WHEN DID DEFINED CONTRIBUTION GET SO COMPLEX? OUTSOURCING CERTAIN FUNCTIONS OF YOUR DEFINED CONTRIBUTION PROGRAM.

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Introduction

NEPC, LLC has been working with defined contribution plan sponsors for almost 30 years and we see the efforts they make to ensure that they are meeting their corporate responsibilities and their plan participants' and beneficiaries' needs. In this paper we discuss outsourcing solutions for defined contribution plans, which is a new service offering available to NEPC clients. We believe it is increasingly likely that plan sponsors will look to outsources certain functions of their defined contribution plans in the coming years.

The backdrop is that defined contribution plans have become the primary workplace retirement benefit for U.S. workers, and employers are overseeing tens of millions to billions of dollars of employee retirement assets. With the support of lawyers, auditors, consultants and investment managers, employers—who are fiduciaries by law—are doing their best to safeguard participant assets, manage costs, earn above market returns, comply with regulations, and issue all the required notices and filings to maintain their plans' tax-deferred status. The burden on employer Human Resources/Benefit Departments and Treasury/Finance is significant and growing.

Increasingly, every decision a fiduciary makes is under the microscope: plan design decisions, investment manager selections and arguably benefit adequacy. Lawmakers and regulators appear ready to attach a social responsibility on employers to ensure the adequacy of their worker's retirement savings and provide them a pension-like income. Also, concerns about fiduciary liability are on the rise. Employers face litigation risk—last year an employer agreed to a $30 million settlement in a suit over the company's 401(k) plans, the highest settlement to date.

Outsourcing certain functions to a qualified expert offers relief on a number of fronts.

About Outsourcing

In 2008, Casey, Quirk & Associates, LLC released a report in which it estimated the investment outsourcing market (also called discretionary or outsourced CIO) would grow to $510 billion by 2012, representing 13% of assets and 25% of institutional investors. The firm has since updated the asset forecast to $739 billion by 2017. The demand for investment outsourcing was expected from corporate and Taft-Hartley defined benefit pensions, foundations & endowments, but a newer area is trending faster than was anticipated, defined contribution outsourcing.

Outsourcing v. Consulting

Employers commonly use consultants to support the oversight responsibilities for their company-sponsored retirement plans. Under the traditional model, the consultant brings data and recommendations to a Plan Committee, and the Committee makes and implements decisions. This consulting

Reasons to Outsource

- The burden on plan sponsors is increasing
- Lack of internal resources to manage and oversee institutional asset pools
- Defray fiduciary liability

model is today referred to as an ERISA section 3 (21) relationship. An alternate model is an ERISA section 3(38) relationship where the company or Committee off-loads fiduciary responsibility (and liability to a degree) to a consultant with discretionary authority. The Committee retains a monitoring duty to ensure that the initial selection and the ongoing retention of the delegated party is prudent.

When considering outsourcing, many organizations start with the same question: Which activities should we outsource? Areas that can be delegated in whole or in part include:

- Investment policy | investment menu
- Policy implementation | manager selection and replacement
- Custom multi-manager fund management
- Custom target date fund management
- Plan administration and compliance

Why Outsource Defined Contribution?

Running a defined contribution plan today can be overwhelming to plan sponsors and fiduciaries. Committee meetings, which a decade ago were focused on manager performance, now commonly include larger conversations, such as those that follow.

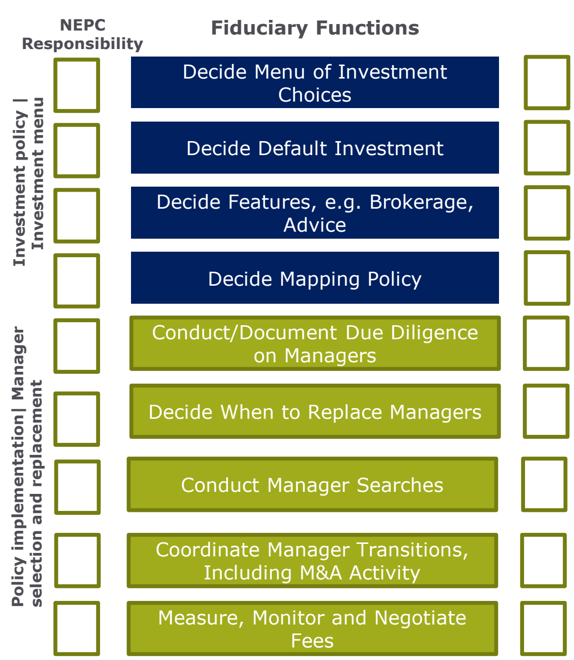
- Is the Plan working?
- Which asset classes should we offer?
- Which asset classes should be offered actively or passively?
- What is the appropriate default?
- Should we adopt a "to" or "through" glide path?
- Which types of managers should be hired?
- When should we replace underperforming managers?
- Are funds similar enough to map?
- How should we think about alternative investments?
- How should we think about income solutions?
- Is the plan large enough to support custom target date funds?
- Are fees reasonable for the services provided?
- Is the allocation of expenses fair via revenue sharing?
- Are we 404(c) compliant?
- Are we compliant with our Investment Policy Statement?

Retain or Delegate?

In a DC Outsourcing relationship, fiduciaries can choose to retain or delegate nearly any function currently in their control to a third party. In the illustration below we identify certain areas that can be retained by the client or delegated to NEPC in a 3(38) relationship.

Areas unlikely to be delegated are decisions around Plan rules (such as company matching contributions, vesting schedules, ability to take loans, etc.) and the offering of company stock. Also, Committees are likely to retain strategy-related decisions, such as whether to operate a bundled or unbundled program, use custom or off-the-shelf investments, and what outcomes to drive towards for participants and their beneficiaries.

Clients control the degree of outsourcing with NEPC's flexible approach



Outsourcing Investment Policy | Investment Menu

For years NEPC has advocated to clients, and offered testimony in Washington to the U.S. Senate Special Committee on Aging and the U.S. Department of Labor, that defined contribution plans should offer fewer funds, lower fees, better target-date funds, and retirement-income solutions. We are strong proponents of auto features such as automatic enrollment and deferral-rate escalators because we believe they are critical in encouraging participants to save early, save more, and diversify.

Decisions like these are difficult for plan sponsors, and getting from education to implementation in a traditional consulting relationship can take years. NEPC can be given control of a plan's Investment Policy Statement and investment menu, and all the incumbent decisions around making the program work better for participants.

Outsourcing Investment Policy Implementation | Manager Selection and Replacement

Generally it is a strong track record that gets a manager hired, and a deterioration of a track record that gets a manager fired. What happens along the way are many difficult Committee conversations. How many periods of underperformance should land a manager on "watch"? How long is long enough to wait for improvement?

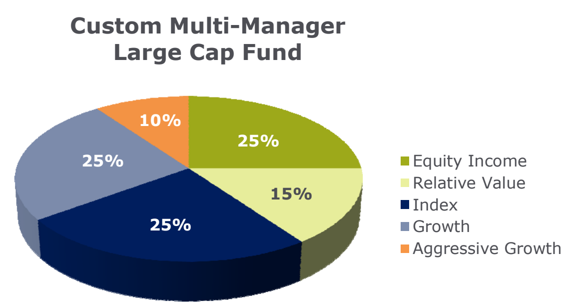
The hiring decision is also burdensome. In a September 2010 analysis of Investment Committee hire/fire decisions, Vanguard found that Committee members actually found hiring more difficult than firing, and speculated this might be because it takes more resources to hire than fire.

With NEPC's DC Outsourcing, NEPC can own these functions.

Outsourcing Custom Multi-Manager Fund Management

Custom multi-manager funds as pictured below are not uncommon in large defined contribution programs today and per disclosure rules released in 2010 (29 CFR 2550.404a-5) became meaningfully more complex to operate. The rules require calculating turnover ratios and expense ratios consistent with the SEC's guidelines for 40 Act funds, and presenting certain investment-related information, such as the description of the investment's objective, strategies and risks, and the "issuer" of the investment. It is expected that given this transparency, participants can better recognize the issuer as the responsible party for the investment and its construction, which isn't necessarily a role that companies and Committees prefer to have. While they can serve in the issuer capacity, they may feel more comfortable delegating investment discretion to a third party.

NEPC can assume investment discretion regarding the allocation and underlying managers of multi-manager funds, or the glide path and underlying funds used in custom target date funds, as discussed next.



Outsourcing Custom Target Date Fund or Glide Path Management

An estimated 15% of all defined contribution plans now use custom target date funds according to Casey, Quirk & Associates' research, but going custom is not without its complications. Historically only the mega plans with the staff, time and expertise have had the ability to construct them.

With custom target date funds, the plan sponsor decides an appropriate glide path in view of their organization's benefit structure, participant demographics, and belief systems, and then determines the asset classes and investment managers to use in each target date portfolio (Income through 2060). They create custom communications and generally control all aspects of the "operationalization" of this exclusive company benefit.

With DC outsourcing, NEPC can serve as the discretionary investment manager of the glide path.

Closing Thoughts

We titled this paper with a question, "When Did Defined Contribution Plans Get So Complex?" We'll end with an answer: a long time ago actually.

Our Founder and Chairman Dick acknowledged in a recent taped interview with Pensions & Investments that managing institutional asset pools is a lot harder today than it used to be. He went on to predict that consultants are going to continue the movement toward more proactivity, transitioning from advisory roles to discretionary roles because the need is great.

> *"...given the increasingly complex markets that we deal in today and the daunting stresses on budgets both in the public and private sector, the requirements for good returns, new solutions, and risk controls for example, those requirements have never been higher. So innovation is going to continue to be in demand. I think the one thing that hasn't changed is the need for solid investment programs that will help the participants retire in dignity."*
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> ***Richard M. Charlton***
> ***Founder and Chairman, NEPC, LLC***

In closing, NEPC has been supporting defined contribution programs for decades. From our experience we know where the stresses are with running large investment programs and with Committee oversight. We are prepared to take discretionary responsibility for those functions of a defined contribution plan that our clients may need or want to outsource in the coming years; we are doing it today.

NEPC, LLC is an employee owned, full service investment consulting firm. Founded in 1986, NEPC is one of the largest independent firms in the industry. We are headquartered in Boston, Massachusetts and have additional offices in Detroit, Michigan; Charlotte, North Carolina; Las Vegas, Nevada; Chicago, Illinois; Atlanta, Georgia; and San Francisco, California.

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