Reducing Volatility in Defined Contribution Plans:

The Fiduciary Considerations of Incorporating Downside Risk Management

Executive Summary

Financial markets gave investors a white-knuckled ride in 2008 and 2009, forcing the nearly 90 million Americans participating in 401(k) and other defined contribution plans to confront the unpleasant reality of market volatility. Even where plan fiduciaries selected investments that outperformed their respective benchmarks, this was little comfort to the many participants who experienced significant reductions in their retirement savings, especially those at or near retirement. In response to these events, and in light of the current market environment, many plans are taking a fresh look at their defined contribution plan investment menus to see what additional products and strategies might augment their offerings and potentially provide for a more appropriate match to their participants' desired risk tolerance levels.

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F-Squared Retirement
Thought Leadership Series

This white paper discusses:

- Downside-risk managed investments
- Why a plan sponsor might consider adding downside risk managed investment products
- Some of the factors that a plan fiduciary should evaluate when adding downside risk managed investments to an investment plan menu

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Introduction

Workers at or near retirement often find themselves on the horns of a dilemma. On the one hand, they have relatively few years left in which to make contributions to their 401(k) or other retirement plans and limited time to recover from large losses incurred close to their retirement dates. As a result, they need to minimize the risk of significant losses in their accounts that could jeopardize their retirement plans.

On the other hand, today's retirees can expect longer and more active lives than ever before. Facing a retirement that may last twenty, thirty, or even forty years, plan participants need investment returns that will increase the likelihood their savings will provide income replacement adequate to sustain their lifestyles throughout their retirement years.

The traditional method of addressing these contradictory needs, one commonly employed by target date funds, is to increase the allocation to fixed income at the expense of equities as the date of retirement approaches. Although this method has historically been viewed as successful in reducing risk, it has done so at the cost of a reduced exposure to the potential for investment growth. That concern, combined with current anxiety over returns from fixed income, has caused many plan sponsors and participants to ask whether there are viable alternatives to this traditional approach.

Furthermore, since 2008, when even some investment choices designed to be "low-risk" suffered significant losses, the demand has intensified among participants and plan fiduciaries for products and strategies that address the need for both portfolio growth and protection of principal. An emerging category of potential plan choices that seek to satisfy this need contains products focused on downside risk management.

Although downside risk management strategies may be new to some fiduciaries, it is important to remember that ERISA's fiduciary standard requires adaptation to changing circumstances. Fiduciaries are required to periodically monitor plan investments and replace them as necessary. In fact, common plan investment menus have changed substantially in recent years. An asset class or investment product that was prudent several years ago could be imprudent today due to changing market conditions. Similarly, an investment option not available to plans in the past may be a prudent and desirable investment today.

To address participant concerns about volatile markets, many fiduciaries are re-assessing the risk tolerance levels of their plan participants and using this information to help guide their investment selection decisions. As loss avoidance is often a primary concern among retirement plan participants, fiduciaries may look to include asset classes and funds that incorporate downside risk management into their investment process.

Following the procedural prudence requirements of ERISA, fiduciaries can adapt to changing market conditions by utilizing new investment products and strategies. The key to doing so is a thorough and well-documented investment selection and monitoring process.

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This white paper discusses some of the primary fiduciary considerations pertinent to including plan investments that offer downside risk management in a defined contribution plan menu. In evaluating any investment option, plan fiduciaries must make a prudent decision that takes into account and appropriately considers all relevant factors, including, but not limited to, the needs of plan participants, the types of investment products available, fees, and past performance. While this paper can be a helpful guide for fiduciaries to begin evaluating such investments, it cannot provide investment or legal advice for any particular plan or investment. Plan fiduciaries should consult with legal or other appropriate counsel to ensure their compliance with the law.

What Are Downside Risk Managed Investment Products?

Downside risk managed products are investment strategies that seek to reduce the potential for significant market losses, while participating in the market's opportunities for growth.

A traditional actively managed equity or fixed income fund may strive to outperform relative to a benchmark and manage risk by aiming to reduce volatility or tracking error to that benchmark. Alternatively, downside risk managed products typically focus on managing against the risk of absolute loss, a primary concern for many investors. As downside risk managed funds generally employ specific strategies that attempt to mitigate the risk of significant market losses as part of their core design, they may offer plan sponsors a more appropriate match to their participants' desired risk tolerance levels.

Why Would a Plan Consider Adding Downside Risk Managed Investment Products?

As fiduciaries, retirement plan sponsors must take the needs of participants into account as part of their decision-making process, and the risk tolerance levels of those participants should be part of that assessment. While this does not mean that each participant or group of participants is entitled to individual consideration—the fiduciary is charged with making decisions for the plan as a whole, and those decisions may not always benefit all participants equally—the structure of defined contribution plans makes it easier to address individual concerns by adjusting the investment options available. The addition of downside risk management products, for example, can help fiduciaries meet participant needs by giving participants additional investment options to suit their personal return objectives, investment time horizons, and risk tolerances. Further, providing such a mix of investment options can be an effective strategy to address fiduciary risk.

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Because plan participants' investment objectives and attitudes towards risk may vary, most fiduciaries strive to offer an array of investment options that give participants the opportunity to select investments based on individual preferences and desires. This typically includes investments suitable for those participants who accept and seek out higher risk in exchange for greater return potential, as well as investments appropriate for risk-averse participants who may choose to forego higher potential returns in favor of greater protection of principal.

When assessing the risk tolerance levels of plan participants, fiduciaries may also find that some participants have risk tolerances that are not static, but instead are adaptive based on the market environment. These participants may prioritize the protection of principal in weak markets, but could be willing to take on greater risk when markets are healthy. Such participants may not find the benchmark-centric risk structure of traditional equity funds or intermediate bond funds to be an appropriate match for their particular risk tolerances as—by design—these investments do not seek to protect against significant market loss. For these investors, fiduciaries may consider offering investment options that have a focus on downside risk management.

Are There Specific Considerations Related to Downside Risk Managed Investment Products?

As with any investment option under consideration by a plan, the prudent fiduciary must gather the information necessary to understand and evaluate how the investment works, its costs, and other relevant factors, some of which are discussed above. Although not a comprehensive list, listed here are some factors regarding downside risk management products in particular that fiduciaries should take into account.

Fiduciaries should consider how these products could be employed by the plan, review their investment policy statements, and understand the differences between various types of downside risk management products that are available.[1]

USE IN CORE INVESTMENT MENUS

Defined contribution plans typically offer participants a core investment menu of mutual funds and/or collective trusts, though plans may also include other types of investment products and services. Within this menu, most plans provide an array of investment options with different risk/return characteristics. These may range from growth-oriented investment options that aim for higher returns, although with higher risk, to capital preservation products that seek to minimize the risk of principal loss. Most downside risk management funds strive to provide participation in the higher returns during strong markets, while attempting to reduce the risk of significant market loss during weak markets. Such funds give participants a different choice along the risk/return spectrum and may be an appropriate addition to the core investment menu.

USE AS QDIAS

Depending upon how a downside risk managed product is structured, it may be appropriate for use as a Qualified Default Investment Alternative (QDIA) or component of a QDIA.[2] These qualifying products can be utilized as default investments for participants who do not provide investment direction and are commonly used in conjunction with automatic enrollment plan designs. When a QDIA is properly implemented, the participant is treated as having affirmatively elected the investment, and the plan fiduciary is not liable for future investment losses that may result from that decision. However, this fiduciary safe harbor is only available if the fiduciary has prudently selected the QDIA itself.

While certain investment products have become associated with QDIAs, the DOL regulation does not endorse specific products. Instead, it describes three investment mechanisms, and any products or services that meet one those three sets of requirements may be used as QDIAs.[3] Two types of investment products commonly used as a QDIA in retirement plans are target date and target risk funds. Target date funds are designed to reallocate investments automatically as a participant comes closer to retirement age. These funds will typically have a glide path that will shift the risk level of the fund in a more conservative orientation as the fund date approaches. Target risk funds, in contrast, are designed to expose the participant to a static level of risk. These funds typically have conservative, aggressive, and moderate risk levels and assume that participants themselves (or the plan administrator in the case of a QDIA) will shift into other risk level funds as needed or as they approach retirement.

During the bear market of 2007-09, many investors experienced significant losses in target date and target risk funds, even those with near-term retirement dates (e.g. 2010) and more "conservative" allocations. In response, fiduciaries who select target date or target risk funds as the QDIA may want to consider if it would be appropriate to select versions that include some level of downside risk management, also known as tail-risk management.

INVESTMENT POLICY STATEMENT (IPS)

Downside risk managed strategies may be different from other investment options that typically comprise plan menus. While a downside risk managed fund can be an appropriate core investment option for participants, these funds might represent a new asset class that may not currently be outlined in the plan IPS. Thus, some plans may need to modify their IPS to include guidelines for properly evaluating and monitoring these particular products.

Fiduciaries should review the plan documents and IPS governing their plan's investment process to make certain that the plan's written policies match the plan's actual governance and administration. In particular, fiduciaries selecting a downside risk managed mutual fund or collective investment trust should (1) ensure their plan documents are written to include the use of such investments, and (2) review the specific metrics the IPS uses to analyze investment performance. If a modification to the IPS is required in order to add a downside risk managed product to the plan's investment menu, plan sponsors should consult with legal or other appropriate counsel. Template IPS language and evaluation metrics for downside risk managed funds may also be available from the investment managers, though it may be necessary to customize such language for use with a particular plan.

DIFFERENCES AMONG DOWNSIDE RISK MANAGED PRODUCTS

As with any class of investments, there are differences among particular downside risk managed products. Fiduciaries need to ensure that their review process includes an examination of the investment goals and objectives, fees, and other factors relevant to the specific products they are evaluating.

There are several types of strategies that an investment manager can use to manage downside risk, with some of the more common methodologies including the use of active asset allocation, tactical management, hedging, or insurance wrappers. Fiduciaries looking to incorporate investment strategies that offer downside risk management into their defined contribution plans have a number of options available. In addition to understanding and evaluating the options available, fiduciaries should consider whether to provide participant education regarding any options selected for inclusion in the plan.

Like other plan investment options, downside risk managed products may come in the form of mutual funds, collective investment trusts, or managed accounts. Each of these types of investments has unique features, varying fee structures, and somewhat different disclosure requirements.[4] Fiduciaries need to understand these differences and consider them as part of the prudent selection process.

Fees are an important factor when selecting a downside risk managed product, but they are not the only factor fiduciaries must consider. While ERISA may require plan fees to be reasonable, this does not mean a fiduciary is obligated to pick the lowest fee—the prudent process is based on the fiduciary's evaluation of the totality of the relevant factors. Certain downside risk management strategies may justify greater costs. However, fiduciaries must understand the fees and the differences from product to product in order to properly evaluate them and make a prudent decision.

As with any actively managed investment, the philosophy of the investment manager is central to understanding how the fund will fit into the plan's investment portfolio. Some downside risk managers may define themselves as "bear market managers" and seek primarily to protect in down markets, while others may target a more asymmetrical approach and aim to protect in down markets, but still offer relative upside performance in normal and bull markets. Fiduciaries should consider the fund's investment philosophy and how well it is aligned with the plan's overall investment goals.

Conclusion

As 401(k) and other retirement plans have become the primary retirement savings vehicles for tens of millions of Americans, fiduciaries and service providers have adopted innovations to better serve participants. One of the remaining challenges for fiduciaries is to help participants better transition from work to retirement, from the asset accumulation phase to the distribution management phase. Downside risk managed products are one way plans may seek to provide growth opportunities to their participants while trying to reduce the risk of large losses. ERISA's fiduciary rules not only give plan fiduciaries the flexibility to explore these and other options, but ensure that fiduciaries periodically evaluate their plans and consider new strategies in response to changing conditions. Plan investment committees must pay attention to new investment realities and make certain that their fiduciary process takes changing market environments into account when selecting investment options. In addition, plan fiduciaries must fulfill their fiduciary duty to understand how their plan investments work, how much they cost, how appropriate they are for their participants' needs, and to select them through a prudent, thorough, and well-documented process.

[1] See 29 C.F.R. §2550.404a-1(b) for additional guidance.
[2] For example, a QDIA must invest in a mix of asset classes—it may not hold assets only in cash. It is important fiduciaries understand how to the investment product or service works to ensure it is suit able for use as a QDIA.
[3] See 29 C.F.R. §2550.404c-5.
[4] While the participant disclosure regulation at 29 C.F.R. §2550.404a-5 provides a common set of required disclosures, the underlying investment products may be regulated by different bodies of law and some disclosure variations may remain.

About the Author

Bradford P. Campbell is a nationally recognized figure in employer-sponsored retirement plans. From 2006 to 2009, he served as the Assistant Secretary of Labor for Employee Benefits, the head of the Employee Benefits Security Administration (EBSA). As ERISA's former "top cop" and primary federal regulator, Mr. Campbell provides his clients at Drinker Biddle & Reath LLP with insight and knowledge across a broad range of ERISA-plan related issues.

While in public service, Mr. Campbell played a key role in the significant ERISA retirement reform efforts of the prior decade, and his regulatory and policy decisions had a fundamental impact on the structure and operation of ERISA plans. Mr. Campbell orchestrated implementation of the most sweeping changes to pension regulations in 30 years, including final regulations establishing Qualified Default Investment Alternatives (QDIAs) to facilitate automatic enrollment in defined contribution plans; requiring electronic disclosure of more transparent plan expense and fee information; and improving participant access to professional investment advice. Mr. Campbell also promulgated proposed regulations requiring plans to disclose concise fee and investment information to participants, and requiring service providers to disclose direct and indirect fees to plan fiduciaries pursuant to ERISA §408(b)(2).

He received his JD, cum laude, from Georgetown, and his BA from Harvard. He resides in Alexandria, Virginia, with his wife, Kerry, and their three children.

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