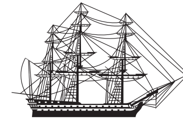

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Achieving better diversification through reenrollment in a QDIA

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Appropriate diversification is key to successful retirement investing. However, in participant-directed defined contribution (DC) plans, where employees manage their own retirement assets, there are often participants who are not well-diversified. Some concentrate their portfolios in specific market segments or styles. Others adopt extreme asset allocation positions, investing too aggressively or too conservatively.

Plan sponsors have traditionally used education to improve participants' portfolio diversification. But participant inertia often overshadows education, leading to only modest changes. Instead, today many more plan sponsors are considering reenrollment, a plan design strategy through which current participants' holdings are transferred into a qualified default investment alternative (QDIA), subject to the right to opt out. They have discovered that reenrollment can improve portfolio diversification rapidly while limiting plan sponsor fiduciary liability.

Introduction

Even though most DC plans offer a broad range of investment offerings, some participants fail to diversify and instead concentrate their investments in employer stock, specific asset classes or styles, or hold overly conservative or aggressive portfolios. Vanguard data on the quality of portfolio construction, based on several million participant accounts, confirms this point. Twenty-one percent of "do-it-yourself" investors, those not using professionally managed allocations, make significant portfolio construction errors by holding either zero-equity or all-equity portfolios (Figure 1)[1].

Moreover, few participants take advantage of other portfolio diversification strategies such as holding small-capitalization or international equities, or holding bonds in lieu of short-term money market or investment contract options. These portfolio construction errors can prove costly in the long run by significantly reducing long-term potential return or by exposing the portfolio to unnecessary levels of risk.

Targeted investment education is the traditional strategy for improving diversification. However, such programs typically produce only limited incremental changes in participant holdings because of widespread inertia. Low trading levels in DC plans are evidence of this inertia. In 2016, only 12% of participants made one or more portfolio trades or exchanges during the year, down from 16% in 2008.[2] The vast majority of participants do not change their investment allocations.

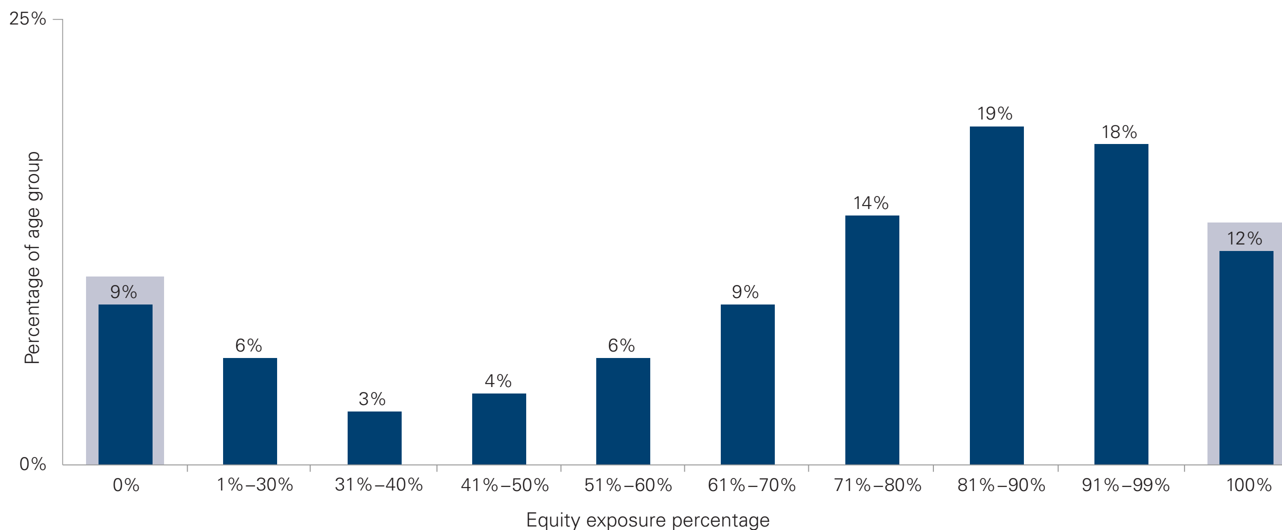
So, how can plan sponsors help improve plan diversification? Reenrollment is a strategy which allows the plan sponsor to default participants' assets and future contributions into a plan's designated QDIA, with participants retaining the right to opt out of the transfer. The use of this strategy, which can rapidly and effectively improve plan diversification, is growing as a result of the QDIA provisions contained in the Pension Protection Act of 2006 (PPA) and the Department of Labor (DOL) regulations implementing those provisions.

While sponsors continue to have fiduciary responsibility for the selection and monitoring of investment options offered under the plan, defaulting participants' assets into a QDIA provides relief from responsibility for investment losses. This is similar to the relief afforded plan sponsors under ERISA Section 404(c) for active participant investment decisions.

This paper explores the legal and practical aspects of the QDIA reenrollment strategy. Following an overview of current fiduciary law, the paper describes reenrollment scenarios and implications for plan sponsors. We conclude with the results from a case study on the impact of reenrollment.

Figure 1. Distribution of equity exposure by investor type, 2016

Vanguard defined contribution plan participants



[1] Vanguard, 2017.

[2] *How America Saves 2017: Vanguard 2016 defined contribution plan data.* Vanguard, 2017.

Background

Regulations resulting from PPA, which provide fiduciary relief for default investments in the absence of participant elections, make reenrollment possible as a diversification strategy. ERISA Section 404(c) (and regulations thereunder) grants plan sponsors limited relief from fiduciary liability for participant investment choices.

The various requirements for satisfying 404(c) include, among other features, giving participants control over the investment of the assets in their accounts and providing a choice among a broad range of at least three diversified investment alternatives. While Section 404(c) is an optional provision, most plan sponsors offering participant-directed DC plans elect to comply to obtain the fiduciary relief for participants' investment decisions.

Before PPA, a plan sponsor complying with Section 404(c) still retained full fiduciary liability when the participant's contributions were invested in the plan's default fund in the absence of specific participant investment direction (such as under an automatic enrollment arrangement). PPA altered these rules by introducing a QDIA provision under ERISA Section 404(c)(5) that offers fiduciary relief if sponsors default participants into a QDIA.

The QDIA rules were implemented in recognition of the rising importance of automatic enrollment programs and the need for fiduciary relief for sponsors defaulting participants into investments under these programs. The regulations also addressed concerns with the conservative investment vehicles often used as default funds before PPA. The DOL acknowledged that short-term investments, such as money market or stable value funds, play a useful role as a component of a diversified portfolio. Diversification suffers, however, when such funds become a participant's sole investment, as in many automatic enrollment scenarios before PPA. The participant's market risk may be lower, but the expected return on retirement savings is also lower, meaning slower growth of retirement savings over time.

Under the QDIA provision, participants who fail to make an investment election will be considered to have exercised control over their investments—and plan fiduciaries will have Section 404(c) protection—if the following requirements are satisfied:

- Participants' assets are invested in a QDIA.
- Participants had the opportunity to direct the investment of the assets in their accounts but did not do so.
- Participants received an initial notice explaining their right to designate how contributions and earnings will be invested and explaining how, in the absence of any investment election, such contributions will be invested. This notice must be provided at least 30 days before their first investment in the QDIA and then annually at least 30 days before the beginning of each plan year.
- Any material provided to the plan relating to participants' investments in a QDIA (e.g., account statements, prospectuses, proxy voting material) is provided to the participants.
- Participants are able to transfer assets out of the QDIA into any other investment alternative available under the plan without financial penalty at least once in any three-month period.
- Participants must be able to invest in a broad range of investment alternatives under the plan.

The QDIA regulations offer three primary investment vehicles that would serve as qualified default investments:

- Life-cycle or target-date funds.
- Balanced funds.
- Managed accounts.

Each alternative must be based on a model that applies generally accepted investment theories, is diversified to minimize the risk of large losses, and is designed to provide long-term appreciation and capital preservation through a mix of equity and fixed income securities.

The key to achieving the fiduciary protection provided by the QDIA regulations is that participants must have the opportunity to direct the investment of assets in their accounts and then fail to do so. Advance notice of QDIA rights and obligations is required at least 30 days before the first investment in the plan and annually before each plan year. The notice must include a description of the circumstances under which an account will be invested in the QDIA, information about the nature of the default investment, and the rights to direct QDIA-invested accounts to other investments. Failure to provide the notice results in a lack of fiduciary protection.

Reasons for reenrollment

Plan sponsors may choose reenrollment if they are concerned that participant portfolios are not adequately diversified. Reenrollment may also be driven by a significant change in a plan's investment menu that might occur during the conversion from one service provider to another or as the result of a decision to revamp the plan's investment menu.

In the preamble to the final QDIA regulations, the DOL makes it clear that the fiduciary relief afforded by the use of a QDIA may be available in a wide variety of circumstances:

> It is the view of the Department that nothing in the final regulation limits the application of the fiduciary relief to investments made only on behalf of participants who are automatically enrolled in their plan. Like the proposal, the final regulation applies to situations beyond automatic enrollment. Examples include: The failure of a participant or beneficiary to provide investment direction following the elimination of an investment alternative or a change in service provider, the failure of a participant or beneficiary to provide investment instruction following a rollover from another plan, and any other failure of a participant to provide investment instruction.[3]

Thus, it is possible for a plan's fiduciaries to initiate a reenrollment of the entire plan by adhering to the procedural requirements in the QDIA regulations. Such a strategy might be used in a variety of settings:

- **Diversification concerns.** A plan sponsor's decision to reenroll participants into the QDIA may relate to: a specific investment option (e.g., participants invested entirely in a money market fund, which was the plan's prior default option); a subgroup of participants (e.g., those with no equity exposure or longer-tenured participants hired before a plan's implementation of automatic enrollment who have not been automatically enrolled into a QDIA); or the entire plan. In these instances, the sponsor implements such a change to enhance participant portfolio diversification and improve expected long-term retirement outcomes for participants.
- **Conversion.** A sponsor changing service providers may also make substantial changes in its investment menu. In lieu of attempting to map participant holdings from one set of investment options to another reasonably similar set of options, the sponsor can choose to default participants into the QDIA during the conversion process.

  Although mapping to similar or "like funds" remains a viable alternative to reenrollment when changing the plan's investment lineup, it does nothing to improve the quality of participant portfolio diversification. Furthermore, the relief provided by the QDIA regulations for reenrollment has greater potential reach than that provided by PPA's mapping provisions, which are narrowly limited to transfers among similar options.[4]
- **Menu change.** Under certain circumstances (such as a merger of plans), a sponsor may decide to make substantial changes to the plan's investment lineup or eliminate a number of options. In these cases, rather than attempting to map those participants in the options being eliminated to similar new options, the sponsor may instead default the participants into a QDIA. This approach is particularly useful in circumstances where no reasonably similar replacement investment option is available, such as when a company stock fund is eliminated.

[3] In June 2012, in one of the first published court opinions addressing the QDIA regulations, the United States Court of Appeals for the Sixth Circuit relied upon this language from the DOL's preamble. In *Bidwell v. University Medical Center, Inc.*, the court accepted the DOL's interpretation of its own rule, affirming that plan fiduciaries may reenroll participants in accordance with the QDIA regulations. The court upheld the findings of the District Court, which had rejected the participants' claim that the plan sponsor breached its fiduciary duties. Instead, both the District Court and the Court of Appeals agreed that plan sponsors who follow the procedural rules of the DOL regulation may move participants' balances into a QDIA, regardless of whether the participants previously elected their investment or had it chosen for them by default. Default Investment Alternatives Under Participant Directed Individual Account Plans; Final Rule, 72 Fed. Reg., 60453 (October 24, 2007).

[4] DOL has yet to issue proposed regulations for mapping relief under Section 404(c)(4). However, the preamble to the QDIA regulations states: The relief provided by Section 404(c)(4) is limited to circumstances when a plan undertakes a "qualified change in investment options" within the meaning of Section 404(c)(4)(B). In contrast, Section 404(c)(5) and this regulation can apply to changes in investment options and to the selection of initial plan investments when participants or beneficiaries do not give investment directions. Section 404(c)(4) applies only when the investment option from which assets are being transferred was chosen by the participant or beneficiary (see Section 404(c)(4)(C)(iii)). Section 404(c)(5), unlike Section 404(c)(4), can apply to the selection of an investment alternative by the plan fiduciary in the absence of any affirmative direction by the participant or beneficiary. While the fiduciary relief afforded by Section 404(c)(4) and Section 404(c)(5) is similar, relief under Section 404(c)(4) requires that new investments be reasonably similar to the investments of the participant or beneficiary immediately before the change, whereas relief under Section 404(c)(5) requires investments to be made in qualified default investment alternatives. *Ibid.*, 60465.

Under reenrollment, as long as participants are given proper advance notice and are provided an opportunity to make an alternative election, sponsors enjoy fiduciary protection in connection with participant investments—either because participants are transferred into the QDIA or because they exercise control by opting out of the reenrollment. In addition to this fiduciary protection, the plan sponsor has taken affirmative steps to ensure proper diversification of participant accounts.

Implementation considerations

Plan fiduciaries need to deliberate on a variety of issues to assess whether reenrollment is suitable for their plan participants.

- **Evidence of diversification concerns.** Sponsors concerned about the quality of participants' portfolio diversification decisions should evaluate data about the types of asset allocation and fund selection decisions their participants make. Among the factors to consider are the overall degree of portfolio risk taken (equity exposure), single-stock risk, extreme asset allocations (either excessively aggressive or conservative), and extended forms of diversification (such as use of international or small-capitalization stocks or bonds for diversification purposes).

  Not only will plan sponsors want to consider the impact of reenrollment on diversification and return potential, but they should also focus on risk levels. For some participants, improving portfolio diversification can mean improving long-term expected returns and increasing risk levels. For others, it can mean a reduction in both.

- **Entire plan, targeted group, or single-fund option?** As part of their analysis, plan sponsors need to consider the merits of reenrolling their entire participant population, participants in a targeted group (for example, those too conservatively or aggressively invested), or participants in a single-fund option (for example, the prior default fund).

- **Investment contracts.** A reenrollment is likely to be deemed a plan event under many investment contract options (e.g., stable value contracts). As a result, insurers may decide to impose a 12-month put or otherwise "mark to market" participant investment contract holdings. This means that assets transferred to the QDIA will be valued at the market value of the underlying securities if the amount is less than the book value of the assets reported on participant accounts before the transfer. Plan sponsors are well-advised to check with the issuers of these contracts to determine if this will occur and to quantify the magnitude of any such adjustment. Often, by delaying the reenrollment for a certain notice period or by satisfying other requirements, transfers from investment contracts can be made at book value.

- **Company stock.** Reenrollment involving company stock requires careful consideration of the impact of a sale of a large block of company stock on the stock's market price. If the amount of company stock being liquidated is large enough, it may not be possible to execute a large trade in a single day without having an adverse impact on the market value of the stock. It may take several days to liquidate the stock in an orderly fashion to avoid this negative trading impact.

  In circumstances where the liquidation of a large holding in company stock cannot be completed in a day or two without creating a negative impact on the stock price, it may be necessary to impose a blackout period. During the blackout period, participants and beneficiaries will not be able to request loans or distributions or make exchanges with respect to amounts in their accounts invested in company stock. Sponsors need to follow the regulatory requirements governing blackout periods, including advance notice to participants.

  Elimination of company stock from a participant's account also may have negative tax implications for the participant who otherwise would have been able to use net unrealized appreciation (NUA) treatment when taking a distribution of the company stock. This tax benefit needs to be balanced against the broader investment considerations involved in the reenrollment strategy, such as reducing single-stock risk exposure.[5]

- **Fees.** Sponsors should also consider how, if at all, changing the investment mix of the plan may affect the asset-based fees paid to the service and investment providers. For example, a shift from higher-cost investment options to a lower-cost QDIA could lead to the service provider requiring additional fee income to replace the reduction in asset-based recordkeeping fees. Sponsors need to satisfy their

[5] These issues are very similar to those that plan sponsors typically consider when closing a company stock option in their plans—trading impact, a blackout period, and tax impact on participants.

duty as plan fiduciaries in determining that fees are reasonable for services provided to the plan.

In addition, some funds charge a redemption fee when invested amounts are redeemed within certain time frames following investment in the fund. Sponsors should review and quantify the amount of any such fees that would be charged if all holdings were liquidated and placed into the plan's QDIA.

Plan sponsors must ensure compliance with DOL regulations outlining obligations of plan sponsors and service providers to disclose plan fee information. Changes in plan fees or new fees as a result of the reenrollment should be disclosed by the service provider to the plan sponsor and may need to be disclosed to plan participants.

- Investment coordination. Because of the potential asset transfers that will occur upon reenrollment, careful coordination between money managers is needed to ensure an orderly transition and minimal impact to the investment portfolios involved.

- Participant communications. While the regulations require the provision of a specific notice to participants at least 30 days before the investment in the QDIA, best practices encourage a multichannel, multitouch approach to reenrollment education. Affected participants are notified more than once and in different communication channels, to ensure that they are well-informed about the reenrollment and their ability to opt out.

  For example, a sponsor may wish to issue the formal notice required by the QDIA regulations 30 to 60 days before the event and then follow up with additional reminders via company newsletters or intranets, targeted emails, and other electronic or print communications. This multichannel approach can help ensure that all participants are given sufficient opportunity to opt out if they wish and may reduce the number of employees who become aware of the change only after it occurred.

- Missing participants. To ensure that all plan participants receive reenrollment communications, especially the required QDIA notice, it is important to identify participants who have failed to provide a current address and cannot be located. The DOL provides guidance on locating missing participants in terminated DC plans in Field Assistance Bulletin 2014-01 (FAB 2014-01). This FAB outlines search steps that can also be applied when trying to locate missing participants in active DC plans. These steps may include certified mail, checking other plan-related records (e.g., a group health plan), checking with the participant's designated plan beneficiary, and using free electronic search tools. Depending on the facts and circumstances of a specific missing participant, plan sponsors may additionally consider use of internet search tools, commercial locator services, and credit reporting agencies.

  Ultimately, if a participant still cannot be located, the plan sponsor needs to weigh the fiduciary risks of taking further action even without notice. For example, action may be required when an investment fund is being eliminated. If a missing participant is moved to a QDIA without notice, the plan sponsor should document the efforts made to locate the individual and subsequently provide notice if the participant is later found.[6]

Reenrollment case study[7]

Early in 2016, Vanguard researchers studied the impact of a reenrollment event within a large DC plan and found that after reenrollment, the occurrence of extreme allocations was significantly reduced and overall portfolios became more age-appropriate. One year later, 92% of participants still maintained a full or partial position in the target-date investments used as the QDIA and plan diversification remained substantially improved.

Background. The study evaluated a reenrollment event that occurred in a large, DC plan transferring recordkeeping services to Vanguard. The conversion involved both a change in recordkeepers and a change in the plan investment menu. Since the prior menu included a stable value investment that required advanced notification to the insurer in order to maintain par value, the stable value funds were reenrolled into the default fund six months after the initial reenrollment. The researchers analyzed the rate at which participants opted out of the reenrollment and the impact on participant portfolios before, as well as both 6 and 12 months after the initial reenrollment event.

Consistent with the QDIA regulations, participants received timely notification of the reenrollment event. Anyone who wanted to opt out of the default fund

[6] In speeches and responses to inquiries, DOL officials have informally stated that once the notice requirements have been met, the fiduciary relief under Section 404(c) is retroactive to the date that monies were defaulted into the fund that otherwise met the QDIA requirements. While the DOL has clearly stated its intent on the issue, it has also indicated that no additional written guidance on this topic is intended to be issued.

[7] Pagliaro and Utkus, 2016.

had the opportunity to choose their own investments on a new participant website.

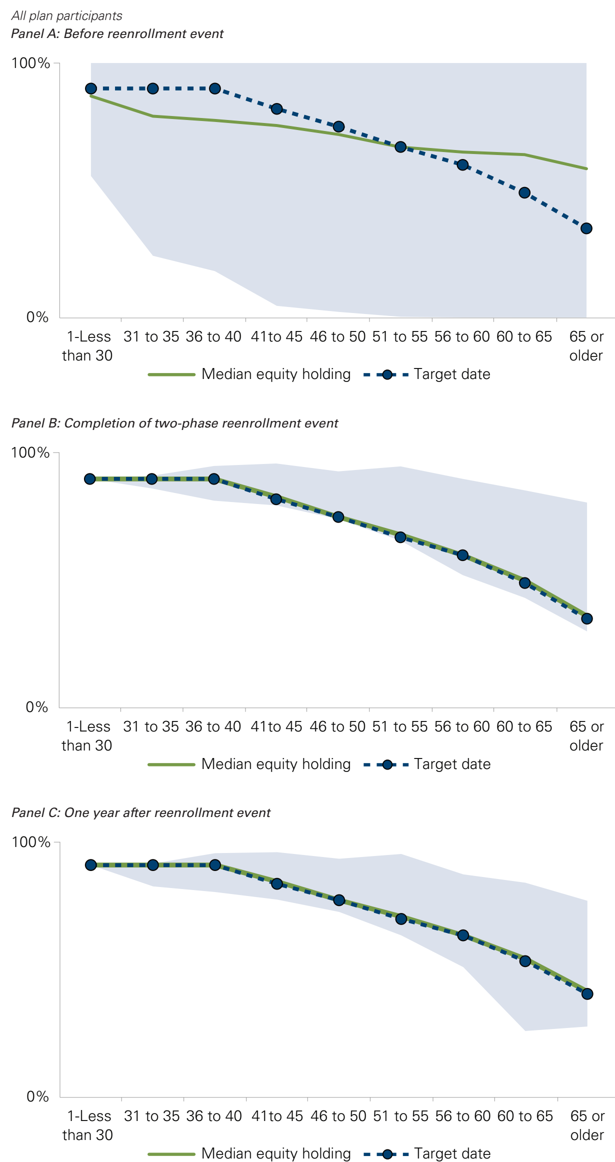
Immediately following the initial reenrollment, 90% of the participants remained in the default fund. Six months later, there was a moderate increase in the fraction of individuals who partially opted out of the default fund. However, only 6% of participants chose a portfolio without a target-date holding. One year after reenrollment, most participants remain invested in the default fund. Yet, opt-out rates increased slightly over time predominantly for older, wealthier males who "try out" target-date funds but ultimately choose to construct their own portfolios.

The reenrollment event dramatically shifted the distribution of participant and plan assets. Before reenrollment, the distribution of participant's average age-related equity allocations varied widely and the median value differed from the equity allocations of the target-date funds (Figure 2—Panel A). After the two-phase reenrollment, the distribution narrowed significantly and the trajectory of the median equity allocation aligned more closely with the target-date series (Figure 2—Panel B). One year later, most individuals stayed at the default. Among those changing, the most noticeable is the change in equity allocations of those age 50 and older whose deviations from the glide path were greater, particularly in the conservative direction (Figure 2—Panel C).

Summary

The principles of diversification and asset allocation are essential to professional portfolio construction. Yet certain groups of investors in participant-directed DC plans pursue sub-optimal strategies, adopting extreme asset allocations or taking concentrated positions in certain asset classes, investment styles, or company stock. Reenrollment into a QDIA is a plan design strategy that can achieve diversification of plan assets in a rapid fashion, while providing plan sponsors with fiduciary relief under Section 404(c). Research suggests that when reenrollment is undertaken in response to a specific plan event or to address specific diversification problems, it can be a highly effective strategy to improve asset allocation and thereby enhance retirement readiness.

Figure 2. Reenrollment and age-related equity allocation



The shaded area is bounded by the 5th and 95th percentile of the equity distributions within each age group.

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Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in a target-date fund is not guaranteed at any time, including on or after the target date.

Diversification does not ensure a profit or protect against a loss.

A stable value investment is neither insured nor guaranteed by the U.S. government. There is no assurance that the investment will be able to maintain a stable net asset value, and it is possible to lose money in such an investment.

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