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Global trends in DB and DC plans

Key themes from our multi-national client survey

March 2015

We are often asked by our clients how other Vanguard clients approach their global retirement plans; what differences we see among various companies; and whether there are specific differences between plan sponsors in different countries. We found ourselves offering anecdotal replies to these questions and decided we needed to be able to provide more fact-based responses.

We conducted this survey in July and August 2014 with the aim of gaining a better understanding of the challenges facing global retirement plan sponsors. More than 90 multi-national companies responded, which together hold more than \$650 billion in defined benefit (DB) and defined contribution (DC) assets. Participating companies were based around the world and administered retirement plans in at least three countries.

This paper highlights four key trends we drew out of the survey and the implications they have for global plan sponsors. These themes also inform our research and we will publish additional commentary in 2015.

We are grateful to the respondents for the time they gave us. We hope the survey provides some ideas about future processes, governance and investment approaches.

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I. Centralization of governance and asset management oversight

Managing retirement plans in multiple countries is challenging and the ability to harmonize the approach can be hampered by the friction between the top-down desire for a more centralized approach and the local desire for more influence and decision-making authority.

The survey showed that, while the majority of global retirement plans are managed using a combination of local and corporate governance (64%, figure 1), there has been an increasing trend towards a more centralized approach (figure 2).

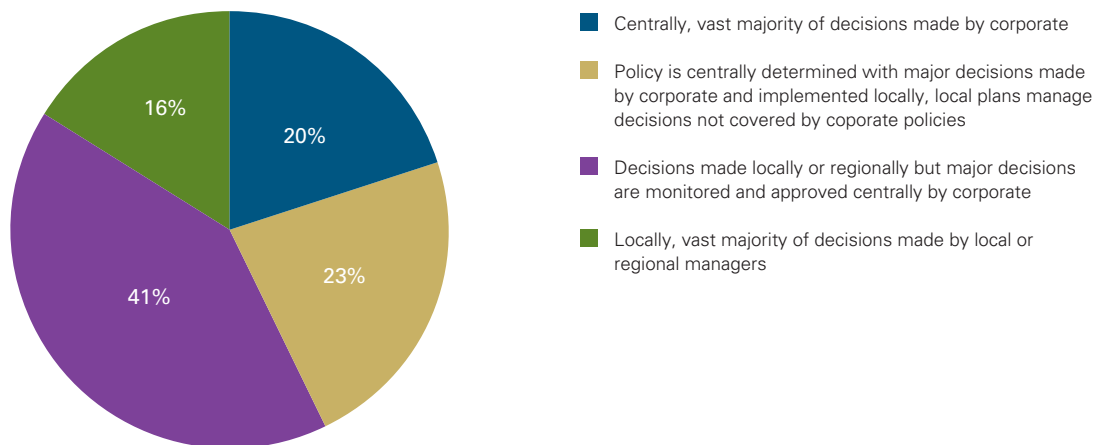
The main reasons given for this move toward centralization were consistent policy/structure and risk management concerns. Respondents identified local market rules, regulations and customs as some of the obstacles preventing centralization.

More centralization is on the way. On average four out of ten companies that do not currently manage their global retirement plans centrally expect to move to a more central approach in the next five years. Even smaller organizations expressed the need to consolidate governance, although the desire to centralize plan oversight was stronger for larger organizations.

Conclusions:

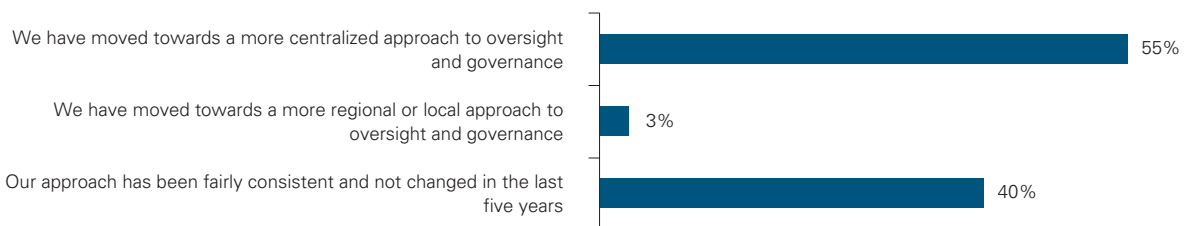
- The move toward centralized governance will continue. This can lead to greater pooling of efforts and assets, potential associated cost advantages and better risk management.
- Improving governance on a global basis takes time and requires healthy dialogue and the engagement of everyone involved. The exact steps an organization takes will vary based on its culture, strategic objectives and employee base. Companies should consider establishing a formal global governance policy.

Figure 1. Current Approach for Global Retirement Plan Management



Source: Vanguard

Figure 2. Change in Governance Approach for Global Retirement Plan Management – Past 5 years



Source: Vanguard

II. Resource challenges for multi-plan sponsors

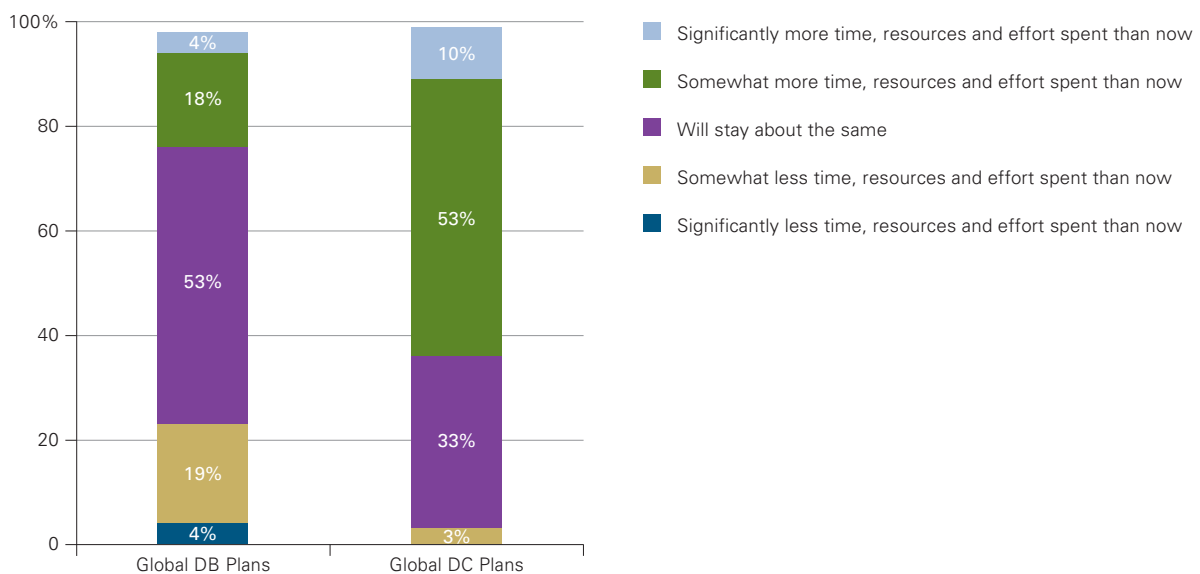
Sponsors struggle to find the time and resource to manage their retirement plans. Legacy plans continue to weigh heavily on resources, even as companies strive to transition to DC plans in order to transfer risk from the organization. On average, 58% of time, resources and effort is spent on DB plans compared with 38% on DC. The figure for DB plans rose to 71% for non-US respondents.

While DB plans will continue to require significant oversight, plan sponsors also expect more resources will need to be spent on DC plans in the future (figure 3). This reflects the expectation that DC will become more prevalent with the number of plans increasing, along with the number of participants and assets.

Conclusions:

- DB plans will continue to consume resources while support for DC plans will increase as their popularity grows.
- Something will need to give. Either resources – and costs – will need to increase, or plan sponsors will need to find ways to simplify the structure and approach to their global retirement plans.

Figure 3. Change in Time, Resources and Effort Spent on Management and Oversight of Global Retirement Plans



Source: Vanguard

III. De-risking and liability matching trends continue in DB asset management

The biggest change in DB plan management over the last decade has been the shift to liability-driven investing (LDI). Previously, the focus was mainly on maximizing total returns for investment portfolios. The switch to LDI will continue, with most organizations (73%) expressing a preference for these strategies over total return strategies for managing DB plan assets (figure 4). This preference was especially strong for DB plan sponsors in Europe.

Of the various LDI strategies, a glide path approach was the most popular (figure 5).

The popularity of LDI investing is unsurprising given that the main concerns in managing and maintaining DB plans were pension risk (defined as the cost uncertainty and/or variability in the pension plan funding ratio) and the cost of the plan for the sponsor.

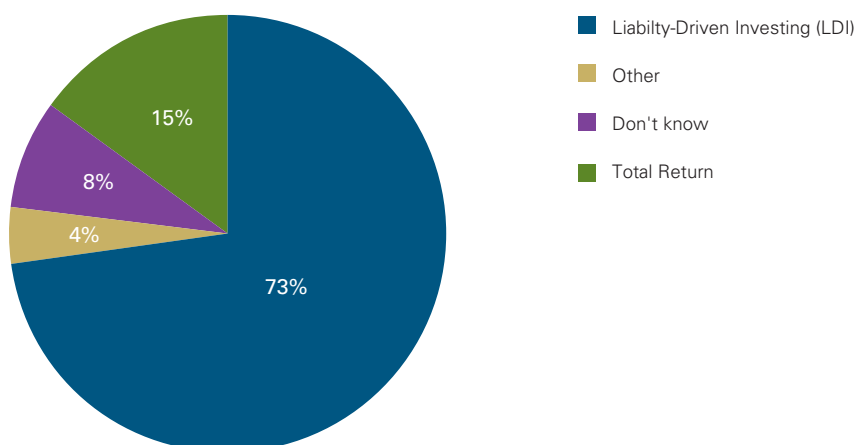
Only 15% of global plans were consistent with their asset allocation across countries. Differences in funding levels, liability characteristics and regulatory environments were the main reasons for this variation.

Passive funds are increasingly looked to in sub-asset allocations that are considered efficient markets (figure 6). When awarding a passive investment mandate, fees and tracking error were considered the most important factors. Costs were also a significant consideration when deciding on an active manager, but the investment strategy, manager experience and performance were more important.

Conclusions:

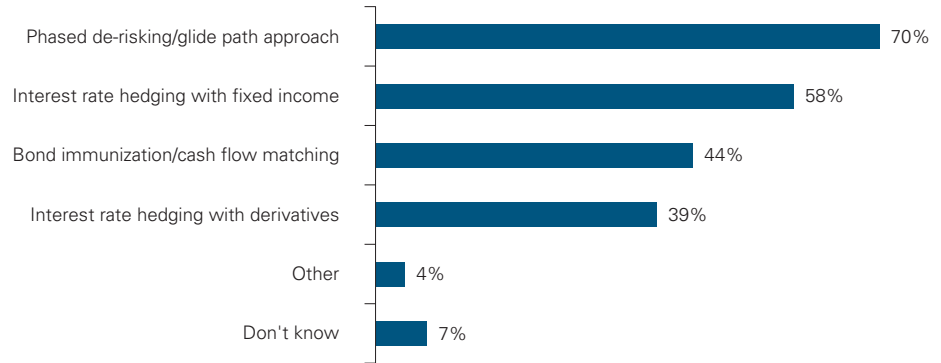
- DB plans will become increasingly diligent in evaluating funding status, costs and long-term performance as they seek to lower risk and simplify the plan's structure.
- DB plans will increasingly look to match their liabilities with LDI strategies. Use of passive strategies is also likely to increase to help lower costs and reduce idiosyncratic risks.

Figure 4. Preference for LDI vs. Total Return



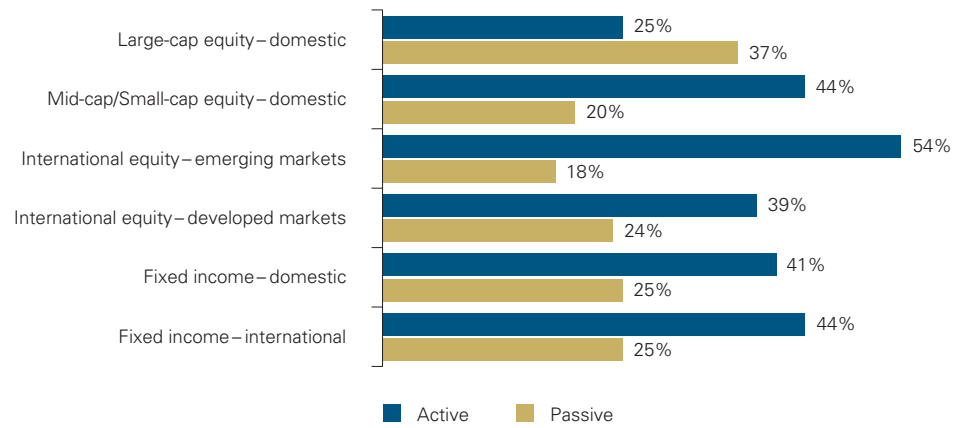
Source: Vanguard

Figure 5. LDI Strategies



Source: Vanguard

Figure 6. Preferences for Active and Passive Management for DB Plans



Source: Vanguard

IV. A 'modern' DC plan is emerging

DC plans are here to stay, with 75% of respondents indicating that DC is the ideal structure for retirement plans. However, the survey results revealed that DC is being further refined.

The initial shift from DB to DC meant that responsibility switched from employers to employees. But there is growing recognition that there must be more of a shared responsibility around retirement outcomes, beginning with the level of DC plan contributions.

When asked how they expected the level of company contributions to DC plans to change over the next five years, 57% of respondents expected them to increase somewhat, with a further 14% expecting them to increase dramatically.

We also asked about the preferences for customized or off-the-shelf solutions for default funds. Standardized, off-the-shelf target-date funds are the default fund structure of choice for DC plans (figure 7). This is especially true among US clients, while customized lifestyle funds and customized funds of funds are more desired elsewhere.

In the US, the preference for standardized, off-the-shelf target-date funds was reflected in reality, as these products are the most commonly used structure by far. While it was also the most popular option outside the US, customized lifestyle and fund of funds options were not far behind (figure 8).

In terms of investment strategies within the default funds, about 95% of respondents preferred their default funds to contain either all passive investments (38%) or a combination of active and passive investments (57%).

The ability to monitor closely and understand the various costs associated with a DC plan when making the decision between bundled and unbundled plans is crucial, with 79% identifying fee transparency as one of the most important considerations.

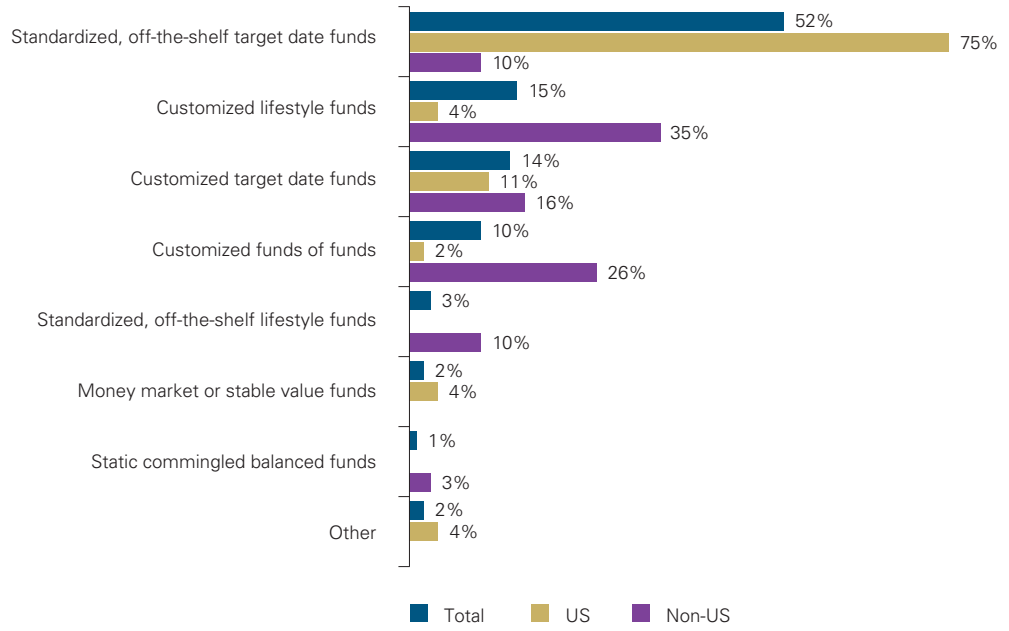
Conclusions:

- As plan sponsors adopt more of a shared responsibility approach to retirement plans, we could see the funding approach change.
- But increased funding levels will not help if employees are left to make poor investment choices. Target-date funds are emerging as the preferred default option to ensure better retirement outcomes for employees. However, there are substantial differences in different jurisdictions.
- The push for fee transparency will continue and we are likely to see lower costs and greater use of passive mandates as a result.

Round up of the key findings

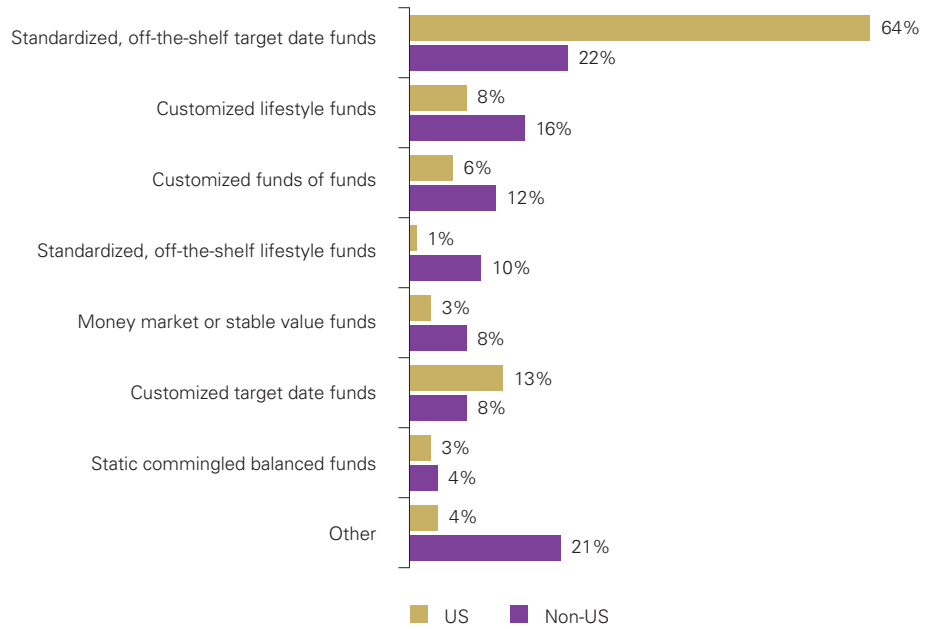
- I The trend to harmonize plan governance across different countries continues. This is largely driven by the plan sponsor's desire for consistent policies globally and to improve risk management practices.
- II Sponsors struggle for adequate resources to manage plans. DB plans soak up significant time and effort while the growth in DC plans is an additional demand on sponsors.
- III De-risking and liability matching continue in DB asset management with an increasing focus minimizing costs.
- IV A modern DC plan is emerging. Features include some responsibility shifting back from employee to employer, better investment outcomes through improved plan design and investment options, and fee transparency helping to drive costs lower.

Figure 7. Preferred Default Fund Structure for DC Plans

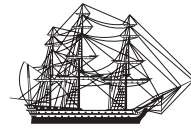


Source: Vanguard

Figure 8. Default fund structures currently employed



Source: Vanguard



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