QPA WHITE PAPER SERIES

Investment Refresh:

Improving Participant Outcomes Through Re-enrollment

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I. Introduction

A defined contribution plan “re-enrollment” has become a retirement plan industry best practice. The mechanism illustrates that the most prudent – and therefore safest – fiduciaries are not those who defensively opt for inaction, but instead are those fiduciaries who assess and understand what is in their participants’ best interests *and* proactively take steps to further those interests.

Yet re-enrollment presents two broad categories of challenges. First, as a threshold manner, the terminology is confusing and misleading. Second, even upon overcoming the terminology, plan sponsors become paralyzed by preconceived notions of participants’ reactions and fiduciaries’ risk.

This White Paper addresses the first of those issues by suggesting a change in terminology. It then acknowledges the most common preconceived notions and provides fiduciaries the context, data, and legal support to evolve toward an informed embrace of a re-enrollment’s value. Ultimately, as you will read, a re-enrollment helps participants and fiduciaries alike to experience improved outcomes.

II. Re-enrollment = An Investment Refresh

As used in the retirement plan context, the term “re-enrollment” is, at best, misleading. In fact, it is better described as inaccurate and flat out wrong. Consider:

- The “re-“ prefix means “again, anew”.[i]
- A participant’s “enrollment” occurs when he or she has become eligible to participate in the plan, elects to participate, and elects for a specific portion of his or her wages to be withheld and contributed to the plan.
- When those meanings are combined, they suggest that a plan re-enrollment requires a participant to repeat those enrollment steps.

If one were to re-enroll in automatic bill pay for a monthly cell phone bill, most would assume he or she must proactively enroll (again) or would not be considered to be in the automatic bill payment program. If one were to re-enroll in graduate school, that would suggest he or she would not be a graduate student if not for those enrollment steps.

But a plan re-enrollment does not require any particular action on a participant’s behalf, nor does the absence of an action result in “non-enrollment” or any other type of exclusion. As a result, it is nothing like the “re-”actions sampled above. If plan fiduciaries were to implement a re-enrollment process and a participant took no action, he or she would retain his or her status as a plan enrollee. Further, he or she would continue to participate at the same rate.

Fiduciaries are better served to consider a “re-enrollment” to be an “investment refresh”. It merely hits the refresh button on each participant’s investment elections. Participants who desire – or demonstrate – inaction receive the benefit of their accounts becoming invested in a default investment selected by fiduciaries. Wise fiduciaries select a default accompanied by a seal of approval from the Department of Labor. Those who desire to continue with their prior investment approach may elect to do so – immediately or at anytime thereafter. And within the course of this investment refresh process, fiduciaries frequently improve their levels of protection.

III. The Benefits of an Investment Refresh

Many plan sponsors – including more than 80% of large plan sponsors – agree that their organization *should* conduct a re-enrollment.[ii] They reach that conclusion for a variety of reasons. They recognize that their employees' investment allocations are too risky or too conservative, in either case because the elections were based upon an incomplete understanding and/or have gone stale. They seek to sound a call to action, which will reverse the pattern of participant inertia and increase employee engagement. Some plan sponsors have received education regarding the related fiduciary safeguards and wish to improve their fiduciaries' protections. Others understand that a change in the plan's fund line-up presents a natural opportunity for employees to make choices among the new options, particularly when adding some sort of actively managed strategy – such as risk-based portfolios and target date funds – expected to serve participants better than their stale do-it-myself elections.

A. Improve Participant Allocations

Most participants do not understand investment options. This lack of understanding is indeed understandable. The terminology itself is overwhelming. Equities. Fixed income. Large cap. Mid cap. Small cap. Blend. Growth. Value. International. Developed markets. Emerging markets. Short-term. Long-term. Core. Treasuries. Money market. Stable value. Target date fund. Active. Passive. Gross expense ratio. Net expense ratio. Participants have to manage their careers, their families, their kids' sports schedules, their religious and community events, possibly a second job, and some sense of work-life balance. With only 24 hours in a day, this leaves little time to understand all of the financial terminology and to study market behaviors.

The lack of understanding causes fear, which causes inaction, which results in static investment elections. Once upon a time, the plan's broker or the participant's brother-in-law (or maybe even the HR manager or CFO) suggested a portfolio consisting of a handful of funds. The participant chose investments in line with those suggestions and let it ride. In the meantime, he or she has not re-balanced the portfolio or made any tactical changes. One recent survey found that nearly half of participants had not checked their investment portfolio in the prior 12 months.[iii] Another found that around one-third of participants had *never* made a change to their initial investment choices.[iv] These static elections become stale.

The stale elections, in turn, result in participants' allocations being dramatically disconnected from their respective risk tolerances. One study found that 88% of do-it-myself investors had either too much or not enough of their assets invested in equities for their age.[v] Another suggests it is not unusual for two-thirds of participants to be misallocated.[vi] Plan sponsors have moved toward broader support of risk-based portfolios and target date funds because they recognize the flaws in their employees' investment allocations. An investment refresh process is consistent with that movement and serves to improve participant allocations.

As a plan sponsor considers an investment refresh, it is well-served to start with a couple of questions: (1) Do we believe that most of our employees understand the plan's investments and have the time, desire, and ability to maintain current elections? and (2) Wouldn't we like to improve our employees' investment allocations?

B. Reverse Inertia and Improve Engagement

The defined contribution plan environment has not yet adequately absorbed the magnitude of the country's shift from a dependence on defined benefit plans to a reliance on participant-directed plans (such as 401(k) and 403(b) plans). Defined benefit plans largely present participants with no options regarding their participation, savings rates, or investment mix. Participant-directed plans, on the other hand, present participants with options in each of those areas. The shift from defined benefit plans in the 1990s and 2000s revealed these options to be dangerous because participants neglected to participate frequently enough, save enough, and invest in a sufficiently diversified manner. The market collapse of 2008 and 2009 left an unprepared generation of savers in an even more perilous situation.

Forward-looking and thoughtful plan sponsors have reacted by implementing automatic plan features at an increasing rate. This trend has caused largely positive results. It has raised participation and savings rates. Automatic escalation will cause those savings rates to climb over time. With employees now relying on participant-directed plans as their primary retirement savings vehicle – representing a shift from the plans' original supplemental function – plan sponsors' embrace of automatic enrollment and automatic escalation has moved many participants closer to the necessary and appropriate savings rate.

On the opposite end of the spectrum, the reliance on automatic features removes incentive for employees to be engaged. Employers invest time, dollars, and risk capital in their attempt to provide a competitive – if not superior – retirement plan package. The return on that investment is low when employees are disengaged because they have less appreciation for the employer's contribution to their retirement security. Simply put, automation feeds inertia and stifles engagement.

An investment refresh process complements automatic features and reverses those negative trends. It allows for a call to action, in which an employer urges its employees to update their investment elections. It allows for the employer to emphasize the value and importance of the plan, and to remind employees of the need to remain engaged. When done correctly in the form of an "active re-enrollment" (discussed more fully later in this Paper), employees are likely to also increase their current and future savings rate. Employers seeking greater employee engagement are likely to attain that goal through an investment refresh process.

C. Fiduciary Protections

At various levels, plan fiduciaries are responsible for participants' investment choices. Unless delegated to an ERISA 3(38) fiduciary investment manager, the plan trustees are responsible for the menu of investments available to participants. In the absence of compliance with ERISA section 404(c), the plan trustees are responsible for the participants' investment choices. In either of those scenarios, trustees face exposure when poor-performing and/or overpriced investment options remain in the plan. More specifically, though, the magnitude of that exposure depends on the amounts invested in arguably imprudent investment options. Plan trustees can mitigate that risk by implementing an investment refresh process using a default investment that meets specific safe harbor criteria. Many call that a "QDIA re-enrollment".

Congress and the Department of Labor took deliberate steps to protect fiduciaries in the case of default investments. Provided that a plan's fiduciaries comply with the Qualified Default Investment Alternative (QDIA) regulations, they will not be held responsible for default investments made on behalf of retirement-plan participants who failed to elect their investments. As one federal court explained it, "the DOL regulation created 'safe harbor relief from fiduciary liability'" for fiduciaries who direct automatic-enrollment investments into QDIAs. That court explicitly and unwaveringly confirmed that the protections apply in the re-enrollment context.

The lawsuit (*Bidwell v. University Medical Center*[vii]) centered around two participants who experienced five-figure losses following an untimely transfer of their plan accounts from a stable value fund to a QDIA. The transfer occurred in the Summer of 2008, as the stock market began its freefall and the price of the plan's QDIA quickly fell. The participants alleged that the plan's fiduciaries had breached their fiduciary duties by transferring not only defaulted assets, but also assets the participants had affirmatively elected to be invested in the plan's default option. They alleged further that the QDIA protections were inapplicable to such a situation. The court disagreed, recognizing that the QDIA regulation clearly applies in the default investment refresh scenario: "In essence the DOL explained that, upon proper notice, participants who previously elected an investment vehicle can become non-electing plan participants by failing to respond." By following the QDIA regulation's requirements, the plan's trustees were protected from any liability tied to the default re-enrollment process.

This regulatory safe harbor clears the way for fiduciaries to gain protection by offering a default investment refresh process that utilizes one of the three permissible types of default investments: (1) a balanced fund; (2) target date funds; or (3) managed accounts. A proper QDIA notice process will ensure that engaged participants bear responsibility for their new elections and non-acting participants bear responsibility for any investment in the QDIA. A QDIA re-enrollment increases fiduciary protections.

D. Perfect Timing: New Investment Options

The introduction of a group of new investment options presents the optimal opportunity for participants to refresh their investment elections. As discussed above, most plan sponsors recognize that most employees are not utilizing appropriate and updated portfolio allocations. This begs an obvious question about the age-old approach of "mapping" investment options from an old line-up to a new line-up: if we firmly believe most participants' investment elections are out-of-date and/or out-of-risk-alignment, why perpetuate that inadequacy by merely moving the same allocation choices to the new investment line-up?

The answer to that rhetorical question has led recordkeepers and investment consultants to recommend refreshed investment elections at the time of significant changes to a plan's investment line-up. This could occur when a plan changes investment advisors (and core fund line-ups). It commonly occurs when a plan adds a new professionally managed strategy, such as risk-based portfolios and age-based target date funds. When the entire fund line-up turns over, it makes sense that participants could benefit by re-evaluating their investment mix. When a plan begins to offer a new professionally managed strategy, it makes sense that participants could benefit by utilizing such a strategy, particularly given participants' poor track record of managing their own assets.[viii]

IV. Debunking the Myths

An earlier section of this White Paper clarified that a "re-enrollment" does not require a new enrollment or savings election. Beyond the misunderstanding created by the misleading terminology, plan sponsors may offer up additional objections.

A. "Participants Will Object."

The most common rationale for rejecting an investment re-election process is the fear of participant objection.[ix] With more than a decade of data since Congress encouraged automatic enrollment, automatic escalation, and the use of a QDIA through the Pension Protection Act (PPA), we see that fear to be both common and misplaced when implementing one of the PPA plan design tools. In the automatic enrollment and automatic escalation context, participants have confirmed that they support and appreciate their employers' use of those automatic features.[x] Similarly, research shows that many participants prefer for their employers to take on a leadership role with respect to plan investments and guiding participants to their investment elections.[xi] JPMorgan reported that an astonishing 82% of participants support their employers conducting a re-enrollment.[xii]

We would be remiss if we did not acknowledge the possibility of complaints from the proverbial squeaky wheel. Most plan sponsors can identify, by name, an individual or a small group of individuals who will object to any process that requires them to update their investment elections. Thus, despite agreeing (in large part) with the above discussion regarding most participants' stale or inappropriate allocations, some plan sponsors refuse to help out those participants because a small group of participants might make some noise. Consider the following responses to that thought process:

- A thoughtful plan sponsor will not permit the concerns of a small group to override what the plan sponsor knows to be in the best interests of a majority of its employees.

- Carefully think through the objection and how quickly its rationale falls apart. It presupposes that an already-engaged individual will contest the need to make a new election. If the participant is indeed engaged and frequently monitors his or her account, won't this be an easy step? And if the step is not easy, isn't that a clear sign that the participant's account is not quite as up-to-date and appropriate as he or she might have suggested?

- With that said, it may be fruitful to proactively communicate with the participants most likely to object. Let them know that you appreciate their engagement. Let them know that you wish all employees were so engaged. Let them know that you are undertaking a process that is designed to help your many employees who really need it and that you have designed the process to be as easy as possible for those who need less help. Most of the potential squeaky wheels are not objecting to the actual decision, but instead are objecting to the notion that no one took the time to consider how special they are.

B. "This Isn't Necessary."

The second most common rationale for rejecting an investment re-election process is the determination that such a process is not necessary.[xiii] This rationale conflicts with most plan sponsors' recognition that their employees are not invested appropriately. To be fair, plan sponsors may arrive at this objection after reviewing a plan-level investment report and seeing plan assets spread across the plan's many investments. When a plan sponsor sees investments in 15, 20, or even 30 different funds, it would be natural to assume that the plan is very well diversified.

Bear in mind, though, that a participant's account in a 401(k) or 403(b) plan is quite personal. The benefit is not a part of a defined benefit plan managed with all of the plan's liabilities in mind. It is provided by the specific participant's account, which must be managed in an appropriately personal manner because its performance impacts not only the value of the investment options, but also the participant's savings habits. If a 401(k) plan participant is invested too aggressively and loses too much value in a market downturn, he or she may exit the market and move to cash. Even worse, though, he or she might also stop saving. The personal nature of 401(k) and 403(b) accounts supports the conclusion that it is indeed necessary to ensure that each participant has been encouraged to make investment elections that fit his or her personal situation. A plan-wide investment report is not relevant to an employee-specific need.

C. "This Is Too Paternalistic."

Employers may be concerned that an investment refresh process represents "holding employees' hands", "telling them what to do", or "making decisions for them". In response to that concern, it is important to revisit the pension plan context. Many employers have moved on from defined benefit plans because of the cost, volatility, and/or uncertainty. Notably, they have not moved on because they disliked that the program ensured an adequate benefit for all participants. They have not moved on because they thought it made more sense for participants to manage their own investments. Defined benefit plans provided participants no choices. As a result, they were considerably *more* effective than participant-directed plans.

An investment refresh process is much less paternalistic than the traditional pension plan approach. It provides employees with ample choices. In fact, it commonly includes the addition of new choices. But that does not mean that it is not helpful. If a plan sponsor were guided by the desire to be unhelpful, it may indeed desire to avoid a re-enrollment for fear that it would help its employees. If, however, a plan sponsor desires to be helpful and provide its employees with choices, an investment refresh is an ideal strategy.

D. "This Sounds Like a Lot of Work."

A re-enrollment is not a non-event. It may indeed involve some work on behalf of those in the human resources, benefits, or payroll departments. But the severity of that workload is mitigated on two fronts. First, a re-enrollment does not involve *that much* work – at least outside of what an employer would ordinarily do to maintain and promote a retirement plan. As discussed above, it does not require participants to fill out new plan enrollment paperwork or to make new deferral or investment elections. Additionally, the plan's consultant or recordkeeper should bear the lion's share of preparing communications, conducting meetings, collecting paperwork, and processing online elections. Second, any plan sponsor responsibilities are created by employees taking positive, proactive steps that improve their level of engagement. In other words, there are great rewards for the efforts a plan sponsor's employees will invest into such a process.

V. Closing Thoughts

This Paper opened with a discussion of terminology. A thorough understanding requires the acknowledgment of an additional matter of terminology: the difference between passive and active re-enrollments. Recordkeepers have done "re-enrollments" a disservice through their passive approach. In large part, they are not hoping for proactive elections. They are not striving for higher engagement. They are, instead, counting upon inaction among disengaged participants who will accept the default target date fund applicable to their age.

The most impactful implementation of an investment refresh process requires an ideological commitment to an *active re-enrollment*. Employees should receive clear communication touting the employer's rationale for and excitement over the changes. Employers should encourage – if not mandate – that employees attend meetings to learn about the changes. The investment consultant should orchestrate those meetings with a focus on proactive elections and creating the foundation for ongoing engagement. The consultant should track the proactive steps and report the corresponding data to the plan sponsor.

A passive re-enrollment is good; an active re-enrollment seeks to be great. By focusing on accurate terminology – an investment refresh process that does not require any "re"-actions – a plan sponsor and its employees may reap the rewards described in this Paper. Participants will update and improve their asset allocations. Employees will reverse their inertia and improve their level of engagement. Fiduciaries improve their levels of protection, particularly when adding new investment elections that meet the DOL's QDIA requirements, such as a balanced fund, target date funds, or managed accounts. As employers attempt to put their employees on a course for a dignified retirement, an "investment refresh" or "re-enrollment" is a best practice designed to help employers achieve those goals.

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[i] Merriam-Webster, retrieved from https://www.merriam-webster.com/dictionary/re.
[ii] JPMorgan "Defined Contribution Plan Sponsor Survey Findings" July 2017 (hereinafter "JP Morgan DC Plan Sponsor Findings 2017").
[iii] PWC "Employee Financial Wellness Survey", April 2017.
[iv] JPMorgan "Defined Contribution Plan Participant Survey Findings" July 2016 (hereinafter "JP Morgan DC Plan Survey Findings 2016").
[v] JPMorgan DC Plan Sponsor Findings 2017
[vi] Russell Investments, "Defined contribution plan re-enrollment: A fiduciary imperative?" March 2016 (hereinafter "Russell Investments DC Plan Re-enrollment".
[vii] No. 11-5493 (6th Cir. 2012).
[viii] J.P. Morgan Asset Management "Guide to the Markets", January 2018 (citing Dalbar Inc. study demonstrating average investor dramatically underperforming other asset classes during the 20-year period beginning in 1997).
[ix] Callan "Defined Contribution Trends Survey" 2017; (hereinafter "Callan DC Trends Survey"); JPMorgan DC Plan Sponsor Findings 2017
[x] JPMorgan DC Plan Survey Findings 2016.
[xi] Russell Investments DC Plan Re-enrollment.
[xii] JPMorgan "Top Re-enrollment Misperceptions" August, 2017.
[xiii] Callan DC Trends Survey.

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