Defined Contribution Institutional Investment Association

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Investment Menu Influences in Defined Contribution Plans: Considerations for Plan Sponsors

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INTRODUCTION

Designing an optimal menu of investment options for a defined contribution (DC) plan that will meet the needs of an organization's diverse set of demographics is a challenging task for plan fiduciaries. Any decisions around the investment menu at the plan level with fiduciaries, committees and providers ultimately impact the participant-level investment experience. Best practices related to investment menus suggest that committees employ a diligent process when designing a menu and selecting managers. This would also include a documented rationale for the investment lineup and diversification options offered to plan participants as well as ongoing monitoring. It is also important to consider the variety of external factors that can impact and ultimately influence DC investment menus. In this brief paper we discuss five influences:

1. Participant behavior and demographics
2. Fiduciary committee beliefs and preferences
3. Regulatory, legislative and legal considerations
4. Industry providers and advisors
5. Capital markets

START WITH THE PARTICIPANT

Behavioral finance explains that, when faced with complex decisions, participants can become overwhelmed by the time and effort required. Because of this, they tend to have difficulty in making logical and rational decisions. DC plan sponsors are challenged with the goal of simplifying the decision-making process, minimizing the opportunity for biases to take over, and helping to guide participants in taking a more systematic approach to selecting their investment options.

Plan sponsors have widely adopted a three-tiered approach to structuring an investment menu as it provides a framework for understanding the plan's demographics in a systematic fashion. Exploring influences on the investment menu through the lens of the three-tiered approach can help plan sponsors understand the overall importance of each influence and evaluate its potential impact on the investment menu design. Below is a high-level overview of the three tiers – note that this approach is one of many, and there is no single "best" approach to designing an investment menu.

Tier 1 – Do it for me

Objective: Provide participants who take no action or do not want to make investment decisions with an automatic asset allocation solution, such as target date funds (TDFs), which give participants a diversified portfolio of broad market exposure. This typically serves as the plan's qualified default investment alternative (QDIA).

Tier 2 – Help me do it

Objective: Provide participants who want to take a more active role in managing their retirement with a diverse set of investment options so they can create their own diversified portfolio. This typically includes both actively and passively managed single-asset class funds.

Tier 3 – Do it myself

Objective: Provide participants who are more sophisticated investors with additional investment choices that may not be suitable for the broader participant base, such as individual stocks and bonds that are offered through a self-directed brokerage account (SDBA).

THE INFLUENCES

Building upon the awareness of the different investor types among plan participants, there are five key influences that are broad-based in nature that plan sponsors may want to consider when designing an investment menu or reviewing the current menu for enhancements.

Participant Behavior and Demographics

Understanding the diverse backgrounds and behaviors of plan participants and beneficiaries is crucial for committees and fiduciaries to make informed decisions about investment offerings. By researching participant engagement with plan features and responsiveness to communication strategies, committees can gauge the pulse of their participant base. These insights allow for the development of plan investment offerings that resonate with current participant trends and preferences, ensuring that investment options are not only suitable but also appealing to them. Maintaining a comprehensive overview of updated participant characteristics enables committees to align their investment decision-making processes with the evolving expectations and requirements of the participants.

Fiduciary Committee Beliefs and Preferences

Fiduciaries adhere to high ethical, legal, and strategic standards in managing retirement plans, ensuring that all operations are conducted with integrity and in the best interest of participants. This involves setting investment beliefs that align with participants' best interests, fostering transparency, and documenting differing beliefs and outcomes to fulfill fiduciary obligations. Fiduciaries are required to plan in perpetuity if any given plan is in operation, including for committee turnover, and committee training is ongoing. Engaging with providers and legal experts and using high-quality research are critical steps in formulating fiduciary opinions that reflect the latest trends and best practices, with a conservative eye for innovation in investments, providers and more when appropriate.

Regulatory, Legislative, and Legal Considerations

Navigating the complex landscape of regulatory, legal, and legislative influences is crucial for retirement plan committees. Staying abreast of legislative developments such as the SECURE Act 2.0 and legal challenges is vital as these can influence the structure and operation of retirement plans. Committees can be proactive in anticipating how new laws and regulations will affect plan administration and fiduciary responsibilities. Engaging with legal experts and staying informed of industry thought leadership are critical steps in formulating strategies that reflect the latest regulatory requirements and best practices. Safe harbors can offer some protections, but sometimes safe harbor plan designs such as QDIA regulations come with limitations and inflexibility.

Industry Providers and Advisors

Effective management of providers' investment influence involves conducting thorough due diligence of those providers, continuously monitoring their services, and ensuring their alignment with a plan's objectives and fiduciary standards. Providers also strongly influence the adoption of technological innovations that can shape potential changes to investment options and services. Potential for conflicts of interest also may exist where an advisor or provider might recommend investment or insurance products and services that benefit their own firm rather than the plan participants. Recordkeeper, consultant, advisor, or other provider restrictions might impact specific investment product availability, personalization or customization options, as well as affecting costs and potential for innovation.

Capital Markets

Capital markets and economic factors such as interest rates, inflation, and market valuations also influence investment menus and require monitoring by investment committees and consultants. Fluctuations in these factors impact decisions related to asset allocation, diversification, and the selection of asset classes within different tiers and structures, including glide paths in TDFs. To ensure investment options stay relevant and effective, it is crucial for committees to regularly review them based on these economic indicators, employing strategies informed by modern portfolio theory and concepts like expected values and asset allocation. Committees may also want to consider the diverse risk tolerances of participants, integrating these into the broader plan-level risk management strategies.

CONCLUSION

Discussions around investment menus at the plan level with fiduciaries, committees, and providers ultimately impact the participant investment experience. Having a systematic process and regularly discussing investment influences with an investment consultant or advisor, such as in conjunction with an existing fund selection process, may lead to an evolution of the investment menu over time and may identify potentially needed updates to plan documents and investment policy statements that can help plan sponsors better manage investment risks for the plan.

One solution does not fit all, but plan sponsors have a fiduciary responsibility to understand their plan's unique attributes and considerations and design an investment menu that meets their participants' needs and is consistent with the plan objectives. Most importantly, investment menu decisions should be "solely in the interest of plan participants and beneficiaries." Understanding key investment menu influences may help to inform these decisions and lead to better participant outcomes.

Please see the Appendix for exhibits intended to describe in more detail the key themes. We encourage plan sponsors, their advisors, and others to actively engage with the content and tailor it to their own unique circumstances.

APPENDIX

Exhibit 1 – Participant Tiers of Preferred Investment Approaches

PREFERRED INVESTMENT STYLE	DESCRIPTION
Tier 1: **Do it for me.**	Participants who invest exclusively in the default investment choice of a defined contribution (DC) plan are typically provided with target date funds, balanced funds, and managed accounts that qualify for QDIA safe harbor status. The default investment, known as the qualified default investment alternative (QDIA), is where participants are defaulted if no action is taken. This tier was re-invented in 2006 with the Pension Protection Act (PPA) QDIA and other automatic enrollment regulations. Participants in this category benefit from an automatic asset allocation solution and a diversified portfolio of broad market exposure. By offering a professionally managed and diversified investment option, it ensures that participants have access to a well-structured investment strategy without needing to actively manage their portfolios. This approach aligns with the goal of providing a simplified and effective investment solution for participants who prefer a hands-off approach to their retirement savings.
Tier 2: **Help me do it.**	This tier of investment preference is for participants who prefer an assisted process in selecting investments, but also a more hands-on approach to managing their retirement savings by using a core menu of investment options. This generally includes various cash, bond, stock, and other asset classes. This tier offers a mix of active and passive options in in mostly mutual fund, CIT and separate account vehicles, allowing participants to create diversified portfolios with broad market exposure. Participants benefit from a more involved approach to their investment decisions, balancing professional management of the asset classes, with more personal control over their asset allocation. The core menu typically includes designated investment alternatives (DIAs) and follows a 404(c) safe harbor approach to maximize plan sponsor and provider fiduciary protections, although it is not mandatory. This tier caters to participants who want to tailor their portfolios to their individual risk tolerances and financial goals.
Tier 3: **Do it myself.**	The third tier of participant investments in DC plans includes options beyond the DIAs within marketplace windows such as SDBAs and annuity marketplace. Offering individual stocks, bonds, mutual funds, ETFs, and annuities to this tier appeals to participants who prefer a hands-on approach to managing their retirement savings, often with the guidance of an advisor. However, only 20% of accounts in this tier are managed with an advisor, emphasizing the need for participant education and support. The evolution of technology and trends has increased the flexibility and control participants have over their investments, but this also introduces complexities. Challenges such as recordkeeper limitations and regulatory separation from safe harbor rules pose risks for plan sponsors and participants. The industry needs to balance the benefits of flexibility and diversification with rules and regulations to improve retirement security and outcomes.

Exhibit 2 – Examples of Goals, Objectives and Best Practices to Managing Investment Menu Influences

INVESTMENT MENU INFLUENCES	DO IT FOR ME	HELP ME DO IT	DO IT MYSELF
Participant Behavior and Demographics	- Align the default investment option with the diverse needs and behaviors of participants and beneficiaries. - Ensure that QDIA is suitable for participants based on their age, salary, account balance, longevity, etc. - Review the algorithm and data points that impact asset allocation decisions of QDIA, glidepath and other providers.	- Consider engagement and financial literacy to inform the complexity and number of options offered. - Analyze demographics, participant behavior and preferences so that list of options meets participant needs. - Review the set of asset classes that are available in the QDIA and glidepath for potential overlap and confusion.	- Consider participant engagement and financial literacy when deciding to offer marketplace windows. - Focus on the needs of participants of what is not available in the core menu or what investments are within the default tier. - Review the level of investment advice that is provided to participants within annuity and brokerage windows.
Fiduciary Beliefs and Preferences	- Coordinate plan governance with employer decisions, committee decisions, provider and advisor decision support. - Encourage ongoing QDIA committee education and discussions for new and existing committee members. - Incorporate various views and perspectives from committee members that influence decisions around designing investments.	- Following and documenting a process of discussing fiduciary beliefs can help a committee align to plan goals and objectives. - Remain focused on designing an optimal participant-focused investment menu that matches committee beliefs. - The number of options and complexity of core menus is the heart of discussion so documenting beliefs is important.	- Determine if the employer wants to offer a marketplace offering and instruct the committee to consider options. - Determine the level of paternalism within these accounts or allow them to be fully flexible with little employer involvement. - Consider their integration into the other parts of the holistic retirement income security picture both in and out of plan.

INVESTMENT MENU INFLUENCES	DO IT FOR ME	HELP ME DO IT	DO IT MYSELF
Regulatory, Legislative and Legal	Leverage QDIA and other safe harbor rules when selecting the type of default options to consider. Follow the DOL Target Date TIPS and GAO discussions on advice, TDFs and more. Stay abreast of legal wins and losses and their potential risks of target date funds, influence of CITs, etc.	Leverage fiduciary standards such as 404(c), 3(38) and other safe harbor rules. Consider investments that synch QDIA and Core Menu asset classes, replacement ratios, benchmarks, etc. Review rules and risks of income-centered offerings, stable value and company stock implications, alternative investments, etc.	Understand fiduciary responsibility to offer a window and the types of investments and insurance available. Review participant level advice standards of the marketplace accounts and where advisor support might help participants. Review IPS language for the availability of marketplace services.
Industry Providers and Advisors	Create a systematic process for the selection, monitoring and retention of the plan's default options. Hear proposals from diverse industry perspectives through research on current trends from 3(21), 3(38), OCIO and other investment advice providers. Periodically review the investment options and services available in default option.	Create a systematic process for the selection, monitoring and retention of the plan's core menu options. Synchronize investment analysis at the plan level directly to participants such as asset classes, income replacement assumptions, etc. Understand fiduciary and nonfiduciary services for investment advice and guidance to both plan and participants.	Perform RFPs periodically to monitor for innovations and review thought leadership to design for marketplace providers. Review recordkeeper capabilities for one or more of these types of investment and insurance marketplace services. Consider in plan and out of plan providers and resources that coordinate retirement income accounts.

INVESTMENT MENU INFLUENCES	DO IT FOR ME	HELP ME DO IT	DO IT MYSELF
Capital Markets and Macroeconomic Environment	☐ Understand drivers of asset allocation, expected returns, and investment assumptions when selecting a default option. ☐ Diversify the default across a broad set of asset classes and manage risk across all participants' investment horizons. ☐ Periodically review expected returns of underlying asset classes used in multi-asset portfolios and models.	☐ Diversify investments across various asset classes such as cash, bonds, stocks and multi-asset funds. ☐ Consider the impact of asset classes such as income-oriented approaches, hybrid insurance CITs, income centered objectives. ☐ Understand how participants are building portfolios with the available building blocks in the plan with other outside accounts.	☐ Allow participants to self-select outside investment options to further optimize their own risk and return preferences. ☐ Offer access to securities such as ETFs, Funds, stocks, bonds, models, CITs, and more. ☐ Offer access to guaranteed products such as immediate annuities and deferred income annuities.

ABOUT DCIIA

Founded in 2010, DCIIA is a non-profit association that brings together constituents across the financial ecosystem to help America's workforce save for retirement and achieve broader financial security. DCIIA's 300+ member organizations include investment managers, consultants and advisors, law firms, recordkeepers, insurance companies, data providers, plan sponsors (through the Plan Sponsor Institute) and others who are collectively committed to the best interests of America's workforce. DCIIA also conducts proprietary research and participates in industry collaboration on retirement topics via the DCIIA Retirement Research Center. DCIIA is the association partner of the Journal of Retirement. For more information, visit: www.dciia.org.

DCIIA Defined Contribution Institutional Investment Association