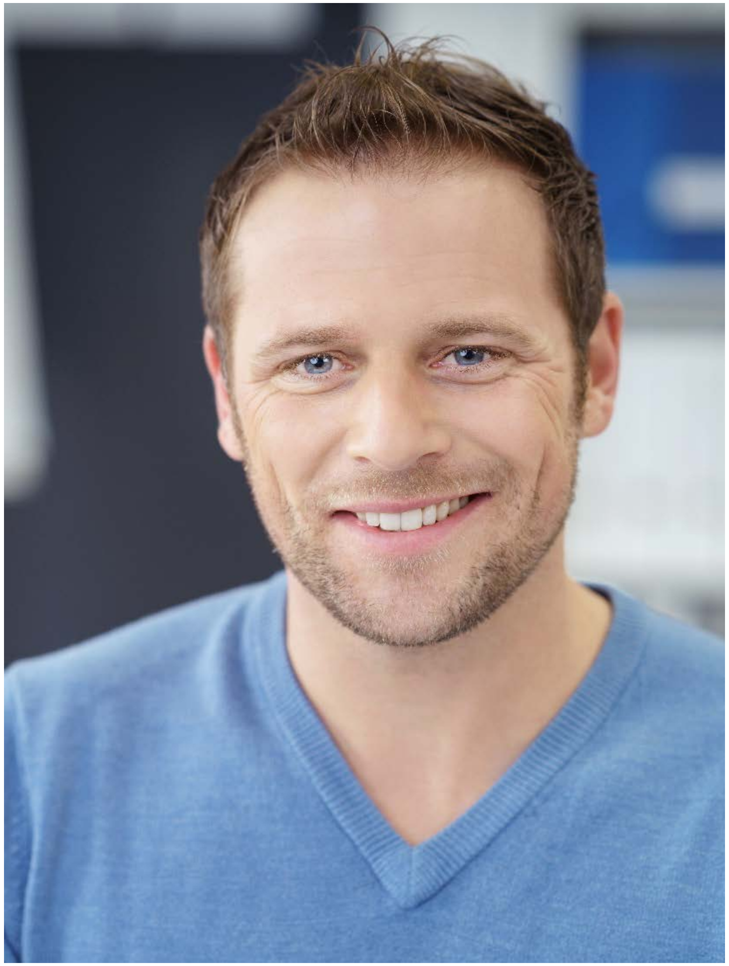
He hasn't started saving for retirement yet, but now that his kids are out of diapers, he's ready to start planning for his future.

Because he waited to start saving, Mark will need to save **14.5%** of his pay for retirement.

Assumes Mark retires at age 62 and lives to age 90.

Also assumes a 6% annual return on investment, 2% annual inflation and 2% wage increases during his remaining working years.

80% income replacement rate includes projected Social Security income.



Determining Adequacy *Example Three*

Sarah is 45 and currently earns $65,000/year.

She has been saving for retirement for several years now, and has a balance of $125,000 in her retirement account.

It's time for Sarah to get serious, with **18%** of her pay going towards saving for retirement.

Assumes Sarah retires at age 62 and lives to age 90.

Also assumes a 6% annual return on investment, 2% annual inflation and 2% wage increases during her remaining working years.

80% income replacement rate includes projected Social Security income.

Adding Flexibility with Defined Contribution *PLUS*

Introducing Defined Contribution *PLUS*

Problem

- Per IRS rules, once an employee's contribution rate has been established in a 401(a) Defined Contribution Plan, it cannot be changed

Solution

- **MERS Defined Contribution *PLUS*** pairs our Defined Contribution Plan with our 457 Program to provide public sector employees with 401(k)-like flexibility
- With combined reporting and statements, the two programs essentially function as a single plan

How Defined Contribution *PLUS* Works

Offering an Employer Match to Incentivize Employee Saving

- Employers establish the contribution structure for the Defined Contribution plan
  - Any employer contributions are deposited into the employee's Defined Contribution account
  - Employee contributions may or may not be required
- Employers can encourage even greater employee participation by offering a match on any voluntary contributions the employee makes
  - Voluntary employee contributions are deposited into the employee's 457 account
  - Employer's matching contributions are deposited into the employee's 401(a) Defined Contribution account

How does Defined Contribution PLUS Compare?

Plan Feature Comparison			
Plan Type	401(a)	457(b)	Defined Contribution *PLUS*
Primary Purpose	Qualified Retirement Plan	Supplemental Savings Program	Qualified Retirement Plan with Supplemental Savings Program
Enrollment	Mandatory	Voluntary	Mandatory
Employee Contribution Flexibility	Limited (Choice only at Enrollment)	Complete Flexibility	Complete flexibility over and above minimum required contributions
Required Contributions	Yes	No	Yes
Automatic Enrollment Feature (optional)	n/a	Yes	Yes
Automatic Contribution Escalation (optional)	No	Yes	Yes
Roth Option Available	No	Yes	Yes
Allows Employer Contribution	Yes	Yes (but included as employee earnings)	Yes
Allows Vesting	Yes	Varies	Yes

Benefits of Defined Contribution *PLUS*

Combining the Benefits and Flexibility of Both Programs

Employer	Employee
• One-stop reporting saves time with Defined Contribution and 457 contributions on one report • Minimum level of participation in the Defined Contribution Plan can still be required • A vesting schedule can be applied to all employer contributions • Loans can be restricted from the Defined Contribution account, while still allowed from the 457 account	• Combined statements and online account access make monitoring performance easier • Employees can contribute up to the current IRS maximum in each plan. (Up to $54,000 in Defined Contribution and $18,000 in 457)* • Voluntary contributions can start, stop or be changed at any time • Matching contributions from employer are not taxed as income when received

*IRS limits for 2017

Contribution Structure *Sample One*

- Employees are required to contribute 2%
- No minimum employer contributions
- Employer will match 100% of the employee's voluntary contributions, up to a maximum of 7.5%
- Voluntary employee contributions above 7.5% are allowed, but will not be matched by the employer

	Required Contributions				
Employee Contributions - Deposited into DC Account	2%				
Employer Contributions - Deposited into DC Account	0%				
	Voluntary Contributions				
Employee Voluntary Contributions - Deposited to 457 Account	0%	1%	5%	7.5%	10%
Employer Matching Contributions - Deposited into DC Account	0%	1%	5%	7.5%	7.5%
Total Retirement Contributions	2%	4%	12%	17%	19.5%

Contribution Structure *Sample Two*

- Employees are required to contribute 2%
- Employer will contribute a minimum of 2%
- Employer will match 100% of voluntary contributions, up to a maximum of 5%
- Voluntary employee contributions above 5% are allowed, but will not be matched by the employer

	Required Contributions				
Employee Contributions - Deposited into DC Account	2%				
Employer Contributions - Deposited into DC Account	2%				
	Voluntary Contributions				
Employee Voluntary Contributions - Deposited to 457 Account	0%	1%	5%	7.5%	10%
Employer Matching Contributions - Deposited into DC Account	0%	1%	5%	5%	5%
Total Retirement Contributions	4%	6%	14%	16.5%	19%

Contribution Structure *Sample Three*

- No required employee contributions
- Employer will contribute a minimum of 5%
- Employer will match 50% of the employee's voluntary contributions, up to a maximum of 5%
- Voluntary employee contributions above 5% are allowed, but will not be matched by the employer

	Required Contributions				
Employee Contributions - Deposited into DC Account	0%				
Employer Contributions - Deposited into DC Account	5%				
	Voluntary Contributions				
Employee Voluntary Contributions - Deposited to 457 Account	0%	1%	5%	7.5%	10%
Employer Matching Contributions - Deposited into DC Account	0%	0.5%	2.5%	3.75%	5%
Total Retirement Contributions	5%	6.5%	12.5%	16.25%	20%

Understanding Your Fiduciary Role

Fiduciary Oversight

- A fiduciary is anyone who has discretionary authority over:
  - Plan assets
  - The administration of the plan
  - The management of the plan
- Fiduciaries are subject to standards of conduct and must act on behalf of participants
- Responsibilities:
  - Adherence to Plan Document
  - Investment oversight
  - Ensure reasonable expenses

MERS provides employers with peace of mind because the ***MERS Retirement Board takes on the <u>sole fiduciary responsibility</u> of their plan*.**

Degrees of Fiduciary Responsibility

When it comes to the fiduciary responsibility for your retirement plan, not all plan providers assume the role of sole fiduciary.

Plan Provider

In some instances, the plan provider takes fiduciary responsibility, establishes the plan document, determines the investment options available and monitors performance.

MERS provides employers with this level of confidence.

Co-Fiduciary Responsibility

Many plan providers act as co-fiduciaries. The provider offers investment information and makes recommendations. The employer is responsible for selecting and monitoring the performance of the funds.

The plan provider and employer share fiduciary responsibility for the plan.

Employer

Most plan providers act only as a record keeper and leave decisions regarding the plan document, investment options and performance monitoring to the employer.

The employer has unlimited choices under this scenario, but risks being held liable for fiduciary violations.

The MERS
Investment Menu

Investment Menu Oversight

- Our streamlined investment menu is a set of funds selected by our experienced investment professionals
- MERS performs the necessary research, due diligence and monitoring to ensure high-quality options
- Our pre-built portfolio funds use institutional investment managers that are selected and monitored by the MERS Office of Investments and MERS Retirement Board

Is a Bigger Investment Menu Better?

Psychologists have concluded that an overload of options can paralyze people or push them into decisions that are against their own best interest.

When Less is Actually More

A study on shopping behavior experimented with jam displays. One table held 24 varieties of gourmet jam; the other held only 6 varieties. The large display attracted more interest, but people were 1/10th as likely to buy from the large display as from the small display.

The same principle of “less is more” was found to apply to participation rates in retirement programs. A large number of fund choices actually *discourages participation* amongst even well informed participants.[1, 2]

[1] *Mottola, Gary and Utkus, Stephen. “Can There Be Too Much Choice In a Retirement Savings Plan?” The Vanguard Center for Retirement Research, June 2003*

[2] *Schwartz, Barry. “More Isn’t Always Better.” Harvard Business Review, 01 June 2006. Web. 24 Feb. 2016*

Simplified Investment Options

- Understanding decision-making process has helped us design a strategic investment menu
- Grouping investment options into logical categories helps participants easily create fully diversified portfolios

Investment Categories

1. *"Do it for me"*
   Fully diversified target date funds that automatically adjust over time
2. *"Help me do it"*
   Prebuilt portfolios that are monitored and rebalanced quarterly
3. *"I'll do it myself"*
   Self-Directed Brokerage Account to access funds outside of MERS*

1 “Do it for me”

MERS Retirement Strategies - Target Date Funds

- A simple, effective, all-in-one investment choice
- Complete diversified investment fund
- Assets change from aggressive to conservative as participant approaches retirement age and throughout retirement
- Default investment selection, based on projected “target-date” of retirement at age 60

2 *"Help me do it"*

Pre-Built Portfolios and Pre-Selected Funds to Build Your Own Portfolio

1) Pre-Built Portfolios for Participants
   - Allows participants to choose a portfolio with a designed mix of stocks and bonds
   - MERS helps participants by monitoring the underlying investment managers
   - Rebalanced quarterly

2) Funds to build your own portfolio
   - Pre-selected options give you access to a variety of funds
   - Actively monitored by MERS
   - Includes several low-cost index funds

3 "I'll do it myself"

Self-Directed Brokerage Account to Access Outside Funds

SELF-DIRECTED BROKERAGE ACCOUNT

CHOICE + FLEXIBILITY + CONTROL

- For participants who want to independently and actively manage an even greater choice of investments
- Access to individual stocks, bonds, CDs, commission free Exchange Traded Funds and more than 13,000 mutual funds
  – 2,500 No-Load, No-Transaction Fee Funds
- Available through TD Ameritrade
- $5,000 minimum balance requirement to use

Evaluating Plan Costs

Monitoring Participant Expenses

- MERS is a multi-employer plan, meaning we are able to allocate costs over all participating customers
- As the plan fiduciary, MERS monitors investment manager expenses to ensure they are reasonable
- MERS members benefit from economies of scale. With over $10 billion in assets under management, the cost of plan investments continues to decrease
- Our weighted average participant cost has dropped to 0.44% for the MERS Defined Contribution Plan and 457 Program Investment Menu

Monitoring Plan Expenses

Provider Comparison Summary

Average Fund Expense by Investment Style	Provider A	MERS	Fee Reduction
Target Date Funds	1.34%	0.43%	-0.91% ↓
Asset Allocation Funds	1.60%	0.56%	-1.04% ↓
Stock Funds	1.79%	0.58%	-1.21% ↓
Bond Funds and Stable Value	1.45%	0.57%	-0.88% ↓
Average Expense – *All Funds*	1.62%	0.51%	-1.11% ↓

Plan Weighted Averages (Appendix III)	Provider A	MERS	Difference
Expense			
Weighted Average Expense	1.66%	0.44%	-1.22% ↓
Performance			
1-Year Weighted Average Performance	12.75%	13.01%	0.26% ↑
3-Year Weighted Average Performance	5.11%	6.10%	0.99% ↑
5-Year Weighted Average Performance	8.66%	9.89%	1.23% ↑

Comparing Providers *Effect of Fees on Participants*

<u>Meet John</u>

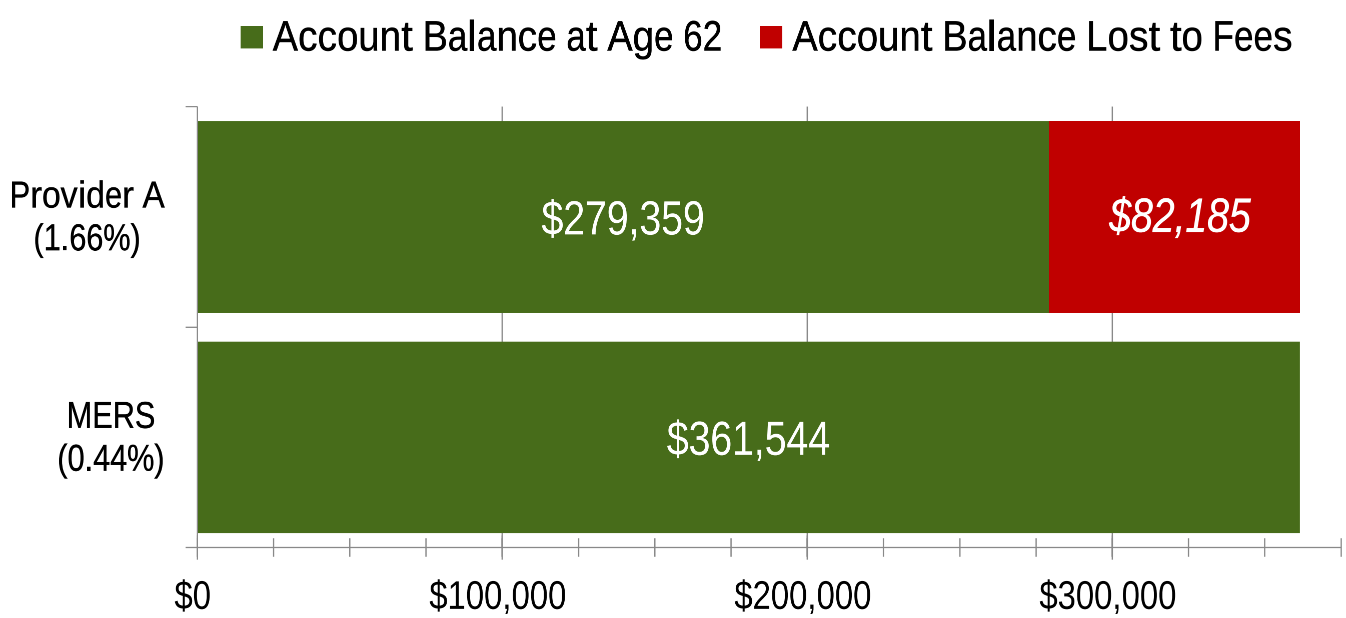
- John is 30 years old
- Current salary is $42,000, with 2% annual salary increases
- His current account balance is $5,000, and he makes 5% bi-weekly contributions until retirement
- Assumes a 7.5% gross investment return before retirement
- Retires at age 62
  - John withdraws assets in equal monthly payments for 25 years
  - At the end of 25 years the balance is depleted
- Assumes a 6% gross investment return throughout retirement

Comparing Providers *Balance at Retirement*

The comparison report will help an employer gauge the impact of higher costs during the ***accumulation phase*** of an average employee:

In this comparison, MERS low fund expenses would provide John with

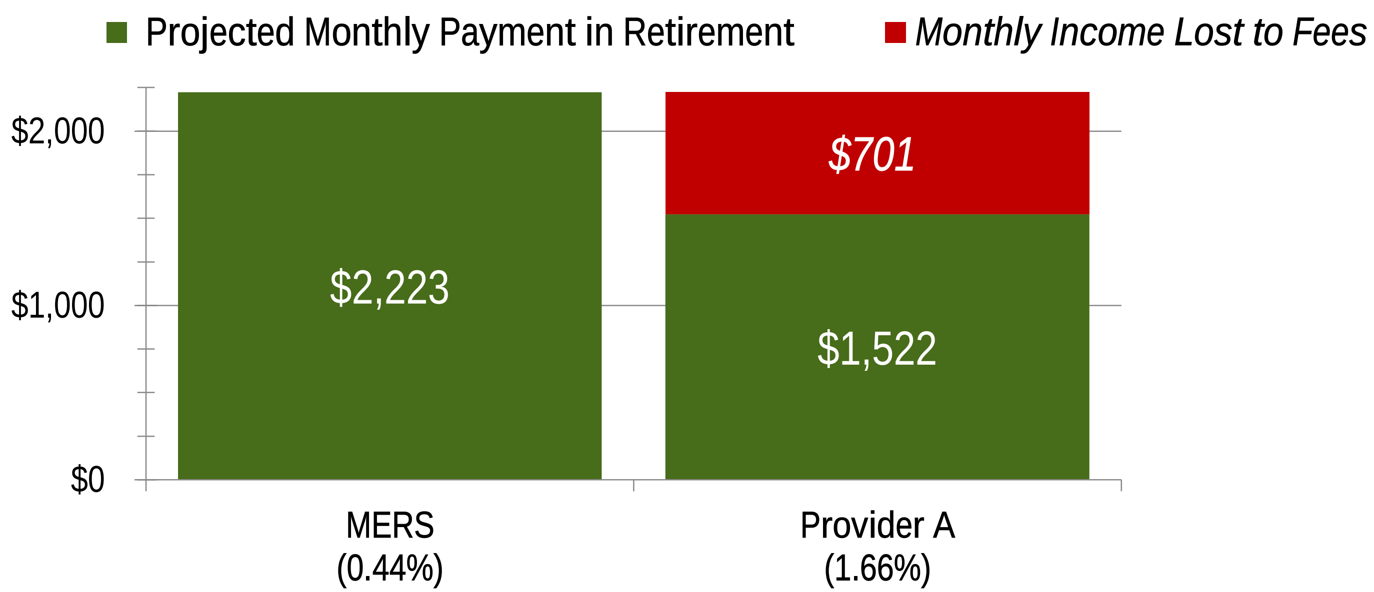
29% more at retirement!



Comparing Providers *Monthly Income in Retirement*

The comparison report will also help an employer gauge the impact of higher costs during the ***distribution phase*** of an average retiree.

MERS low fund expenses would provide John with
46% more in monthly income during retirement!



Participant Education

Participant Education is Key

Preparing Participants for a Successful Retirement

- Regardless of the plan design, ensuring that participants understand how their benefit works is a crucial component for building an effective retirement plan
- Higher financial literacy among employees is associated with higher voluntary participation rates or lower quit-rates in automatic enrollment plans
- Financial literacy has a larger effect on saving than a sizable increase in income
- Knowledge of a plan’s specific features—such as the employer matching threshold—is also associated with increased saving

Source: Center for Retirement Research at Boston College

Retirement Readiness Reports

- Plan providers often offer financial planning for a fee
- MERS provides a solution that reaches a broader percentage of participants
- Retirement Readiness reports provide individual guidance at no additional cost to the participant or the employer

Retirement Readiness Snapshot Reports

Developing the Full Retirement Picture

The "Full Picture" report allows participants to:

- Add spouse and outside investment information online to build their "Full Picture" report
- Identify their risk tolerance and receive customized suggestions for improving their retirement readiness
  - Increase retirement savings
  - Review investment selections
  - Consider delaying retirement
  - Adjust retirement income replacement rate

Resources

One Click Away

- To keep up with trending information related to retirement follow us on Facebook, Twitter, LinkedIn and YouTube
- Our website provides helpful calculators and other retirement resources

Quick Bite Webinars

- Our webinar series delivers online education
- Participants can tune in live and ask questions or view recorded sessions from the library of topics any time

Pizza & Planning

- Free, local education for employees held after traditional work hours
- Hosted at various locations throughout the state

On-site education

- Group presentation can be held at your location during work hours or whenever is convenient for your employees
- Attend benefit fairs
- One-on-one meetings for all MERS programs

Contacting MERS of Michigan

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