

It's 2015: What does your DC look like?

Institutional Investor Institute
Corporate Funds Roundtable

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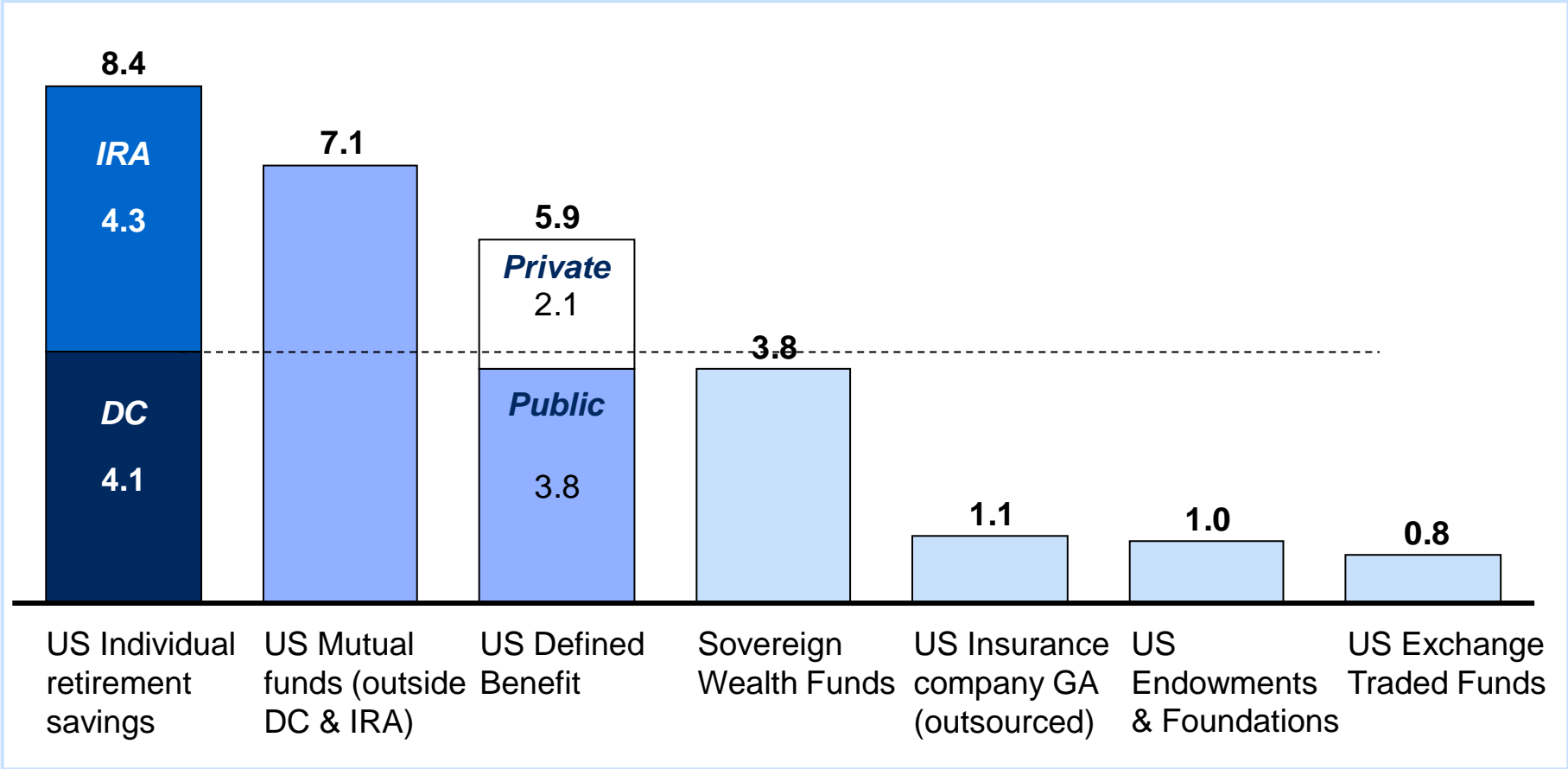
Today's discussion

- For a solution born almost by accident, **at \$4T in assets, DC is fast becoming the backbone of U.S. Retirement. DC has also proved incredibly stable and resilient**, recovering from a trillion dollar decline during the crisis and about to face down \$2T in outflows over the next 5 years from retiring boomers with an equal level of new contributions.
- However, the precipitous decline in participants' assets at the height of the crisis has **raised awareness of the U.S. retirement savings gap**, which reached 37% in 2009, **and elevated DC to an even more prominent position on employer, participant and government agendas.**
- The resulting changes in priorities and preferences among these groups are shaping **new product, distribution and economic realities** which are transforming DC .
- **To stay ahead of these shifts, plan sponsors will need to make a number of choices** across advice, addressing core benefit adequacy concerns, addressing participants' lifetime income needs, next generation target date solutions, share of passive and institutional, and addressing leakage

For a solution born almost by accident 30 years ago, at \$4T in assets, DC is now the dominant retirement asset pool

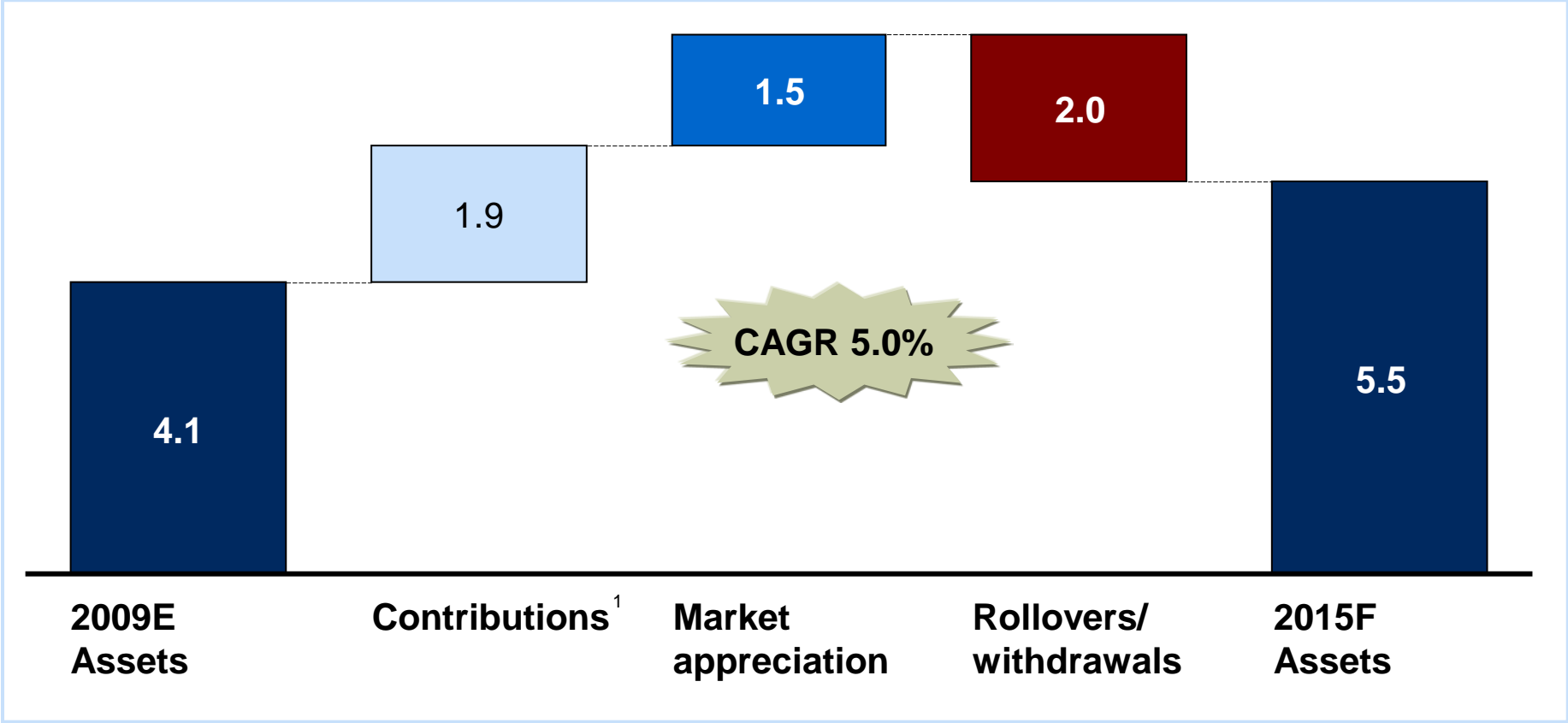
Asset holdings – 2009

\$ Trillions



We expect DC to continue to grow, reaching \$5.5 trillion in assets by 2015 despite outflows from retiring Baby Boomers

DC assets²
\$ Trillions



1 Assumes post-fee returns of 5.5%

2 Excludes Other DC (Profit Sharing Plans, Money Purchase Plans and Stock bonus plans)

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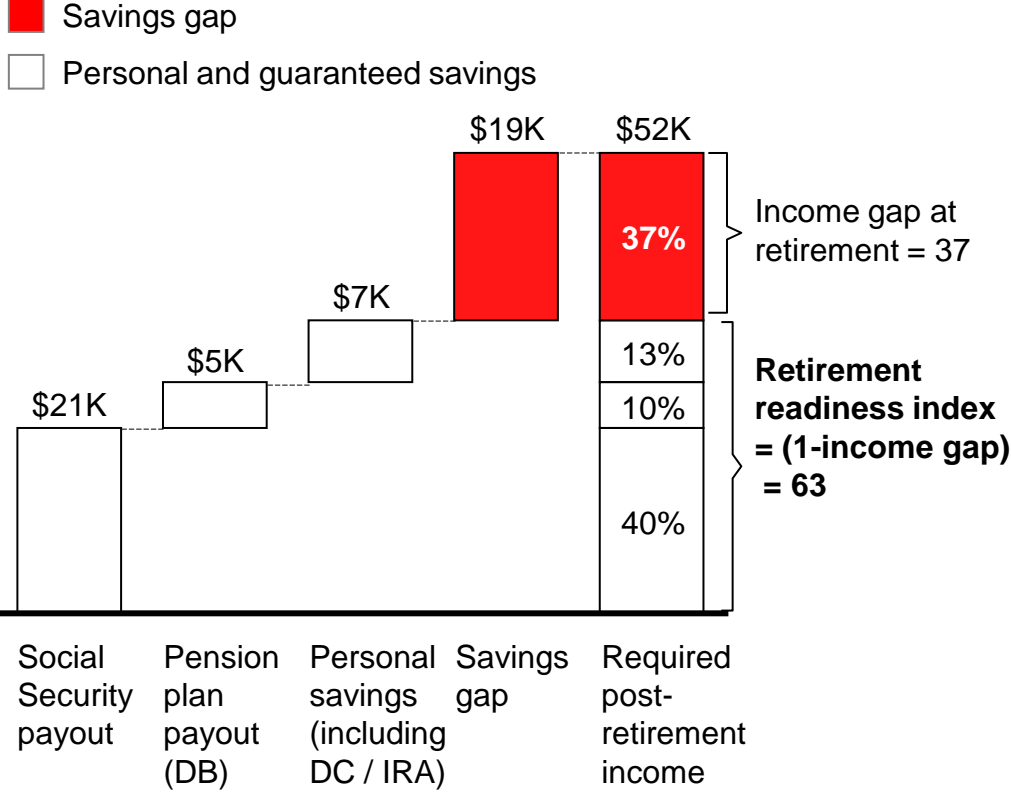
Who is the average American household?

Median characteristics¹

- Post-tax income: \$52,300
- Age: 49 years
- Likely retirement age: 62 years
- Estimated years in retirement: 19 years
- Probability of having a DB pension: 20%
- Probability of having access to DC: 64%
- Probability of having an IRA: 32%

How much does he/she need to save for retirement?

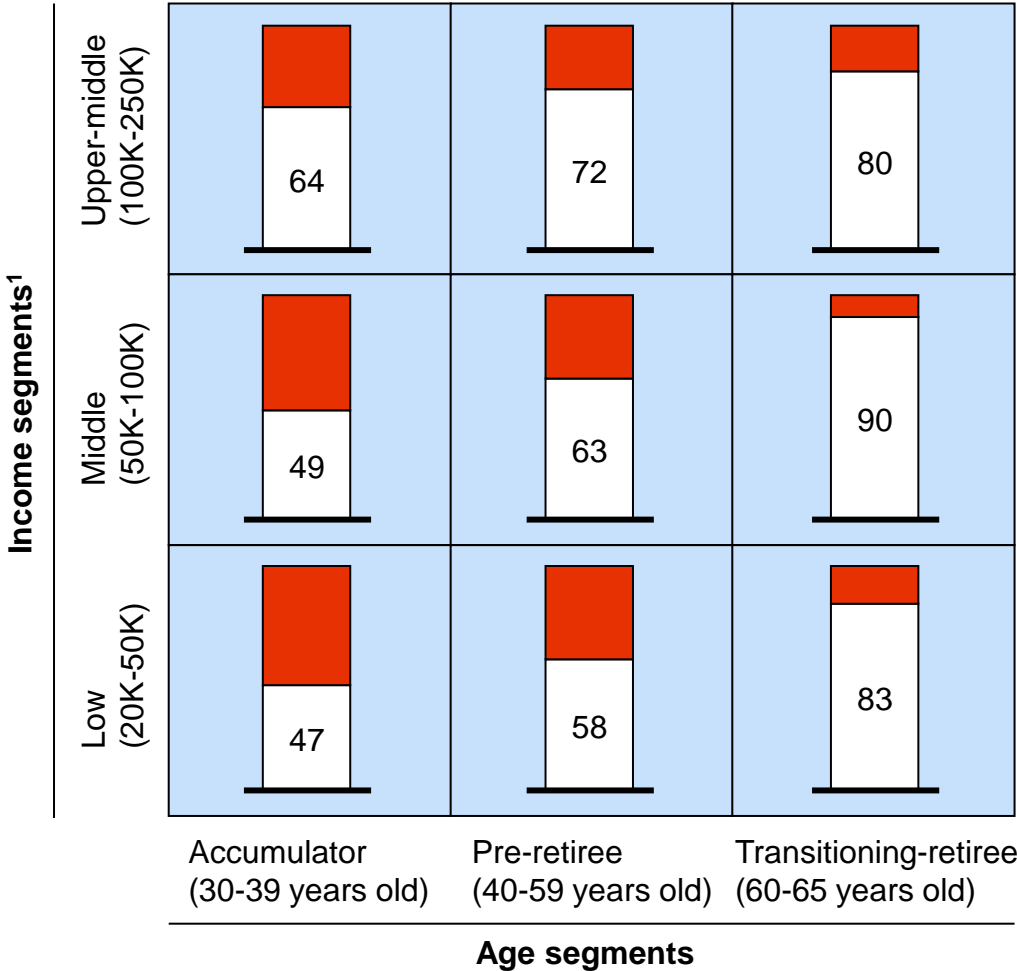
\$ '000s, income required at retirement



¹ The average American worker represents the middle income (\$50-100K) 40-59 years old HHs
² Total savings required estimation based on annual spend at retirement and post-retirement change in expenditure; assumes replacement ratio of ~100%, based on Aon Consulting's 2008 report on post-retirement change in expenditure

... And exists across Americans of all ages and income groups – not just lower and middle income households

Retirement readiness index for households by age and income



- **30-39 year olds face the greatest gap** and will need more personal savings because of lower DB penetration rates but have more time to close their gap
- **Transitioning retirees (60-65 year olds) have the smallest savings gap** of the three age cohorts, thanks to their high **DB savings**, allowing them not to rely heavily on personal savings
- **Pre-retirees (40-59 year olds)** have less guaranteed income than their older counterparts due to lower DB penetration, and have less time to close the savings gap before retirement
- **Low-income households** receive a high share of required income from Social Security but still **have a very high gap due to low DC/IRA participation rates**. This segment is also the least able to cut discretionary spending to improve their retirement preparedness, since 80% of their income goes to basic needs such as food, housing and healthcare

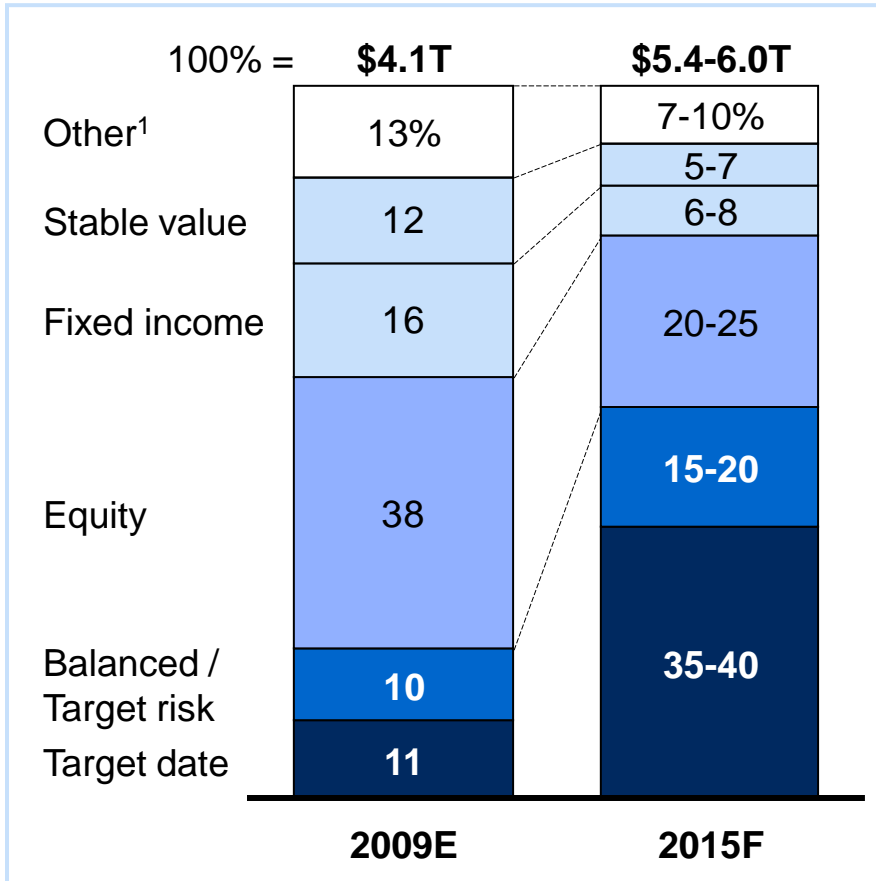
¹ Income segments <20K and >250K and age segments <30 and 65+ have not been shown

Awareness of this gap elevated DC to an even more prominent position on employer, participant and government agendas, leading to new products, distribution, economics and regulation realities

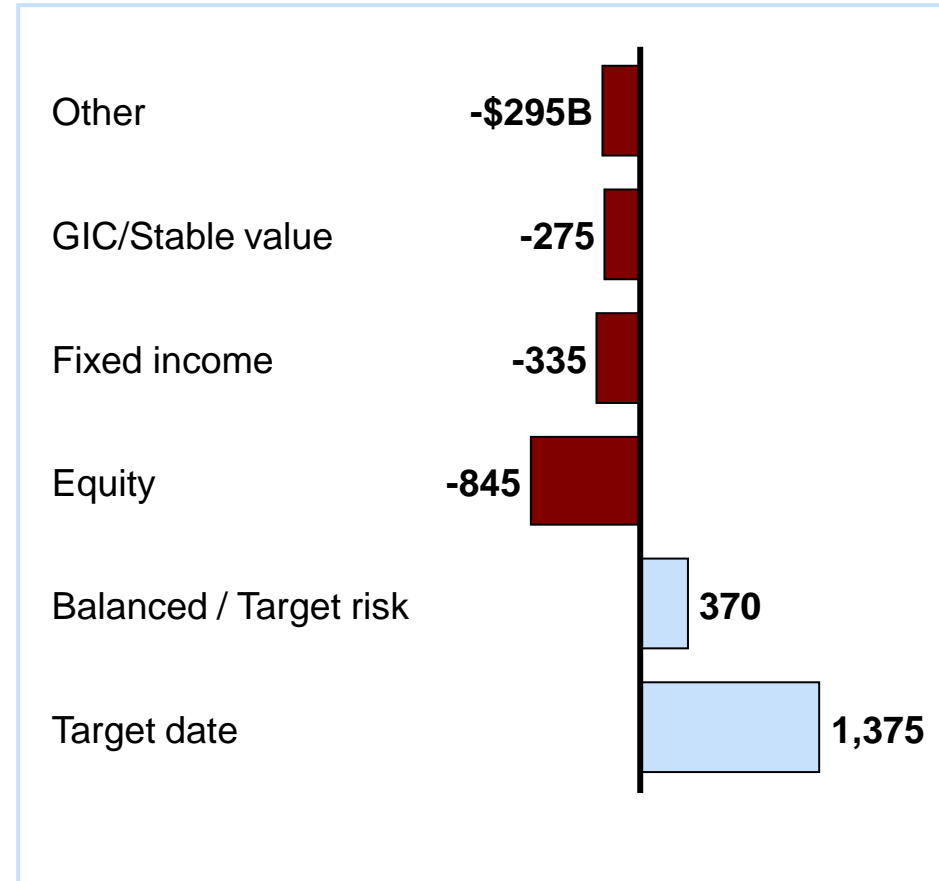
- 1 **A new suite of target-driven solutions** will account for 60% of DC assets in 2015 and capture \$1.7T of flows
- 2 There will be a **continued streamlining of investment choices** and options
- 3 **Major shift in asset allocation** will occur driven by cost, automation and demographics; passive will gain share to the loss of active U.S. equity and stable value
- 4 **Blurring lines between tax code and size segments** and large concentrations of flows will require players to rethink how they segment clients
- 5 **Accessing shelf space will require sales models to become more institutional in nature** and consistent with the new economic realities of 2015
- 6 **Continued pricing and margin pressure** will force recordkeepers and asset managers to retool their service and operating models
- 7 **Regulatory discontinuities** across fees, advice, auto-IRA, default/escalation rates and retirement income will continue to threaten to reshuffle the industry balance of power

1 By 2015, target driven solutions will account for nearly 60% of AuM and capture \$1.7T of flows

DC assets



DC cumulative net flows² (2010-15)



1 Includes Company stock and assets held through brokerage window

2 Excludes Other DC (Profit Sharing Plans, Money Purchase Plans and Stock bonus plans)

NOTE: Asset growth of target date and balanced/target risk funds are driven by flows from: (i) Auto-enrollment and presence as default option, (ii) Participants switching assets to target date funds and (iii) Reenrollment / re-mapping when sponsors change DC providers (on average, every year 6-7% of DC assets change recordkeeper)

1 Solutions will shift toward more customization, conservative glide-paths, and open architecture

Forces driving QDIA shift

- 1 **Increased product scrutiny** driven by disappointing 2008 returns, and increased consultant involvement
- 2 **Shift to lower cost products** due to greater cost-sensitivity and greater scrutiny
- 3 **Desire to diversify** through non-correlated asset classes
- 4 **Desire to reduce fiduciary risk** due to single manager managing bulk of participants' assets

Shift to...

Large/Mega
(>\$250M)

- **Customized multi-manager** solutions including **non-correlated asset classes** to diversify risk

Mid-sized
(\$50-\$250M)

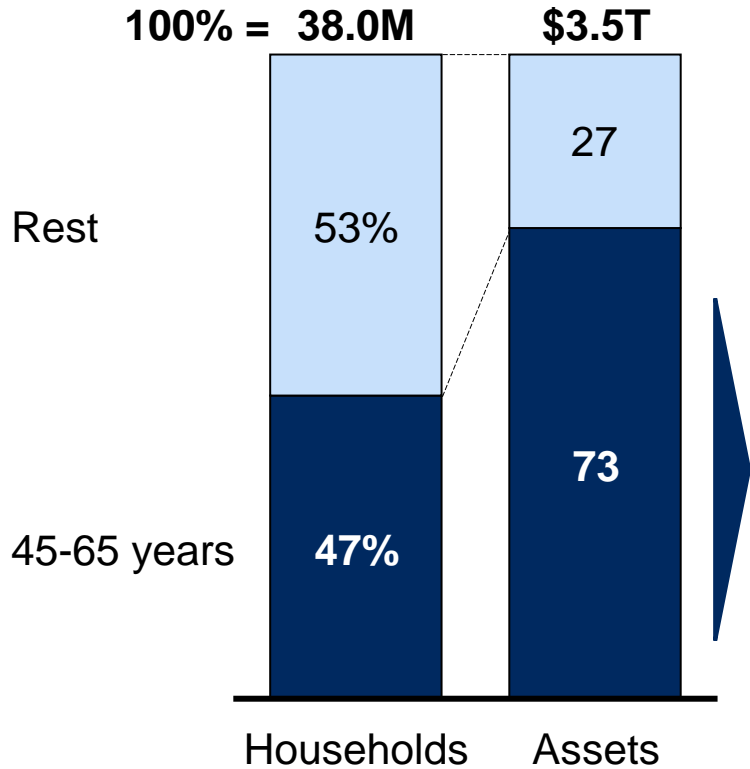
- **Open architecture, semi custom** solutions (e.g., built off of plan fund line-up), **offering a few pre-packaged glide-path choices**

Small
(<\$50M)

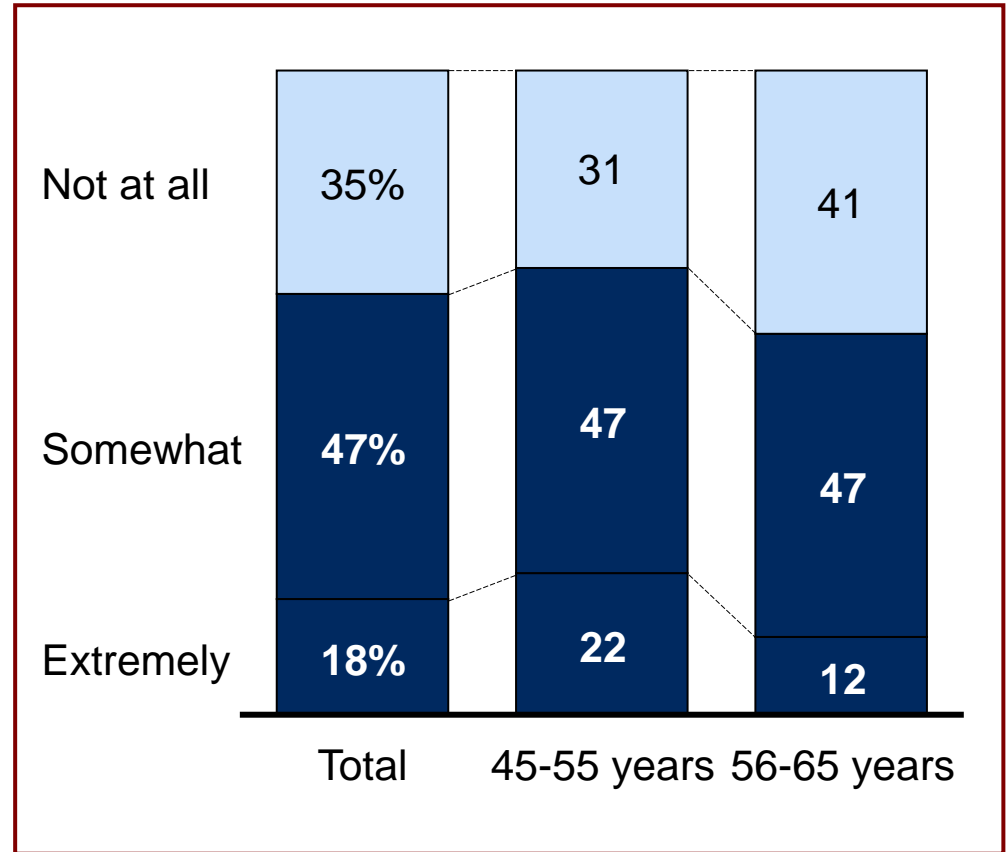
- **Low cost, off-the-shelf** solutions with high share of **passive investments**, and potentially multi-manager

1 Majority of DC assets are held by participants near retirement, most of whom have expressed interest in guaranteed income solutions

Distribution of DC participants and assets (2008)



Participants interest in guaranteed income solutions



1 However, despite increased plan sponsor awareness, few are actively considering guaranteed income solutions today

Share of large/mega sponsors...	Typical sponsor profile	Illustrative sponsor quotes
<p>Considering, but not adopting in short term</p> <p>24%</p>	<ul style="list-style-type: none"> Generous DC plan (e.g., white collar firm) Frozen DB Tenured workforce Low turnover 	<p><i>We're waiting to see what solutions emerge and what other sponsors do</i></p> <p><i>We plan to address this eventually</i></p>
<p>Aware but not considering</p> <p>68%</p>	<ul style="list-style-type: none"> Blue collar participant base for whom DC is biggest financial asset Concerned by cost & fiduciary risk 	<p><i>We've been looking at this, but there's a lot of issues and limited desire in our participant base</i></p> <p><i>We're not looking at guaranteed income because we have a DB</i></p>
<p>Unaware</p> <p>8%</p>	<ul style="list-style-type: none"> Bare-bone benefits Low participation Conservative DC approach 	<p><i>This has not been on our radar</i></p> <p><i>We know its out there, but no one has come to us to talk about it</i></p>

1

In-plan guaranteed income solutions must surmount five barriers

Importance¹

Barriers to adoption

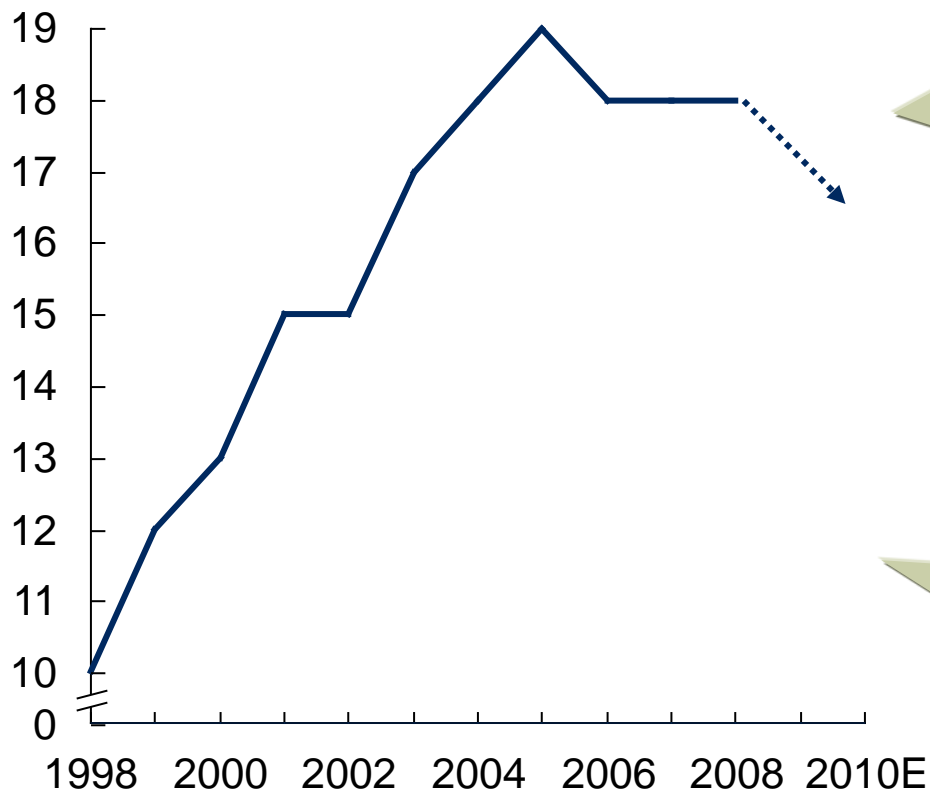
Description

Illustrative quotes

Product complexity	<ul style="list-style-type: none"> ▪ Annuity features and riders are too complex for sponsors and participants 	<p><i>“Current products are too complex – without simplification people will just not see the value”</i></p>
Portability	<ul style="list-style-type: none"> ▪ Inability to carry-over guarantees: <ul style="list-style-type: none"> – Sponsor changes guarantor – Sponsor changes platform – Participant rolls over assets 	<p><i>“If portability is solved, I think we’ll see guarantees skyrocket”</i></p>
Credit risk / stability	<ul style="list-style-type: none"> ▪ Concerns over insurer capacity to underwrite and pay for guarantees 	<p><i>“I don’t trust insurance companies. I have to be convinced that it is safe”</i></p>
Cost	<ul style="list-style-type: none"> ▪ Perception of annuities as unjustifiably expensive for given returns 	<p><i>“Guarantees are prohibitively expensive”</i></p>
Litigation risk	<ul style="list-style-type: none"> ▪ Heightened fiduciary concerns related to a perceived recommendation of high risk in-plan accumulation guarantees 	<p><i>“We are worried about fiduciary liability. Adoption by other plans would help”</i></p>

2 Investment menus continue to be streamlined

Average number of funds in DC line-ups



Illustrative quotes

“We’re trying to simplify our line-up. For example, we are consolidating our three foreign equity funds into one multi-manager ‘foreign active equity’ option to make choice easier for participants”

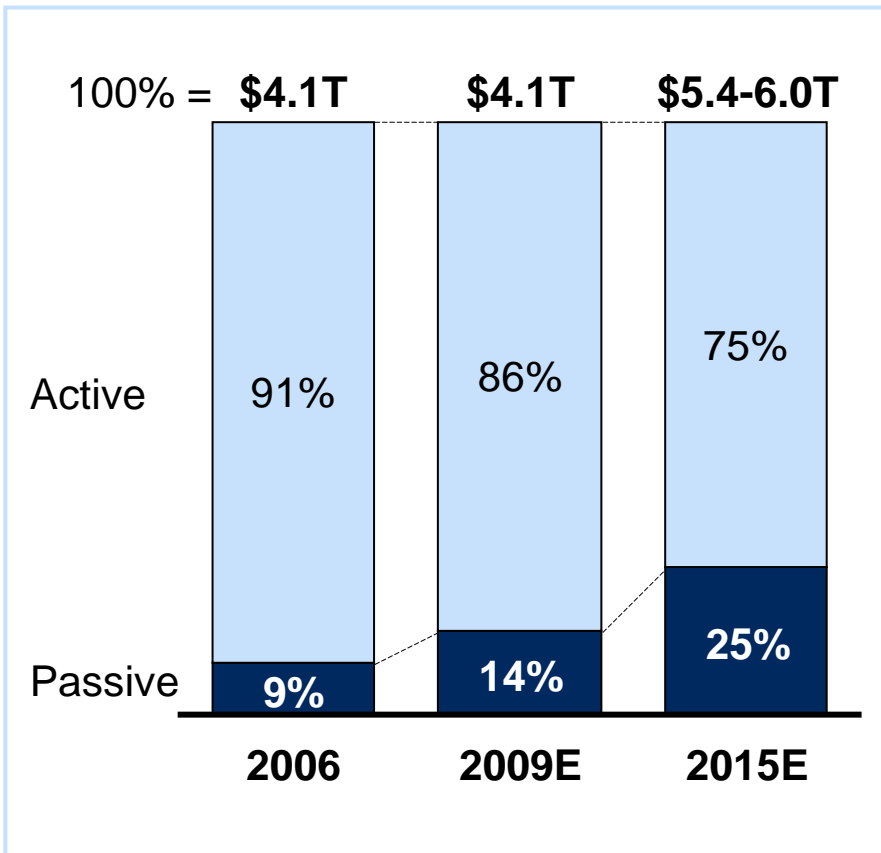
– Mega sponsor

“Sponsors are realizing that ‘less is more’, reducing bloated investment menus to a manageable number of funds participants can understand.”

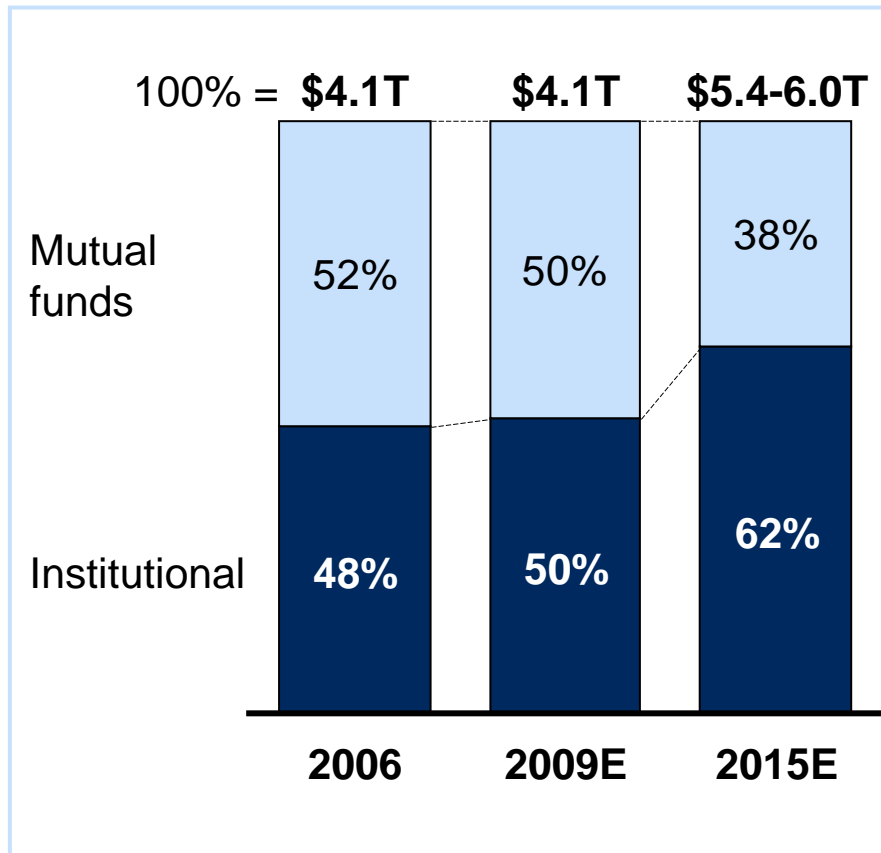
– Pension Consultant

3 Sponsor demand for passive and institutional vehicles will continue to grow

DC assets – Active vs. passive



DC assets – Mutual funds vs. institutional



4 New regulatory environment is driving increasing convergence across for-profit and not-for-profit tax segments

Examples of 403(b) regulatory changes¹

- All 403(b) plans including non-ERISA plans required to maintain written plan documents for each provider similar to 401(k) plans
- Plan sponsors have the ability to terminate their 403(b) plans
- Employer contributions to 403(b) are subject to all the nondiscrimination tests that apply to tax-qualified retirement plans like 401(k)
- Purchase of life insurance contracts within 403(b) plans are prohibited after September 23, 2007

Implications for industry players

- Increased competitive environment for plan providers, as plan sponsors will consolidate the number of providers in order to reduce the administrative burden
- Accelerated shift from individual 403(b) products to institutional solutions with open architecture, putting pressure on administrator economics
- Opportunity for 401(k) players to leverage their broader DC market experience in the 403(b) market
- Increased importance of a lean cost-base, in order to bid competitively for new and renewal RFPs

¹ Effective July 26, 2007 and applicable after December 31, 2008

5 Increasing complexity of DC and heightened sponsor concerns will accelerate the “institutionalization” of distribution

1. Increasing complexity of DC

Increased role of Treasury, Finance and Procurement

*“Now that cost is on everyone’s mind, I’m seeing **more involvement from procurement** in the RFP process and in ongoing plan monitoring... **Treasury is also more involved...** because DC plans have moved from a fringe benefit to the retirement centerpiece”*

2. DC as the core retirement vehicle

Increased role of Consultants

*“The crisis did not change much, other than the need to watch our costs more carefully. **Now that I have less HR support, I need our plan provider or consultant to fill in the gaps** where I can’t deploy resources”*

3. Heightened cost sensitivity

*“**As the business becomes more complex, more and more sponsors are using consultants...** even in the mid-market”*

4. Increased fiduciary concerns

*“With **so much change** and a **heavier workload**, I rely on consultants a lot. **We’ll probably use them even more** in the future: they’re vital for industry expertise and an unbiased in-depth knowledge of different vendors”*

6 Continued pricing and margin pressures will force recordkeepers to retool their service and operating models

Commoditization of services is increasing ...

Open architecture

“Open architecture is now a given in large, and increasingly prevalent in mid and small”

Administrative recordkeeping

“While admin mistakes could cause me to change providers, administrative excellence doesn’t stand out as a reason to close the deal”

Fees

“With rare exceptions, top providers are all price competitive within a certain range”

Communication tools / delivery channels

“All providers offer functional sponsor/ participant websites, skilled call centers, and solid communication tools – its table stakes”

Financial education / advice

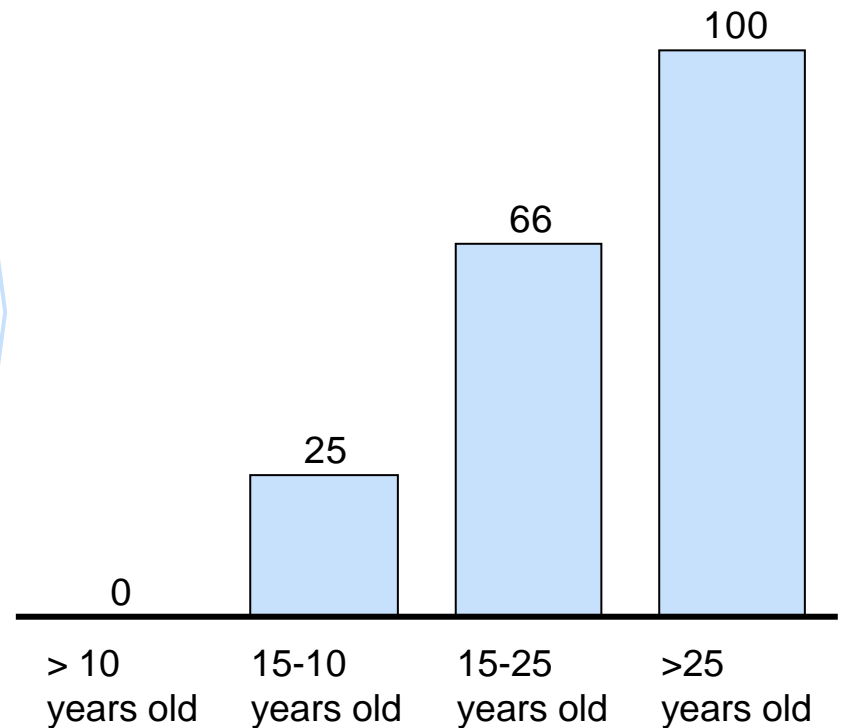
“Top providers offer similar educational tools and comparable investment advice services”

... putting intense margin pressure on RKs

Average profit/participant by plan start date

Indexed

DISGUISED EXAMPLE



7 Key legislative proposals under consideration could significantly impact the balance of power within the industry



- 1 Auto-IRAs**
- 2 Advice**
- 3 Fee transparency**
- 4 Auto-default and auto-escalation rates**
- 5 Retirement Income / Distribution**

Choices plan sponsors need to make to stay ahead of these shifts

- Determine the best way to **address core benefit adequacy concerns**, e.g.:
 - Adopt auto-enrollment / auto-escalation
 - Move to target date / target risk funds as default funds
 - Re-default participants into new default options
 - Ensure savings rates and in particular default level are sufficient to ensure a dignified retirement
- Develop a perspective on the best way to address **participants' lifetime income / decumulation needs** – e.g., what products to offer and whether within DC plans or as part of IRA roll-over solutions
- Assess how to best **provide advice** to participants and the nature of that advice in light of increased risk of outliving assets – including whether / how to offer access to in person advice and at what cost
- Identify how to best **communicate with and educate participants** and in particular **overcome participant inertia**
- Develop a view on how **target date / lifestyle fund performance** should be assessed and use this to inform the choice of the right default option; assess whether a tailored target date fund would be required
- Decide the right mix of **retail and institutional, and active and passive** options; and determine steps needed to educate participants on these new options
- Determine how much **leakage** there is through pre-retirement withdrawals and identify any actions needed to address this issue

Appendix

Questions for the audience

- Are you considering or have you already adopted open architecture target date funds? (adopted, currently considering, interested but not currently considering, not interested)
- Are you considering or have you already adopted a retirement income solution? (adopted, currently considering, interested but not currently considering, not interested)
- By 2015, our allocation to passive solutions will: (increase, stay the same, decrease)
- By 2015, in our plan, stable value will be (a distant memory, an option but not the default, the default)
- When we default participants, the maximum level we default participants at is (<3%, 3-4%, >4%)
- Who is the main decision maker in adding/replacing investment options to the DC plan (cio, DC administrator, treasurer, head of employee benefits etc)
- What prompts the replacement or addition of a new investment option (Recordkeeper suggests it we accept, Investment consultant recommendation as part of annual review, Proactive Investment consultant recommendation, Direct outreach from asset manager, In response to Internal review)
- By 2015, we will have (adopted auto-enrollment but not re-enrolled employees, adopted auto-enrollment and re-enrolled employees, not adopted auto-enrollment)
- In our plan, our use of consultants is (increasing - we use them more often and on a broader set of issues, not changing, decreasing - we use them less or on a narrower set of issues)