Mercer

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Top considerations for defined contribution plans in 2024

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Summary

In light of persistently high inflation and market volatility, financial concerns remain top-of-the-list for American workers. Mercer's 2023 *Inside Employees' Minds Survey* found that employees are now most concerned about covering their monthly expenses, being able to retire and (especially for lower-income workers) rising personal debt levels. From a corporate perspective, a September 2023 Employee Benefit Research Institute survey revealed that 39% of employers rate their employees' financial well-being as a high concern in 2023, up from 29% last year.

Companies are finding that they need to focus on employee financial well-being while addressing broader workforce management issues. This challenge is causing many organizations to consider full or partial delegation of their retirement plans' investment and operational responsibilities. For some, this is the first time they have investigated this option.

Defined contribution (DC) plans continue to be challenged by a less certain outlook for capital markets. At the same time, financial concerns — from day-to-day expenses to retirement considerations — continue to rise in importance for plan participants.

Although the "great resignation" or "great rethinking" appears to have nearly run its course, benefit teams have not seen much relief and continue to be asked to do more with less. Elevated turnover is having an impact on committee membership, retirement plan staff and institutional memory.

Employees continue to report that one of their top concerns is being able to retire. As a result, investment committees will have to dig deeper into their investment offerings. They need to evaluate the potential for unintended risks, and find new opportunities through avenues such as private investments.

In addition, prompted in part by the SECURE Act 2.0, sponsors should look more strategically and holistically at what they offer participants, including cost-effective income solutions that help get participants to and through retirement.

Another challenge comes from the development of more sophisticated and more insidious cyber and data risks. These, when added to continued fee litigation, are prompting many plan sponsors to consider risk management through a new governance lens — just as they are weighing the challenges and opportunities presented by Artificial Intelligence (AI).

This paper offers ways for sponsors to align their investments — and their plan design features and operations — to match the evolving needs of participants.

Six themes to consider for 2024

1. What are you getting from your investment providers?
2. Is there any juice left to squeeze?
3. Are you thinking like a participant?
4. Participants are sticking around for longer. How will you navigate their retirement income needs?
5. Does your DC plan need a chief risk officer?
6. The arrival of AI — how can you keep pace?

1. What are you getting from your investment providers?

Quarterly fiduciary committee meetings generally include discussions of investment performance and risk. However, an important and sometimes overlooked step involves looking at how subtle changes to investment strategies are being affected by evolving capital markets. Similarly, it is important to look for any unintended consequences as industry dynamics and cost pressures drive change. In light of these concerns, the following shows four areas we believe warrant closer examination.

- US large cap growth — the appreciation of growth stocks has continued, creating diversification and operational concerns for some investment managers. Many managers prudently limit their allocations to individual securities at a certain level (or are required by the US Securities and Exchange Commission (SEC) classification of their investment funds to act in this way). As a result of risk controls, active large-cap growth managers may be forced to underweight high-conviction names relative to market-cap-weighted indices, or to reclassify their funds from diversified to non-diversified. It is therefore important to understand whether this is an issue for your large-cap growth option and to consider how best to release the pressure valve if needed.

- Managed accounts — an increasing number of DC plans offer managed accounts, as sponsors seek to respond to participants' desire for advice. Not surprisingly, new proprietary managed account offerings from recordkeepers are therefore on the rise. However, not all models are created equal and there can be notable portfolio impacts for participants. Understanding the portfolio creation process, especially the nature of investment allocations, is therefore critical as these solutions can vary significantly. Additionally, fiduciaries should be wary of being lured by "low-cost" options. They should understand how such solutions differ from those being put forward by other providers and evaluate the impact they will have on overall administrative fees.

- Target-date funds — target-date fund providers continue to look for unique ways to address the interest of participants and plan sponsors in retirement income, personalization and environmental, social and governance (ESG) offerings. Many providers are aiming to offer a target-date flavor to meet different participant needs. This is being done in the hope of gaining or maintaining market share in this increasingly competitive space. We believe target-date funds set up with an eye towards facilitating decumulation in a way that feels customized, and which also includes an income stream, will gain interest in the near future. As this is the default of most DC plans, it is critical for plan sponsors to evaluate how their target-date provider and others are evolving their relevant glidepaths and strategies.
- Capital preservation — the recent swift increase in rates, and the current high interest rate environment, have both benefitted money market funds. At the same time, by design, stable value funds have seen a more gradual increase in crediting rates. This has led some sponsors to question whether the addition of money market, with or without the elimination of stable value, is warranted. The current interest rate environment is also bolstering yields in other DC plan fixed-income options. This factor should also be taken into consideration in conjunction with capital preservation options. We encourage fiduciaries to consider the longer-term interest rate environment, which is expected to benefit stable value. They should also consider the complexities of offering multiple capital preservation options before taking any action.

25% of institutional asset owners plan to use OCIO for the first time or to expand their OCIO relationships in the next 24 months.

Source: Cerulli US Outsourced Chief Investment Officer Function 2022; 172 institutional asset owners.

2. Is there any juice left to squeeze?

Labor markets have shifted rapidly over the past few years. Now that we are on the other side of the "great resignation," companies are looking for opportunities to reduce expenses and enhance resource efficiency. Benefit teams are being asked to do more with less. At the same time, elevated turnover is having an impact on committee membership, retirement plan staff and institutional memory.

Outsourcing components of DC plan management (or outsourcing all aspects of it) is one answer to resourcing and turnover pressures. It could also offer improved governance, as OCIO and related administrative teams provide daily oversight of plan investments and operations. Some large and multi-national sponsors may be able to take advantage of their own size and scale to reduce workloads and save on costs by being more efficient. This can be done through globally structured investment strategies with the support of an OCIO. While for those with an employee base concentrated in the United States, pooled employer plans (PEPs) and other pooled plan structures may be an attractive mechanism to offload both investment and operational duties.

Another area of opportunity that will continue to appear for plan sponsors is the role of private investments in DC plans. Mercer's 2024 *Inside Employees' Minds* study finds that being able to retire is the second-highest concern of employees. It also finds that 72% of respondents say that inflation and volatility have increased their levels of stress. As fiduciaries grapple with how to help employees with these financial pressures, earnest discussions need to be had about private assets, such as private real estate, private debt or infrastructure. Private assets help diversify return sources, especially in an unpredictable geopolitical and interest-rate environment. They also have the potential to improve returns over the long term. Private investments require expertise in execution, given complexity in managing liquidity needs. Greater scale is also helpful in providing access to better fee or investment structures. OCIO and PEP models can provide solutions for both.

3. Are you thinking like a participant?

Participants may not think of their financial resources in the same way that benefit programs are structured, which may lead to lower adoption of these programs. At the same time, employers are continuing to provide new financial wellness benefits for their employees often through separate point solutions. As the links between long-term retirement benefits and shorter term financial needs strengthen, point solutions will need to become more encompassing if they are to truly add value. Furthermore, framing your benefit offerings to align with participant needs will be key as DC plan features and other benefits continue to evolve to address broader financial needs.

To ensure that efforts to address employees' needs do not get ignored, it is important to have a thoughtful, holistic approach to communications and engagement. This is important as messaging included in off-the-shelf materials may not be effective or aligned with your organization's broader strategy. Having an annual planning session and reviewing materials regularly may help improve the overall effectiveness of your participant outreach.

The opportunity to expand DC plan design sparked by SECURE 2.0 could also prompt you to take a strategic look at what you offer to participants. Ask the following types of questions:

- How will the changes required under SECURE 2.0 affect your current retirement benefits?
- How will the necessary and optional changes align with your other benefit offerings?
- Are any changes that you are considering duplicative with an existing offering?
- Are participants better served by a different offering outside of the DC plan?
- What is the cost/benefit of individual financial wellness benefits if they are delivered through the broader DC plan?

Conducting a detailed analysis of potential plan design changes could open up a path that will lead to an enhanced retirement plan and more cohesive financial well-being program.

88% of Boomers, 86% of Gen X and 92% of Millennials want access to retirement income options.

Source: 2023 Natixis Defined Contribution Plan Participant Survey.

4. Participants are sticking around for longer. How will you navigate their retirement income needs?

The design of DC plans and communications, along with the mainstream media, have encouraged DC plan participants to leave assets in their prior employer's plan after termination or retirement. This benefits both the participant (through institutional quality investments and pricing) and the plan (through economies of scale). It also underscores the importance of developing a retirement income philosophy. Most DC plans and committees are well versed in structuring prudent plans for the accumulation phase of the retirement savings journey. However, many have yet to develop an approach for supporting participants as they transition to and through retirement.

The market is rapidly developing new retirement income solutions and investment offerings. Recordkeepers are increasingly offering sophisticated education resources and tools aimed at facilitating the decision-making process for participant. In partnership with insurers, investment managers have developed guaranteed income solutions and are working with recordkeepers to facilitate their administration. Some of the largest target-date fund providers are already live, or are in the process of launching guaranteed income variations of their target-date suites. Managed account providers are offering customized guidance and advice for the drawdown period. Employees of all ages want guidance and help.

We therefore anticipate that evaluating retirement income solutions will become a requirement for plan fiduciaries within the next five years.

Building a retirement income strategy starts with research and education on the current landscape. It also requires a detailed assessment of your participant population. Understanding the demographics of your participants will help shape an overarching philosophy on retirement income. If it is to be successful, this process will take time and careful deliberation. Starting these conversations now is critical to delivering future outcomes that will benefit employees.

5. Does your DC plan need a chief risk officer?

The risks DC plans face continue to grow and change. This means that the processes for managing those risks must also evolve. At times, it may feel like you need an expert on DC plan risks solely to keep pace with developments and avoid any missteps.

Cyber and data risk management have taken center stage recently and we anticipate that both the number and level of threats will increase as bad actors learn how to use AI. Undertaking a risk audit around cyber and data protection is an effective way to uncover potential gaps in your protective measures.

It is also important to highlight that ERISA plans are carved out of most corporate cyber insurance policies. We believe that this is an emerging focus for insurance and will be a new type of offering alongside fiduciary liability insurance.

Similarly, lawsuits are becoming more nuanced. We saw the first jury trial for an ERISA case in 2023. There has also been a recent suit relating to ESG use through brokerage windows. Fees continue to be one of the main sources of litigation. However, cases are now going farther than they did previously. They are now considering managed accounts and other plan features. They are even moving into nuances of plan administration. Virtually all areas of DC plans are potential targets for litigation. This underscores the importance of ensuring that plan administration and governance procedures are well established and well documented.

6. The arrival of AI — how can you keep pace?

As a result of the rapid growth and integration of AI into daily life, we believe changes will follow in how retirement benefits are consumed, and how DC plans are administered. From a communication perspective, tools like ChatGPT will eventually be able to replace the process for creating both highly customized participant communications, as well as standard disclosures and notices. These new communications will hopefully drive more participant behaviors at a reduced cost.

Data storage, analysis and access will also evolve. Recordkeepers that have not already migrated to the Cloud (or even started the process) are already behind the curve. Those who do not integrate the capabilities of AI into the analysis and provision of comparative plan information will struggle to engage plan sponsors. They will also lag in the development of participant tools and solutions.

The growth of AI should mean that data accuracy will improve and that transitions from different administrative platforms will become smoother and easier to execute. On the flip side, better out-of-plan consumer experiences and customization — without the confines of ERISA — may lead to reductions in the retention of former participants' assets. However, this will provide opportunities for multi-and pooled-employer plans to fill those gaps and also help set the standard of participant experience with their greater combined resources.

Sponsors should keep a close eye on how plan service providers are preparing for and integrating AI into their offerings. This should lead to open and productive dialogues about the issue.

Conclusion

Given participants' key concern about being able to retire, plan sponsors need to take a fresh look at how their investment managers are addressing this issue. They need to evaluate all relevant elements, including investment strategies, advice models, target-date structures and capital preservation options.

The time pressures afflicting so many benefits teams is causing some organizations to consider a change in historical practices linked to the management of their DC plans. Potential changes include the partial or full delegation of investment and operational responsibilities. In addition, nudges from SECURE 2.0, along with a more consumerized digital experience, are driving an ongoing push for short- and long-term benefits solutions. These are being designed to improve employees' financial well-being and, increasingly, to run in concert with their employer's company DC plan.

Finally, companies should be directing more attention and resources to managing emerging cyber and data risks. They should also consider the opportunities and challenges linked to AI. This all points to the benefits of taking a more focused approach to risk. It will become ever more important to have open dialogues around governance and the development and documentation of all policies and procedures designed to protect both participants and plan fiduciaries.

Contact us

If you'd like to discuss the findings contained within this report in more detail, or if you'd like to explore the ways in which we may be able to support your organization's DC plan, please contact your Mercer consultant.

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