

Financial Services Practice



Winning in the Defined Contribution Market of 2015

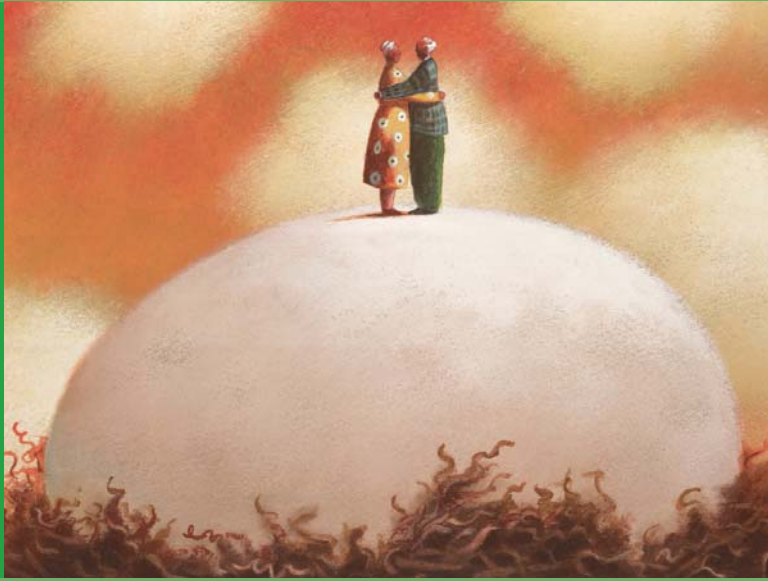
New Realities Reshape
the Competitive Landscape

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Introduction

Born almost by accident nearly 30 years ago, defined contribution (DC) has become the favorite child of asset gatherers. Despite a trillion-dollar decline in assets during the recent financial crisis, DC has surpassed private defined benefit (DB) as the major pool of retirement funds with \$4 trillion in assets. Although faced with the prospect of \$2 trillion in outflows over the next five years due to retiring baby boomers, DC will continue to thrive, with an equal level of new contributions.

However, the basis for competition in DC is shifting. The precipitous decline in participants' assets at the height of the financial crisis raised awareness of U.S. retirement readiness, which fell to 63 percent¹ in 2009/10, 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 have profound implications for industry players and will reshape the competitive environment.

Some of the current market trends were underway before the financial crisis (see our 2007 paper *Redefining Defined Contribution*) and have now accelerated. But there are a number of new realities looming, revealed by our post-crisis research, which included interviews with more than 80 plan sponsors, industry experts, registered investment

¹ McKinsey's Retirement Readiness Index (RRI) is a measure of household retirement preparedness, taking into account Social Security, DB plans and personal savings, including DC plans. To maintain their standard of living in retirement, households need an RRI of 100. The average household RRI is 63, which represents a 37% shortfall in income required at retirement.

advisors (RIAs) and consultants, as well as analysis based on our proprietary model of DC flows, assets and economics by products and segments. Among our key findings:

- A new suite of target-driven solutions will account for 60 percent of DC assets and revenues by 2015 and capture \$1.7 trillion of flows.
- Investment choices and options will continue to be streamlined, to the benefit of both participants and investment-only DC (IODC) providers. The latter will see their share of DC assets increase from 43 to 50 percent.
- Cost, investment automation and demographics will drive a shift in asset allocation. Passive and target-driven solutions will gain share at the expense of active U.S. equity and stable value.
- The blurring lines between tax code and size segments and large concentrations of flows will force players to rethink how they segment clients.
- Competition for shelf space will require sales models to become more institutional.
- Continued pricing and margin pressure will force recordkeepers and asset managers to retool their service and operating models.
- Finally, potential regulatory discontinuities across fees, advice, auto-IRA, default and escalation rates, and retirement income solutions will threaten to reshuffle the balance of power within the industry.

Asset gatherers that take action now on these imperatives will continue to pull away from the pack; those that cannot adapt or continue to dabble will be marginalized.

These new realities will alter the traditional routes to success in DC. Asset gatherers – whether integrated recordkeepers, asset managers or wealth managers – that aspire to be leaders in the DC market of 2015 will need to focus on these imperatives:

- Focus on the client segments and product categories that will benefit disproportionately from the new market realities.
- Retool sales and operating models to counter margin pressure and meet client demand for more institutional service.

- Build new businesses in major growth categories.

Asset gatherers that take action now on these imperatives will continue to pull away from the pack. Those that cannot adapt or continue to dabble will be marginalized.



The Largest Growth Opportunity for Asset Gatherers

With over \$4 trillion dollars in assets, DC is more than four times the size of the market's other growth darling – ETFs – and on par with the global sovereign wealth fund market. DC and IRA together represent nearly one-third of U.S. household assets, more than retail mutual funds held outside of DC plans and ETFs combined.

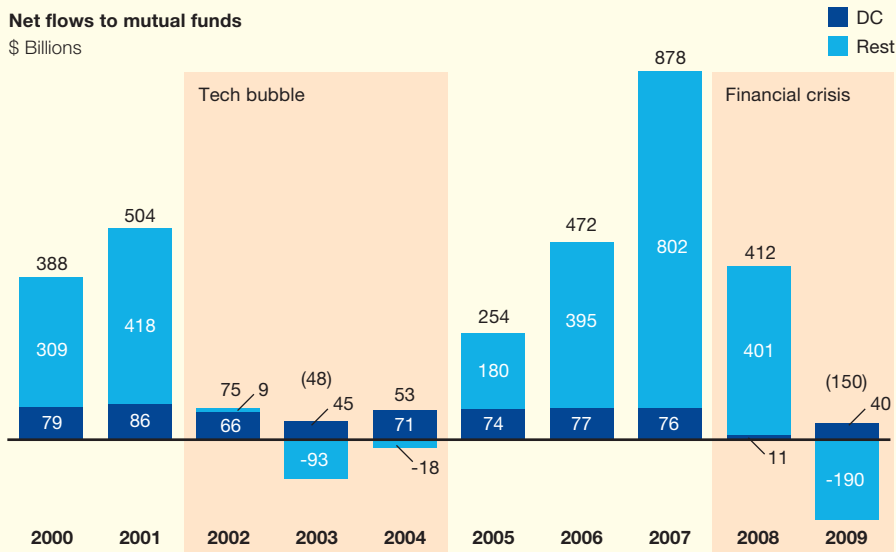
DC's growth story is also one of remarkable resilience through crises. While non-qualified flows typically turn negative during financial crises and spike in times of prosperity, qualified flows are consistently positive and roughly stable throughout the economic cycle (Exhibit 1, page 6). True to form, Americans kept saving in DC plans between 2007 and 2009. Plan participation rates increased to 69 percent from 66 percent, and contribution rates remained roughly constant at around 7 percent of participants' wages. The crisis actually underscored for many Americans how woefully unprepared they are for retirement. This awareness, along with the growing adoption of auto-enrollment and auto-escalation provisions, promises to deliver \$1.9 trillion in DC contributions over the next five years.

DC flows have also proven more persistent and "stickier" than other retail flows. The average holding period for a mutual fund in a DC plan is six to seven years, compared to three to four years in a traditional brokerage account.

Exhibit 1

Flows into DC are relatively stable and more resilient during market downturns

Net flows to mutual funds
\$ Billions

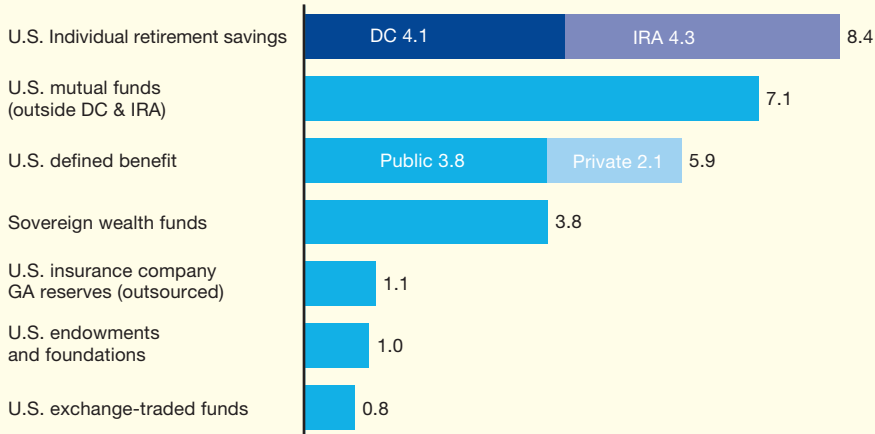


Source: Investment Company Institute, "The US Retirement Market, 2009"

Exhibit 2

DC and IRA assets combined represent the largest asset management opportunity

Asset holdings – 2009
\$ Trillions



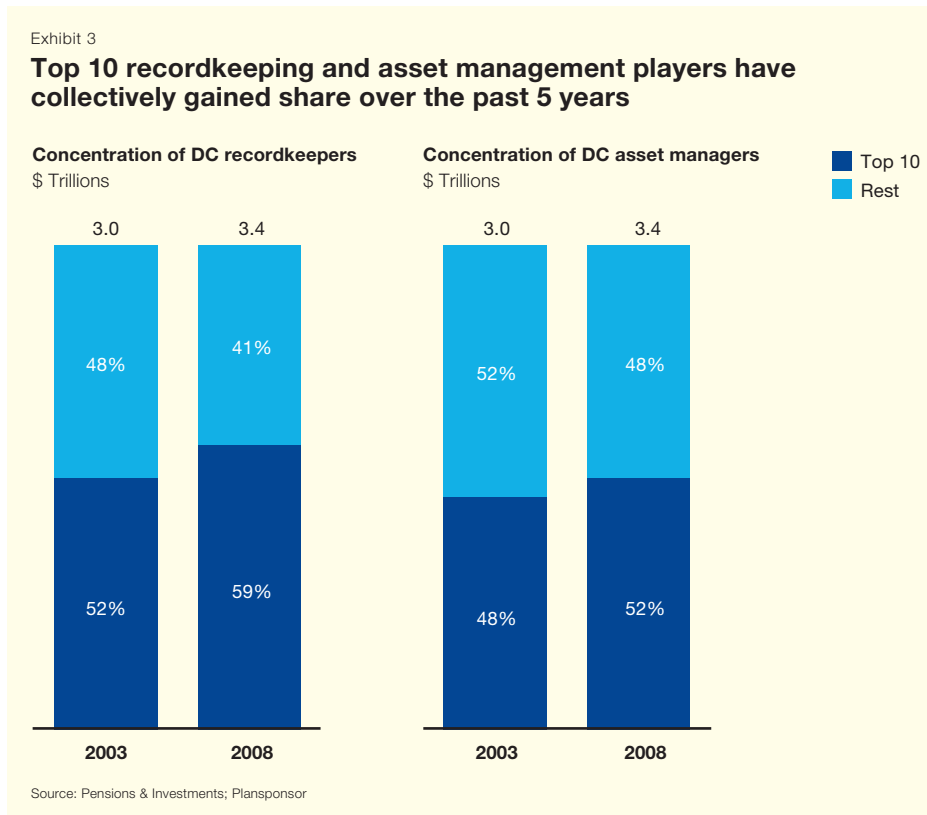
Source: Federal Reserve Flow of Funds; ICI; NACUBO; Foundation Center; Sovereign Wealth Fund Institute

We expect DC to continue its remarkable track record of sustainable asset growth, reaching \$5.5 trillion in assets by 2015. Together, DC and its sister market, IRA, represent the largest asset growth and flow opportunity in retail financial services (Exhibit 2). Most asset gatherers – integrated recordkeepers, asset managers and wealth managers – recognize the scale of the opportunity and its vital importance to their growth aspirations, but this awareness must be bolstered by an understanding of how fundamentally different the market will look in five years.



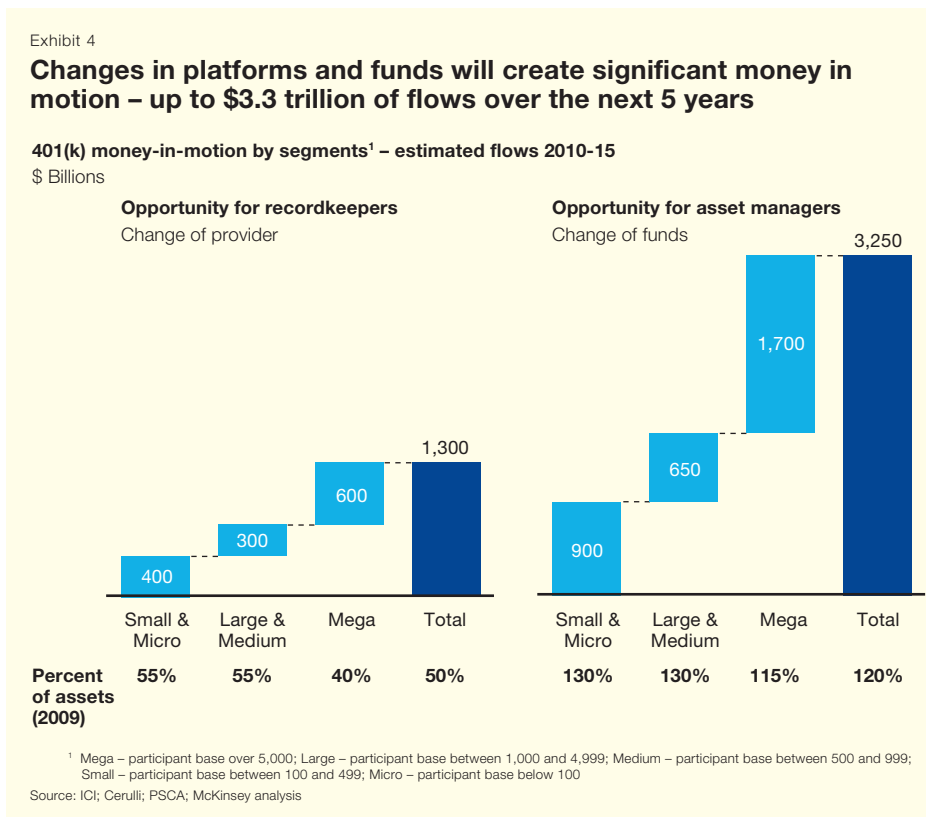
New Products, Distribution, Economics and Regulation Reshape the Competitive Landscape

On one level, DC competition appears stable and almost clubby. Over the past five years, the combined market share of the 10 largest recordkeepers has increased from 52 percent to 59 percent, and the 10 largest asset managers now hold 52 percent of assets compared to 48 percent in 2003. However, a deeper analysis shows that the market is up for grabs, with large pools of assets changing hands. Over the next five years, about \$1.3 trillion of 401(k) assets will change recordkeepers due to plan switching. Another \$3.3 trillion of assets will be in play, moving to new investment vehicles or strategies, as plans change providers for specific asset classes and participants rebalance allocations. More fundamentally, seven trends will dramatically alter the competitive playing field.



A new wave of target-driven solutions

The Pension Protection Act (PPA) of 2006 created a boom in target-date funds, which used their status as Qualified Default Investment Alternatives (QDIAs) to become the default choice for the majority of sponsors. Most of the assets accrued to integrated players. Over the next five years, we expect target-driven solutions to capture \$1.7 trillion of flows (Exhibit 5, page 12) and account for 60 percent of all DC assets and revenues. But the competitive dynamics in target-driven solutions will undergo a revolution driven by plan sponsor demand, consultants and innovation. In the minds of many plan sponsors and consultants (as well as regulators), target-date funds failed to deliver during the financial crisis. This is opening the way for innovations, ranging from fully customized, open-architecture solutions (e.g., those incorporating non-correlated asset classes or custom glide-paths) for large and mega plans to semi-customized multi-manager products, created from plan line-ups, for mid-sized to large plans to predominantly passive low-cost offerings for small plans. This new wave of

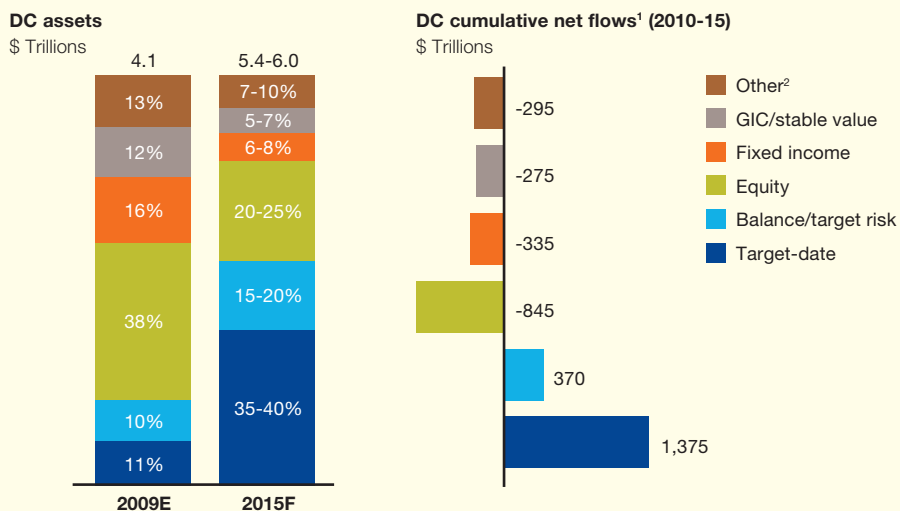


target-driven solutions creates a natural market entry point for new players, particularly for institutional asset managers experienced in customizing portfolios for institutional mandates. As regulators and clients alike pry open the proprietary target-date world, they are also creating opportunities for high-performing managers to enter through select sleeves within existing proprietary funds.

More fundamentally, the industry has not yet effectively solved the question of what happens when participants reach their target date. These funds were designed primarily as accumulation vehicles, and most fail to meet clients' needs for income, capital preservation and inflation protection. Guaranteed-income options, despite professed demand (90 percent of sponsors are aware of them, and more than 60 percent of DC participants express interest), have failed to gather assets in DC. While offering guaranteed-income solutions as QDIAs could create real growth, significant hurdles remain, including portability, credit risk and stability, cost and, most importantly, product complexity and participant education. Given current market inertia, a break-

Exhibit 5

By 2015, target-date funds are set to emerge as the largest asset class, capturing nearly 40% of assets and majority of the flows



¹ Excludes other DC (profit-sharing plans, money purchase plans and stock bonus plans)

² Includes company stock and assets held through brokerage window

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)

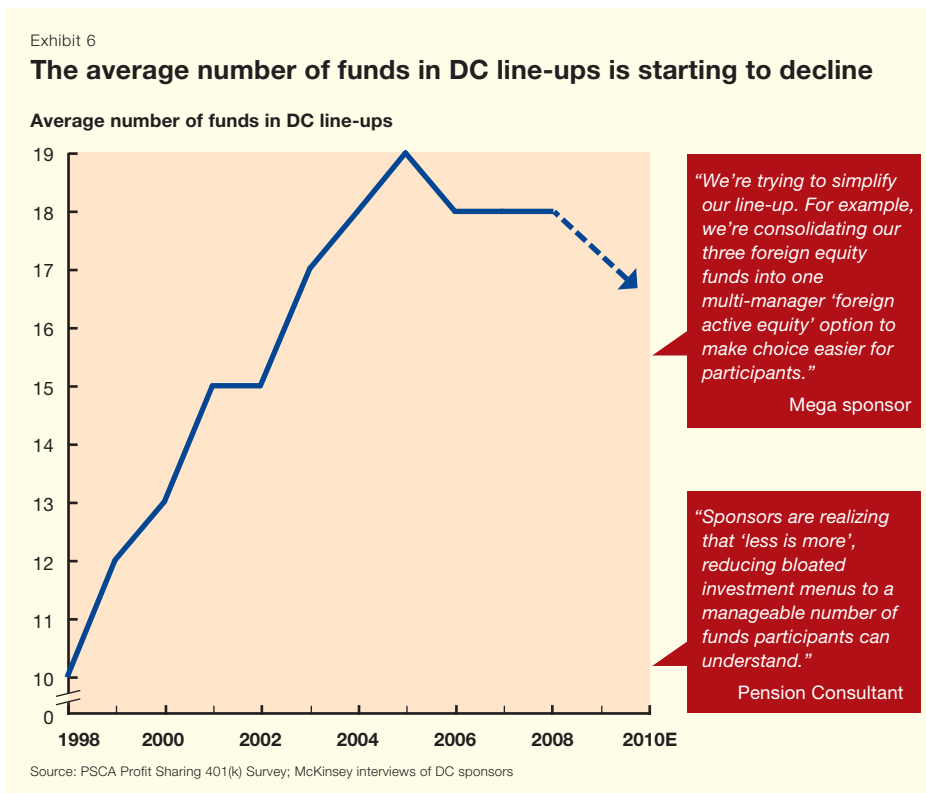
Source: ICI; EBRI; PSCA; Vanguard; McKinsey analysis

through in guaranteed-income solutions likely hinges on a few large-plan sponsors adopting them or meaningful regulatory intervention that alleviates concerns and dispels the wait-and-see attitude of plan sponsors. Innovators that overcome these barriers and create target-driven solutions (e.g. target-date, target-return, target-risk, target-income, target-inflation, guaranteed-income) can expect significant rewards in the years ahead.

Fewer options but more competition

Plans will continue to streamline and simplify fund line-ups, driven largely by the guidance of pension and investment consultants. While less is more for participants (research shows that too many choices lead to sub-optimal participant choices²), it also heightens competition among asset managers for diminishing shelf space, but with larger ticket sizes. The trend toward simplifi-

² See, for example: Sheena Iyengar and Emir Kamenica. "Choice proliferation, simplicity seeking and asset allocation," *Journal of Public Economics* (April 2010).



cation will force asset managers to specialize more, deliver a clear value proposition around a narrower band of asset classes and solutions, and raise the bar for investment performance (Exhibit 6).

The streamlining of investment options coupled with the shift to open-architecture in target-date funds will create significant growth opportunities for IODC managers. By 2015, we expect their share of DC assets to increase from 43 percent to 50 percent, surpassing the share of proprietary managers. However, this growth will not be uniform.

Major shifts in investor asset allocation driven by cost, automation, and demographics

For much of the past two decades DC investment allocations benefited active equity managers. Now, a confluence of trends (e.g., sponsors' fiduciary and cost concerns; the growth of QDIA solutions) is redirecting some of these flows to lower-fee, passive solutions. We expect the share of

passive assets in DC plans to double by 2015 to 25 percent. ETFs might benefit from this movement, but they are starting from near-zero assets today (mostly in small/micro segments). Uptake in broader DC segments is likely to be limited in the next one to two years, due primarily to limited sponsor and consultant awareness and a lack of revenue-sharing and 12b1 fees in most cases, although this may change going forward.

While DC asset allocation historically has been largely immune to demographics (largely due to participant inertia), automated rebalancing of asset allocation in target-driven solutions and the aging of the population will change this dynamic. By 2015, nearly 70 percent of assets will be held by individuals at or within five years of their “target date” for retirement. This shift will create significant growth opportunities, particularly for fixed-income managers and income-oriented equity managers. Active equity managers, after two decades of benefiting from DC growth, will be on the short end of this trillion dollar shift. (They may be able to withstand the pressure by branching into equity income or international equities.) Stable value managers will also suffer, but to a lesser extent.

Blurring of lines between tax codes and size segments forces a rethinking of segmentation

With the lines between tax codes and size segments blurring, pressure on the traditional owners of these segments will increase, as outside players seek new avenues for growth. For example, after a long journey, the 403(b) world now resembles the 401(k) world. This transformation was initially driven by regulatory reform (e.g., new requirements to maintain written plan documents for each provider; ability of plan sponsors to terminate plans; employer contributions subject to all non-discrimination tests that apply to 401(k) plans; prohibition of purchase of life insurance in 403(b) plans) and more recently by the shift to a single recordkeeper environment, open architecture, and the increasing role of pension consultants. Similarly, the lines between size segments within the 401(k) world are breaking down, as sponsors of all sizes increasingly demand similar solutions (e.g., open archi-

Segmentation in DC is also being shaped by stark contrasts in flows. Small and mid-size plans and K-12, for example, will experience inflows, driven by increased (and automatic) enrollment; mega plans by contrast will suffer \$200 billion in outflows, owing to an older workforce.

ture, participant advice), opening every segment to competition and forcing players to think beyond traditional size and tax code segments to build an advantage.

Segmentation in DC is also being shaped by stark contrasts in flows. Small and mid-size plans and K-12, for example, will experience inflows, driven by increased (and automatic) enrollment and workforces; mega plans by contrast will suffer \$200 billion in outflows, owing to an older workforce.

Shrinking shelf space requires sales models to become more institutional

The shift from DB to DC as the primary retirement plan for employers, heightened fiduciary and cost concerns, and the increasing complexity of DC rules and solutions are leading plan sponsors to turn more often to pension consultants for guidance on a broader set of issues from recordkeeper selection to plan design and investment choices. In parallel, employers are

DC is becoming an institutional game, requiring deep relationships with pension and investment consultants and other influencers, as well as more embedded and senior relationships with sponsors across all involved functions.

professionalizing their decision-making, involving finance, treasury and procurement functions at the expense of human resources. These trends are leading to more sophisticated plan design, rigorous decision-making, in-depth due diligence, and increasingly stringent and formalized standards for providers in both asset management and recordkeeping. DC is becoming an institutional game, requiring deep relationships with pension and investment consultants and other influencers, as well as more embedded and senior relationships with sponsors across all

involved functions. Asset managers and recordkeepers will need to transform their sales models and capabilities to succeed.

Continued margin pressure forces players to adapt their models

Commoditization is pressuring already razor-thin margins for recordkeepers. The looming resurgence of per-participant flat fees, which could come as a consequence of new fee disclosure regulation, could provide some relief, but would also dampen upside revenue potential. These factors paint a fairly grim view of recordkeeping as a source of growth. We project that recordkeeping's share of DC revenues will shrink from 11 percent today to 8 percent by 2015. The asset management side faces similar, albeit less

dire, pressures, as sponsors shift to lower-fee solutions such as institutional and passive vehicles. This trend, which has been underway in the large and mega plan segments for some time, is now moving to smaller sponsor segments. As a result, institutional vehicles already represent 50 percent of assets under management (AUM).

Regulatory discontinuities threaten to reshuffle the industry's balance of power

DC was born 30 years ago as an unintended tax loophole and has since benefited from the broad trend in regulation and policy that has shifted responsibility for retirement savings to the individual. However the regulatory and policy framework has not kept pace, and millions of Americans are still under-prepared. Our analysis of consumers' balance sheets in 2009 indicated that the average American family faced a 37 percent shortfall in the income they will need in retirement.³

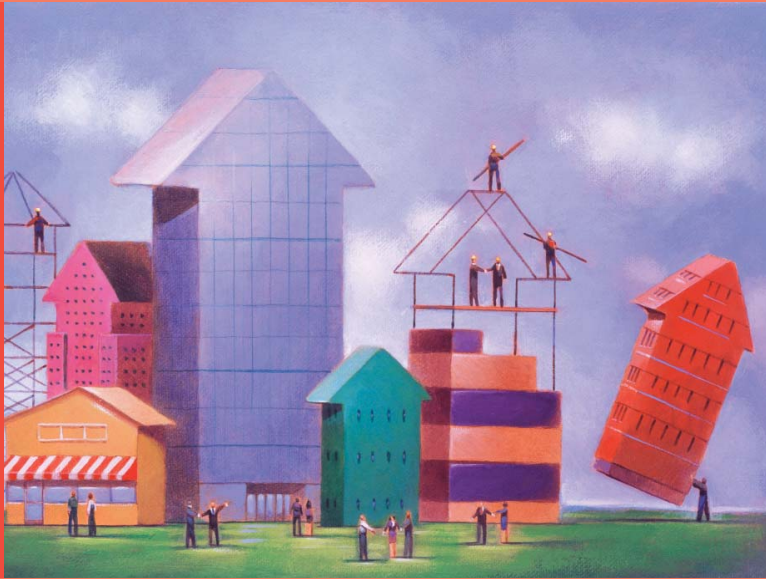
In light of this shortfall, Congress, as well as the Department of Labor and other regulatory bodies, are considering revisions in retirement regulation. Among the multitude of proposals put forward, five in particular could significantly alter the competitive landscape for DC.

First, the introduction of auto-IRAs could have a material impact on small plan providers (e.g., Simplified Employee Pension plans, Savings Incentive Match Plans for Employees of Small Employers, micro 401(k)s), increasing participation by 40 million and funneling over \$100 billion into DC over the next five years. Second, increasing auto-default and escalation thresholds could direct an additional \$90 billion into DC by 2015 (and dramatically improve Americans' retirement readiness). Third, proposals around greater fee disclosure (e.g., displaying absolute dollar amounts to participants) could induce a shift to flat per-participant recordkeeping fees and away from revenue-sharing models with asset managers, making recordkeeper economics

The adoption of any of these regulatory measures could significantly impact who wins and who loses in DC, just as the PPA changed competitive dynamics by providing safe-harbor protection for the adoption of target-date or target-risk solutions as QDIAs.

³ McKinsey's Retirement Readiness Index (RRI) is a measure of household retirement preparedness, taking into account Social Security, DB plans and personal savings, including DC plans. To maintain their standard of living in retirement, households need an RRI of 100. The average household RRI is 63, which represents a 37% shortfall in income required at retirement.

more stable but capping their upside. Fourth, decisions regarding who can provide advice – and how they can provide it – could shift the balance of power between recordkeepers, asset managers and advisors to those with access to participants. Finally, a decision on whether to make retirement income solutions QDIAs or to require one in every plan could provide an entry point for manufacturers with annuity capabilities and dramatically shift a plan's typical allocation. This would also greatly reduce the IRA opportunity, dramatically changing the economics for integrated recordkeepers. The adoption of any of these regulatory measures could significantly impact who wins and who loses in DC, just as the PPA changed competitive dynamics by providing safe-harbor protection for the adoption of target-date or target-risk solutions as QDIAs.



To Win in the DC Market, Asset Gatherers Must Refocus, Retool and Innovate

In the past, when change was more incremental, asset gatherers could focus on near-term execution and operational improvement in DC. This approach will not suffice any longer. Players must develop convictions about where the DC market is heading and decide where and how to execute against those convictions. For example, the choice of which client segments to target can have \$100 billion in implications on flows. Likewise, the shift to an institutional sales model and pricing will have a meaningful impact on the structure and value-added of current retail-oriented sales models. Investments in innovative target-driven solutions today may yield outsize rewards five years from now (while lack of investment could mean being shut out of the market). Decisions about product emphasis might position a firm squarely in the midst of massive new flows or leave it on the sideline, desperately holding onto depleting assets. Changes in DC that seem incremental will turn out to be profound in five years' time.

For asset gatherers to emerge as leaders in the DC market of 2015 they must refocus their portfolios on clients and products that will be disproportionately valuable; retool core businesses to withstand margin pressure; and build new businesses that leverage core capabilities.

Refocus the portfolio

“Double down” on the one or two client segments that can be “owned” and that will benefit from market trends. Even today, leading recordkeepers and DC-focused asset managers consistently own one or perhaps two segments, while laggards overextend themselves. And too many players focus on the mega 401(k) space, which is overserved and offers increasingly thin margins and negative growth prospects, compared to other segments. Between 2010 and 2015, mega 401(k) plans will experience close to \$200 billion in negative net flows, while all other 401(k) segments will see \$190 billion in positive flows. The smaller size 401(k) markets are often less crowded and typically faster-growing, but to be competitive and profitable, players must have lower-cost distribution models.

To win in a DC environment of blurring tax code lines and client needs, recordkeepers and asset managers must rethink how they segment (e.g., employer behaviors, workforce characteristics) and leverage new segmentation models as a differentiator. For example, players with distinct capabilities in attractive verticals (e.g., law firms, banks, high-tech) could develop tailored service offerings in an effort to become the provider of choice. Providers could also customize services to reflect the needs of the workforce of a given segment. For instance, they could offer paperless solutions and online features that meet the needs of sponsors who want lower-fee options and provide participants with easy access to technology at the worksite.

Build specialist asset management expertise on the right product flow categories. To win in the new DC environment, asset managers must fight the urge to be all things to all people and instead distinguish themselves within specific asset classes and adapt to the growing institutionalization of DC. Fixed-income and passive managers will benefit from shifts in the DC market. Others, especially active equity players, should aim for distinctiveness in select categories (e.g., equity income). The goal should be to “own” an asset category, preferably in a big flow category, and to adapt the portfolio in areas that are under pressure (e.g., from U.S. equity to equity income).

Retool the core businesses

Build institutional-strength distribution and investment capabilities to access scarcer, more valuable shelf space. From both a product and distribution standpoint, the DC business has historically sat awkwardly between the retail and institutional worlds, incorporating elements of both. If anything, DC has seemed more retail than institutional. Now, however, DC is clearly leaning to the institutional side, both in vehicle choices and sales models, and future winners will be those that can adapt to this shift. Asset managers and recordkeepers must develop new sales approaches and coverage models to effectively address the demands of CFOs and treasury and procurement functions, as well as the advice of sophisticated consultants and RIAs. Recordkeepers will need to be more than pure transactional service providers and proactively help sponsors with decision-making and services. Similarly, to expand and maintain their client base, both recordkeepers and asset managers must invest in building relationships with consultants, as winning the trust of sponsors' new "right arms" will be critical.

Develop a low-cost operating model and optimize pricing to counter margin pressure and reflect true cost-to-serve. Configuring a low-cost operating model will be a prerequisite for recordkeepers and integrated players alike. In the past, firms have focused on scale as defined by assets alone to keep costs in check, but this strategy will no longer suffice. Revenue pressures are leading many recordkeepers – even those at scale – to take on new business at or below cost. These pressures demand a more disciplined and sophisticated approach, which could include standardizing offers to create true scale, eliminating customization wherever possible, outsourcing and offshoring, applying lean principles to eliminate wasted effort, and aggressively moving to e-delivery, self-service models and service delivery tailored to specific segments. Even the largest players will need to adapt to remain competitive.

Disciplined pricing is a necessary complement to cost containment. Historically, the industry has offered standardized pricing structures that did not reflect the value-added to each plan, i.e., they did not account for the level of customization, types of solutions, participant balances or roll-over retention. To succeed, firms must build processes to measure each plan's profitability and understand the true cost of different services and customization. This will allow them to devise a pricing strategy that is competitive but profitable, while communicating the full value of their services to clients.

Build new businesses – or innovate in existing ones

Build new business lines in target-driven solutions. The goal of innovation in DC until now has been to have a perfect theoretical answer from an investment or actuarial point of view. The results have often been large, complicated prospectuses and little in assets. To win, players must now wrestle with thorny investment and risk issues, such as protecting against inflation or targeting a safe return or income stream, while innovating in marketing (making the complicated simple) and nudging consumers to overcome their behavioral biases (e.g., inertia, familiarity bias). Working with employers will be particularly critical in a market where adoption of new solutions is heavily dependent on a few large-scale plans acting as trendsetters. Winners will also need to anticipate and adapt quickly to regulatory changes.

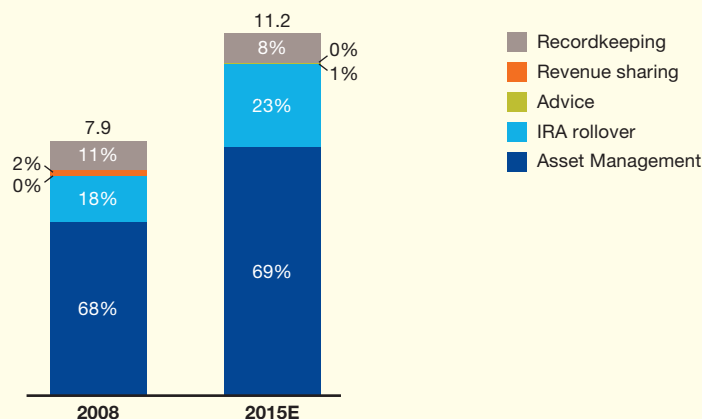
Build better capabilities for capturing the IRA rollover. DC has historically been thought of as an asset accumulation vehicle, with profits derived during the accumulation phase. But winning integrated recordkeepers will now use DC as a client acquisition platform to capture economic value throughout participants' lifetimes. Industry economics will shift dramatically by 2015. Driven by margin pressure and increasing IRA rollovers, recordkeeping revenues will drop from 11 percent of DC revenue pools to just 8 percent, while IRA rollovers will jump from 18 percent to 23 percent of revenue (Exhibit 7).

Exhibit 7

Economics in the DC industry will continue to shift towards asset management and IRA rollovers versus traditional record keeping

Illustrative revenues pools for mega 401(k) plan segment

\$ billions



Source: McKinsey analysis

Players must rethink how they assess and capture the value of recordkeeping platforms, viewing them as client acquisition engines to attract rollovers and deliver a broader set of solutions to individual participants. Integrated recordkeepers must take a holistic view of the economics that drive platform, asset management and IRA revenues and tie these economics to execution realities (e.g., actual, rather than aspirational, roll-over rates).

DC recordkeepers will also need to execute better to take advantage of the rollover opportunity. While some firms have increased their capture rate to above 50 percent, the industry average is only 25 percent, which translates into hundreds of billions of dollars in leakage to retail wealth firms. Recordkeepers need to transform their pricing structures, redesign their rollover processes, align their product and service offerings, redesign incentives and structure their organizations to deliver a lifetime value proposition to plan participants.

The leakage from DC platforms will account for over half of the net flows into retail and will be the largest “money in motion” event for the next five years. Most retail wealth firms cannot state what their “fair share” of IRA rollovers might be and are under-resourced for the opportunity. The leaders, however, are already building a deep understanding of participant trigger points, tailored solutions to accompany clients in their journey from asset accumulation to asset disaggregation, and most importantly, world-class processes, as cycle times and client experience are often the primary drivers of rollover capture rates.

* * *

The stakes in the DC market have never been higher. The financial crisis and ensuing recession have focused the attention of sponsors, participants and the government on the crucial role DC plans play in ensuring retirement security for millions of Americans. This scrutiny will lead to regulatory changes that will alter the competitive landscape in both predictable and unpredictable ways. In addition, a confluence of trends – some new, some of older vintage – are further reshaping the DC market. In this shifting environment, marginal asset managers and recordkeepers will struggle to gather assets and miss out on one of the largest growth opportunities of this decade. Even more established institutions will need to take timely action to continue to thrive. Players that move in and out of the market or that are seen as potential transaction candidates will lose credibility, whereas those with a clear and long-term commitment to the retirement market and an attractive value proposition for sponsors and participants will solidify their lead.

Appendix I

A closer look at DC market growth and economics across products and segments

McKinsey & Company's proprietary Defined Contribution Model offers unique insights into inflows, outflows, assets and economics at the tax code (e.g., 401(k), 403(b), 457), segment (micro, small, mid-size, large, mega, K-12, higher education, healthcare), asset category (e.g., target-date, domestic equities, international, fixed-income) and management style (e.g., passive, active) levels. In addition, the model provides information regarding assets changing hands annually, both on the recordkeeping and asset management sides, and the market share of different player types (e.g., integrated, IO, pure recordkeepers). Among the insights generated from this research:

Flows and assets

DC assets will total \$5.5 trillion by 2015 (Exhibit A). Over the next five years, the DC market will cumulatively grow by 35 percent, reaching close to \$5.5 trillion in assets under management (AUM) by 2015. This growth will occur despite net outflows beginning in 2013 (primarily from mega plans) and is based on a conservative market appreciation of 5.5 percent (post-fee).

Solution and management style shifts

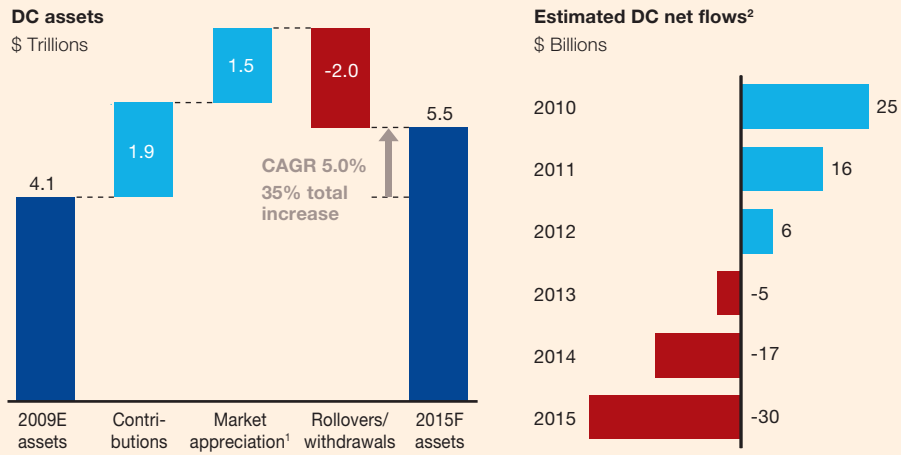
Asset allocation funds will capture the lion's share of net flows. As the QDIA of choice, target-date funds (TDFs) will capture the vast majority of DC net flows. By 2015, TDFs will see \$1.4 trillion of cumulative net flows and control 40 percent of DC AUM.

Traditional equities and stable-value/GICs will lose ground. Equities are projected to experience over \$800 billion in net outflows over the next five years. Similarly, GIC/stable-value products will cumulatively lose over \$250 billion of assets.

There will be a shift to passive assets (Exhibit B). Passively-managed products are expected to account for up to one-fourth of all DC assets by 2015, up from only 9 percent in 2006.

Exhibit A

DC assets estimated to grow by 35% by 2015 despite outflows outpacing contributions



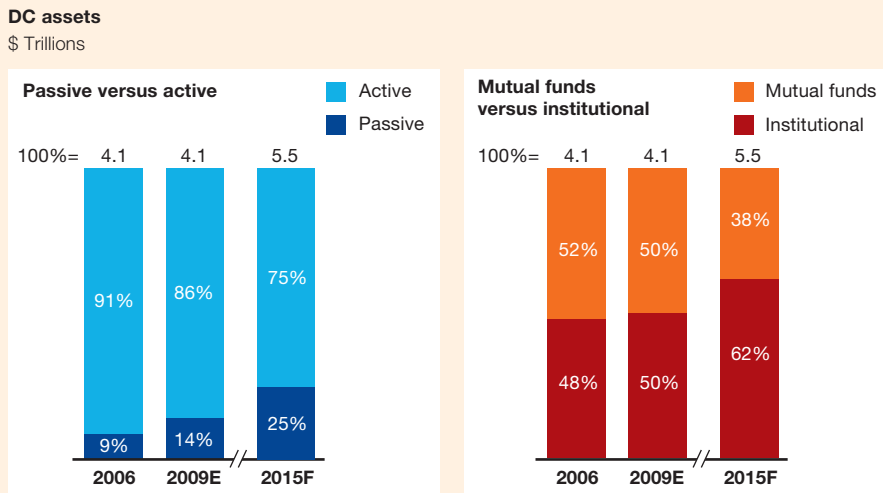
¹ Assumes post-fee returns of 5.5%

² Excludes other DC (profit sharing plans, money purchase plans and stock bonus plans)

Source: ICI; Cerulli; McKinsey analysis

Exhibit B

Sponsor demand for passive and institutional vehicles will continue to grow



Source: SimFund; ICI; PSCA/Casey Quirk; USI McKinsey Asset Management Survey; McKinsey analysis

Sponsor demand for institutional vehicles will increase. Institutional vehicles will grow at the expense of mutual funds, reaching 62 percent of DC assets in 2015, up from 48 percent in 2006.

Segments

Small/micro and mid/large will be the fastest-growing 401(k) segments (Exhibit C). Small/micro and mid/large plans are projected to grow assets at about 7.5 percent over the next five years versus 3.5 percent growth for mega plans. The growth of smaller plans will be driven by new plan creation and the adoption of auto-enrollment.

Mega 401(k) plans will experience negative net flows and continued pressure on economics. Over the next five years, retiring baby boomers will be responsible for approximately \$200 billion in net outflows from mega plans. This contrasts with \$70 billion and \$110 billion in net inflows, respectively, for large/mid and small/micro plans. The gap between mega and smaller plans is the result of larger rollover balances in mega 401(k) plans, due to higher per-participant asset balances.

Not-for-profit, K-12 and healthcare segments will experience faster growth. Between 2010 and 2015, K-12 and healthcare plans are projected to grow about 6 percent, as opposed to 5 percent for higher education plans. Faster growth in K-12 and healthcare will be driven by higher workforce and participant growth.

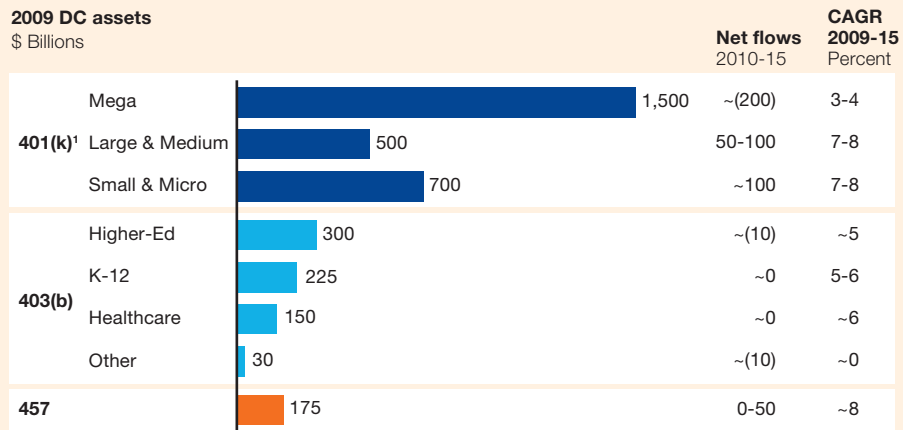
Economics

Asset management revenue margins will remain stable despite the shift to passive and institutional investments (Exhibit D). Despite the increasing shift to lower-fee passive and institutional vehicles across various asset classes, overall DC revenue margins are projected to remain relatively stable. Rising allocations to target-date/target-risk/balanced products, which typically command higher fees, will offset the move to lower-fee products.

Recordkeeping margins will face continued pressure. Per participant recordkeeping revenues have dropped by about 30 percent since the crisis, severely squeezing margins.

Exhibit C

DC outflows will be primarily in the mega 401(k) segment; large-medium and small-micro 401(k) will continue to experience positive net inflows



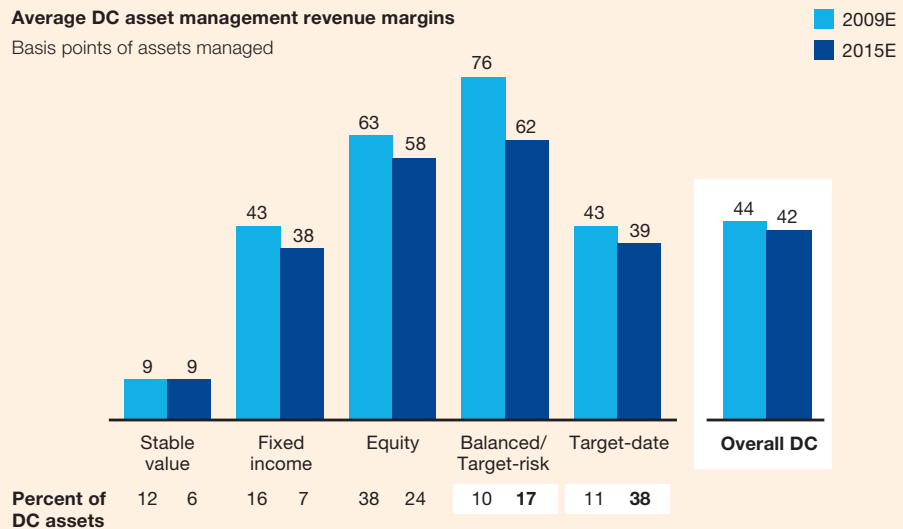
¹ Mega – participant base over 5,000; Large – participant base between 1,000 and 4,999; Medium – participant base between 500 and 999; Small – participant base between 100 and 499; Micro – participant base below 100

Source: ICI; EBRI; Cerulli; Spectrem Group; Vanguard; McKinsey analysis

Exhibit D

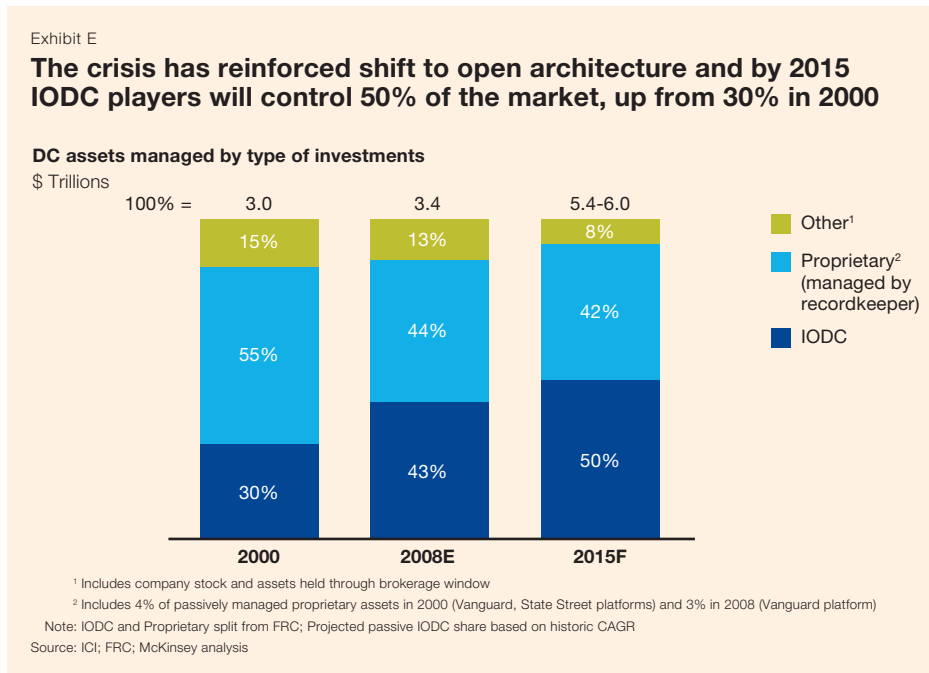
Overall margins will remain roughly constant

Average DC asset management revenue margins
Basis points of assets managed



Percent of DC assets
12 6 16 7 38 24 10 17 11 38

Source: SimFund; ICI; PSCA/Casey Quirk; USI McKinsey Asset Management Survey; DC Sponsor interviews; McKinsey analysis



Competition

IODC players will become stronger (Exhibit E). The financial crisis led many sponsors to revisit their investment line-ups and reconsider the merits of bundled products, especially for target-date solutions. This has reinforced a shift to open architecture and will stimulate growth for IODC players. They are projected to control 50 percent of the overall DC market by 2015, up from 30 percent in 2000.

Appendix II

The IRA race: A battle for the largest non-cash opportunity in wealth management

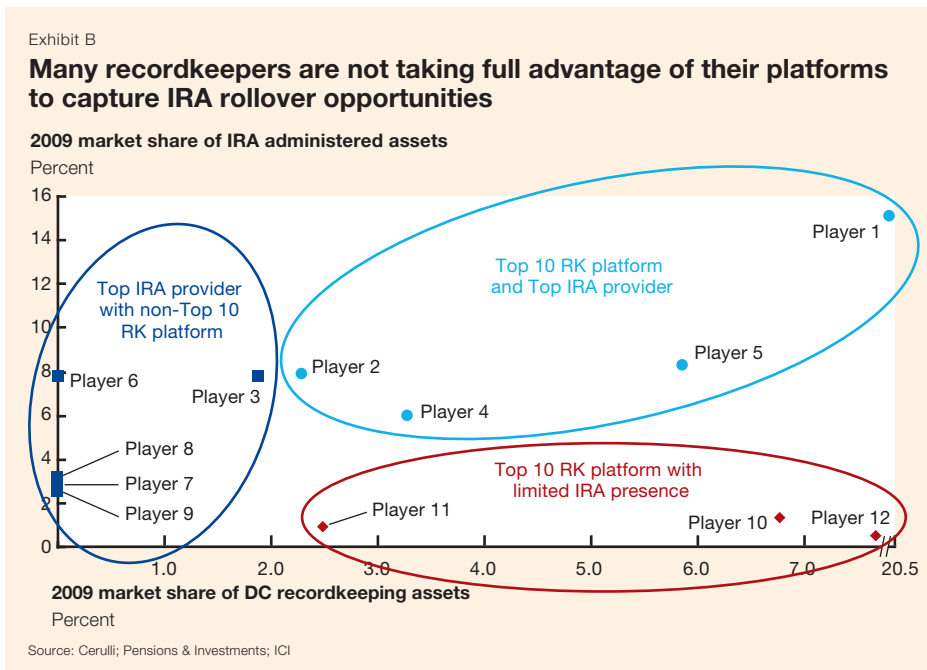
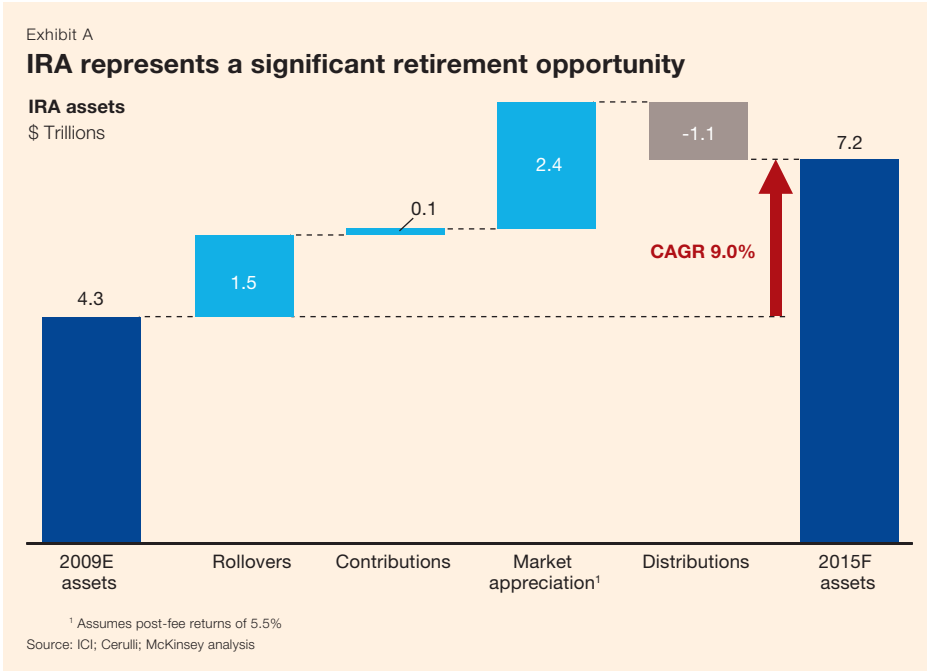
Thanks to massive rollovers from retiring baby boomers, IRA is the single largest non-cash opportunity in wealth management today. More than \$1.5 trillion will roll over in the next five years, which translates into \$30 billion of bottom line value over the lifetime of these participants. And the game is very much still open. Despite the formidable advantage of owning a recordkeeping platform and the relationship on the DC side, many platforms have failed to capture these advantages, with wealth managers across the spectrum – from RIAs to wirehouses, independents and regional broker dealers – benefiting.

A race for these assets will emerge between platforms and other wealth players. Winners will leverage their brand and market presence, their ability to identify and funnel leads, a seamless process, and high-quality solutions and advice.

- With \$4.3 trillion in assets today and an expected \$1.5 trillion in rollovers over the next five years, the IRA market will reach a staggering \$7 trillion by 2015. Every percentage point of DC market share represents a \$40 million annual bottom-line opportunity, as the average lifetime profitability of the customer is \$2,000 and two million participants roll over an average of \$50,000 every year from DC (Exhibit A).
- Despite the formidable advantage of owning a rollover platform, most of the top IRA providers do not have a DC recordkeeping platform. Every year, 73 percent of assets continue to leak from platform providers that have failed to capitalize on their scale in DC (Exhibit B). However, while on average DC recordkeepers retain only 27 percent of assets rolled into an IRA from the plans they administer, best-in-class players retain over 50 percent.

To capture their fair share of the rollover opportunity IRA providers can take the following actions:

- Develop creative solutions that address sponsors' concerns about proprietary product push. Sponsors are often unwilling to grant recordkeepers direct access to participants' rollover assets, mainly due to concerns about providers pushing proprietary products. At the same time, some sponsors



prefer participants to keep their assets in the plan to help keep plan costs low (because of asset-based revenue sharing). Providers should think creatively about solutions. For example, they could promote product-agnostic alliances that address fiduciary concerns about product push. Furthermore, providers could develop a model of revenue-sharing that would allow sponsors to participate in the upside from participants' IRA rollovers.

- Build participant relationships early and make the most of each interaction. Recordkeepers should try to make the most of each participant interaction to drive awareness of their product offering and rollover capabilities. Recordkeepers can foster proactive dialogue about additional services and rollover when new participants open accounts and should continue this dialogue every time the participant calls in. This requires service staff to be trained (and incentivized) to identify "leads" and seamlessly transition service conversations into broader IRA rollover discussions.
- Overcome participant inertia by developing solutions with built-in rollovers and seamless processes. Participant inertia often leads to deferment of the decision to roll over assets and leaves them with the DC sponsor. Recordkeepers can tackle this challenge by creating automatic rollovers for employees at retirement (e.g., into IRA accounts that mirror participants' 401(k)s). Asset managers could develop QDIA products that automatically roll participant assets into an income-focused IRA on retirement. In addition, rollover processes should be streamlined (e.g., avoid or defer the need to provide time-consuming information; allow users to "save and exit" instead of forcing them to restart the process from scratch if they exit temporarily) to avoid leakage of assets.
- Leverage brand and market presence to gain participant mindshare. While leveraging institutional relationships with sponsors to initiate conversations with participants, recordkeepers and asset managers should not neglect the importance of building a strong retail brand. Because of the reluctance of many sponsors to grant direct access to participants, many participants will be forced to choose an IRA provider from among the retail providers they have come to know through their own experience. Investing in a strong brand image focused on retirement will be important in competing for DC assets that are rolling over.

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