



RETIREMENT PLANS

Bridging the Gap

By [Robert Rosenberg](#)

Three years ago, \$4 billion Hallmark Co. was struggling with a decision that it saw as financially necessary, but morally difficult. The 97-year-old privately owned greeting card manufacturer, which is still run by the grandsons of its founder Joyce C. Hall, was being forced to freeze its 62-year-old traditional defined benefit (DB) plan and replace it with a cash balance plan. Payments would be made into that fund until January

2010, and then those too would end. Like other companies propelled down this road by the increasing volatility of pension assets and liabilities—IBM Corp. becoming the poster company of otherwise good employers pulling the plug on traditional DB—Hallmark started out by sweetening its 401(k) plan match in January 2006—the date of the freeze and switch to the cash balance plan. It promised to sweeten it again—this time to a 60% match on 5%—in 2010 when it was scheduled to suspend pay credits. Hallmark also supplements the 401(k) with profit sharing between 5% and 10% annually on employee salaries.

But that didn't feel like enough to Hallmark or to Doug Judd, the investment manager for Hallmark's DC, DB and senior management retirement plans. While the company did as much as it could to protect the employees' 401(k) holdings by providing portfolio management tools, Hallmark knew that what it took away with the DB plan was the steady stream of income over the lifetimes of its employees, and what it needed to replace it with was some kind of road map that would help its former workers make it through retirement. So, Judd was assigned to look for options to help Hallmark's employees—not with how to build the nest egg, but how fast to spend it. "You retire with a lump sum, say a million dollars—but this is not your father's million dollars," says Judd. "How do you make the money last? Because if you follow the actuarial tables, then you could live another 20 or 30 years."

The quest led Judd to MassMutual and a new product category, the retirement management account. An RMA is an income planning and administration program that allows a person to assess his or her needs in retirement. It then provides a guide to making savings last through those leisure years. In the RMA model, a plan is devised that will give the person a steady stream of income during those years, but since few can say for sure how many years that will be—insurers coming closest with their actuarial models—the program involves a combination of products including equities, fixed income and, probably the most critical element, an annuity. "The RMA is like a personal pension plan tailored to the specific and changing needs of the retired employee," says J. Spencer Williams, senior vice president of MassMutual Income Group. Unfortunately, at this time, MassMutual doesn't offer this as an institutional product to be used within an active 401(k). But in the RMA, Judd saw the seeds of what companies will ultimately need to be providing their workers. "The idea that they're bundling together in one package the financial consulting, along with the annuities and the modeling, to figure out how much you can take out of the account is something that could be appealing," he says.

Welcome to the new vision of corporate paternalism. While companies are feeling the financial pinch and cutting back on certain traditional benefits, a growing number are more than willing to provide employees with as many options and as much good advice as companies can lay their hands on. The realization has finally set in that, with contracting Social Security and Medicare coverage and declining numbers of DB plans offered, employees are left with nothing but their 401(k) and a fervent hope that the money can hold out as long as the body. "Employers now understand that they need to help educate employees that 401(k) plans are retirement plans, not supplemental savings plans," says Mercer Human Resource Consulting CEO Michele Burns. And the sad fact is that "employees don't seem to be saving adequately." Essentially, quips Judy Schub, managing director of the Committee of Investment of Employee Benefit Assets, which represents pension plan sponsors, "it's the DB-ization of DC plans."

Why should companies care what happens to employees after retirement? Aside from the fact that the next generation set to retire

will be the biggest the nation has ever had to contend with and their insolvency can only drag down the overall economy, executives are beginning to appreciate that the size of the generation will also have a massive impact on their workforces and the supply of labor. On one hand, companies want to maintain as much of their historical knowledge base as they can—they at least don't want to see it walk out the door at one time. On the other hand, they don't want hordes of lower productivity workers remaining on the job simply because they can't afford to retire. "Strategically, employers are beginning to see a need to understand what happens to their workforce if they have not adequately saved for retirement," says Burns. "A strategic CFO is focusing on what changes to my retirement plan are going to do to my workforce, what behaviors will change as a result and what does that mean 10 or 15 years down the road? Will my workers be able to retire or will they be working longer—and what does that mean to my business plan?"

Unfortunately, the picture of millions of baby boomers retiring with only their 401(k) money and a likely reduced payout from Social Security to rely on is not a pretty one. First, besides those workers who are not even offered the 401(k) option—approximately 75 million, according to Center for Retirement Research at Boston College—another 20% to 30% of those who can save in a plan opt not to enroll. And it's not just less highly compensated workers who stay out of the plan: A recent survey reveals that one in 11 highly compensated employees—those earning \$100,000 or more per year—do not participate in their plans.

Then, there is the problem of early withdrawals. Employees still tend to regard the 401(k) as just another savings account, and many borrow against it regularly—a recent Wall Street Journal Online-Harris Interactive Personal Finance Poll found that 31% of participants have at some point tapped into their 401(k) plans. Many also opt to take a lump-sum payment at 59½—the first year a worker can withdraw without paying a penalty to the IRS. Some policymakers such as Alicia H. Munnell, the director of the Center for Retirement Research and a former member of the President's Council of Economic Advisers, have called upon the government to pass rules preventing these loans except in dire circumstances or with heavier penalties to discourage the practice. (See Q&A page 11.)

As recently as three years ago, the average amount held in a baby boomer 401(k) was only \$60,000, certainly not enough to carry that retiree through an average 20 years of retirement. The seriousness of the problem has not really sunk in for most boomers, possibly because their parent's generation had such a relatively comfortable retirement thanks to munificent Social Security and Medicare payouts, more plentiful corporate pension plans and a vibrant stock market. "The challenge is, What do we do going forward?" observes Mark Warshawsky, retirement research director at Watson Wyatt Worldwide, who served as an assistant secretary at Treasury during the passage of the Pension Protection Act, a sweeping reform that has opened the door for major changes in DB and DC plans. "We know intellectually that Social Security and Medicare will have to be changed in a way that will make them a lot less generous. And given what we've seen with the decline of DB [plans] for many workers, that calls for some very sober thinking."

It also calls for action, with the first of the baby boom generation set to begin retiring in the next several years. If these facts have not caused employees to pause, they have become a concern of many forward-thinking companies anxious to not only get employees into 401(k)s, but also better educated about investing and saving in general.

Congress is lending a hand with the PPA. Although initially a vehicle to fix some of the persistent problems with DB plans, the PPA lays out the beginnings of a blueprint for a richer, more comprehensive approach to 401(k)s—despite the fact that many of the specific rules and regulations are still being decided by the Labor Department.

What may turn into the most powerful tool given employers by the PPA was a provision that essentially legitimized automatic enrollment in defined contribution plans, with a minimum deduction of 3% and authorization to increase the contribution annually by 1% until it reaches 6%. Automatic enrollment basically relies on the inertia of employees—they didn't want to take the time to enroll, and now the assumption is they will probably not take the time to quit. Although some companies are holding off until the issuance of final rules by the Labor Department, the number of companies using automatic enrollment has been steadily rising over the past two years.

Another beneficial change: Plan sponsors are now encouraged to invest in life cycle or target date funds in cases where plan participants did not specifically elect an investment. In the past, those funds would have likely ended up in a low-yielding money market fund.

Companies seem ready to take advantage of these new rules. But some forward-thinking ones had started building up their 401(k) well before the PPA—albeit at the same time they were taking back the more reliable goodies of their DB plans. Besides higher matches, some plan sponsors are blazing new trails in the area of education and advice. IBM, for instance, is teaming up with Fidelity Investments and a Goldman Sachs Inc. unit, called the Ayco Co., to provide a soup-to-nuts advisory service that ranges all the way from planning retirement income to saving for college to managing debt.

Hallmark uses Financial Engines Inc.'s two primary products, the Web-based Online Adviser and Personal Asset Manager, to help employees structure their assets. With the employee's permission, Hewitt Associates Inc., Hallmark's record keeper, feeds asset information into Financial Engines, and based on the person's risk tolerance, Online Adviser provides a recommended asset allocation and projected retirement income. Personal Asset Manager performs the same role, but with a bit more hand-holding.

Among the more popular new vehicles are target date or life cycle funds. These essentially allow DC plan participants to buy into funds that will adapt their investing strategy to their age and savings objectives during all stages of their careers.

Another option growing in popularity is the annuity, and experts are pushing the insurance industry to create more affordable annuity products that provide a guaranteed stream of income and protect against inflation. In fact, Wharton School professor of insurance and risk management Olivia Mitchell points out that some countries have required that people purchase annuities: "Germany mandated them. At age 65, you have to buy an annuity that kicks in if you are still around at 85." A similar scenario in the U.S. is hard to envision. And in any event, notes Mitchell, the boomer generation has shied away from annuities, in part, she believes, because many still have not gotten their minds around the longevity risk. She suggests that there's another factor at work: "People, for better or for worse, feel like they can manage their money better. They don't want to give up control to an insurer. There's also what I call the 'lump-sum illusion': in other words, people think they're rich. Little do they realize that \$100,000—or even \$1 million—doesn't go very far." Mitchell notes that plan sponsors have been leery of offering financial advice. The PPA only speaks to what happens in the accumulation phase. "Thus far, there has been no discussion in a regulatory sense about whether there should be a default payout structure."

But, for any investment strategy to be effective, experts are fast to tell companies that assumptions about how well investment options will perform and whether employees will end up with enough of a cushion must be based on real-life participant behavior and not some fanciful image of how companies would like employees to save. JPMorgan Asset Management recently conducted an analysis of the 1.3 million participants whose 401(k) accounts are administered by JPMorgan Retirement Plan Services and uncovered three behaviors among participants that would undermine the assumptions frequently made by most target or life cycle funds:

- Most participants do not start saving 10% of their income until age 55
- 20% of participants had outstanding loans against their 401(k) between age 30 and 50
- 15% of participants make near-retirement age withdrawals starting at the age of 59½.

"To be effective, target funds must recognize the volatility that this kind of behavior brings to a portfolio," says Anne Lester, senior portfolio manager for the global multi-asset group at JPMorgan Asset Management, which has \$2 billion in nine different target date funds. "We plotted the growth of two hypothetical portfolios invested in the S&P 500. For each, we assumed the same contribution rates, but one of the participants borrowed three times against his account for such things as a home purchase, college tuition and a boat. The portfolio reflecting this real-life behavior actually ended up \$400,000 below the other, even though the loan activity was only about \$25,000."

Lester explains that the borrower-participant also chose to suspend his contributions while he repaid the loans. "That second hypothetical mirrors the behavior of a significant number of participants, and all we are saying is that funds should be designed with that in mind," Lester noted. "When folks are talking about the DB-ization of 401(k)s, we take that to mean a rigorous quantitative approach to long-term investing. As we see it, what is important for retirees right now is not always maximizing the upside, but rather minimizing the shortfall and ensuring that participants make it at least to a minimum level of income replacement. We need to be focusing not just on the median outcome, but on the median and below because those are the people who will be in trouble."