

Improving plan diversification through reenrollment in a QDIA

Vanguard commentary

August 2012

Successful retirement investing depends on appropriately diversifying holdings and allocating assets. In participant-directed defined contribution (DC) plans, where employees manage their retirement assets, some participants are not well-diversified, concentrating their portfolio in specific market segments or styles. Others adopt extreme asset allocation positions, investing too aggressively or conservatively. Plan sponsors have traditionally used education programs to improve participants' portfolio diversification. Yet such strategies often result in only modest changes because of participant inertia. Today, many more plan sponsors are considering the plan design strategy of reenrollment, through which current participants' holdings are transferred into a qualified default investment alternative (QDIA), subject to the right to opt out. Reenrollment can improve portfolio diversification rapidly while limiting plan sponsor fiduciary liability.

Vanguard Strategic
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Introduction

Even though most DC plans offer a broad range of prudent investment offerings, plan sponsors have observed that some participants make portfolio construction errors, concentrating their investments in employer stock, in specific asset classes or styles, or holding overly conservative or aggressive portfolios. Vanguard data on the quality of portfolio construction, based on several million participant accounts, confirms this point. Nearly one in six participants makes significant portfolio construction errors, holding either a zero-equity portfolio or concentrating their holdings in company stock (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 types of portfolio construction errors can prove costly in the long run, either by significantly reducing long-term potential return or exposing the portfolio to unnecessary levels of risk.

Targeted investment education is the traditional strategy for improving diversification. However, such programs typically lead to only incremental changes in participant holdings because of widespread inertia. This inertia is exemplified by low trading levels in DC plans. Over the five-year period ended in 2011, the percentage of participants in plans recordkept by Vanguard executing any trades (exchanges) in their portfolios in a given year never exceeded 16%. The vast majority of participants do not change their investment allocations.²

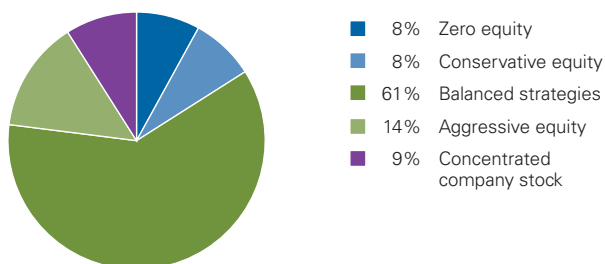
Reenrollment—through which the plan sponsor defaults participants' assets and future contributions into the plan's designated QDIA, with participants retaining the right to opt out of the transfer—can rapidly and effectively improve plan diversification. The use of this strategy is growing as a result of the QDIA provisions contained in the Pension Protection Act of 2006 (PPA), and the Department of Labor (DOL) regulations implementing those provisions. Defaulting participants' assets into a QDIA affords plan sponsors relief from responsibility for investment losses, similar to the relief afforded under ERISA Section 404(c) for active participant

investment decisions. Sponsors retain fiduciary responsibility for the selection and monitoring of investment options offered under the plan.

This paper discusses 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. Participant portfolio construction

Vanguard defined contribution plan participants



Source: *How America Saves 2012: A report on Vanguard 2011 defined contribution plan data*, Vanguard.

Data as of December 2011.

Background

Regulations resulting from the PPA, which provide fiduciary relief for default investments in the absence of participant election, 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 investment decisions made by participants.

¹ Vanguard, 2012.

² *How America Saves 2012: A report on Vanguard 2011 defined contribution plan data*. Vanguard, 2012.

Prior to PPA, a plan sponsor complying with Section 404(c) still retained full fiduciary liability where 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 that were often used as default funds prior to 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. However, when such funds become the exclusive investment of participants, as often occurred in automatic enrollment scenarios prior to 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 deemed 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 in which an account will be invested in the QDIA, information about the nature of the default investment, and 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 clear that the fiduciary relief afforded by the use of a QDIA may be available in a wide variety of circumstances:

[I]t 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 prior to 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's 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 investment 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

Sponsors need to weigh a variety of issues before proceeding with a reenrollment strategy. Plan fiduciaries should consider these factors in their deliberative process to assess whether reenrollment is suitable for their plan participants.

- **Evidence of diversification concerns.** Sponsors concerned about the quality of portfolio diversification decisions by participants will want to 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). Sponsors will want to consider not only the impact of reenrollment on diversification and return potential, but also 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, sponsors need to consider the merits of reenrolling their entire participant population, participants in a targeted group (for example, those who are 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, meaning that assets transferred to the QDIA will be valued at the market value of the underlying securities if 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

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.

- **Fees.** Sponsors should consider differences in fees in evaluating whether to proceed with a reenrollment strategy. Consideration should be given to how, if at all, the changing 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 duty as plan fiduciaries in determining that fees are reasonable for services provided to the plan.

Also, 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 prior to the investment in the QDIA, best practices employ 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 prior to the event, and then follow up with additional reminders via company newsletters or intranets, targeted e-mails, 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 Field Assistance Bulletin 2004-02 (FAB 2004-02). This FAB describes specific methods that may be used including certified mail, checking other plan-related records (e.g., a group health plan), checking with the participant's designated plan beneficiary, and use of the IRS or Social Security Administration letter-forwarding services. Depending on the facts and circumstances of a specific missing participant, plan sponsors should also 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 study⁷

In this 2008 case, Vanguard researchers studied the impact of reenrollment on a large DC plan and found that reenrollment immediately improved the portfolio diversification in the plan. One year after the event, 87% 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, Vanguard-administered 401(k) plan. A division of the company changed recordkeepers and chose to reenroll their participants into the plan's new QDIA, which was a series of target-date funds. The researchers analyzed the rate at which participants opted out of the reenrollment. Participant portfolios before and 12 months after the reenrollment event were also examined.

⁶ In speeches and responses to inquiries, DOL officials have informally stated that once the notice requirements have been met, the fiduciary relief under 404(c) is retroactive back 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 Mottola and Utkus, 2009.

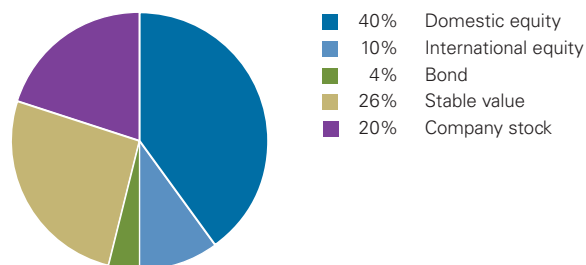
Consistent with the QDIA regulations, participants were provided the right to opt out before the reenrollment date; they could also change their investment choices after the reenrollment. The reenrollment event took place after a comprehensive, multichannel communication campaign that included e-mails, letters, a transition newsletter and website, and onsite meetings.

Immediately following the initial reenrollment effort, 92% of the participants maintained either a full (74%) or partial (18%) position in the age-based target date fund. This result was particularly striking in that the communications program strongly encouraged participants to take proactive action on their own. One year later, 87% of participants still maintained either a partial or full position in the target-date approach. It was their sole investment (61%) or part of their portfolio (26%). This result demonstrates the powerful effect of framing the investment decision as an “opt-out” from the target-date fund.

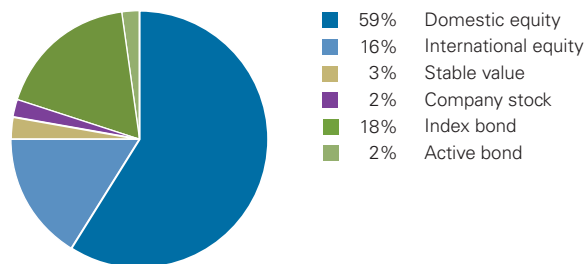
Figure 2. Pre- and post-reenrollment asset allocations

Average participant allocation

Pre-reenrollment—Friday, June 27, 2008
Equity exposure 70%



Post-reenrollment—Monday, June 30, 2008
Equity exposure 77%



Source: Vanguard, 2009.

Portfolio changes and portfolio quality. The day after reenrollment, the stable value exposure fell from 26% to 3% and the average company stock exposure fell from 20% to 2% (Figure 2). Reducing these exposures was one of the goals of the reenrollment. Assets in these options flowed (through the default target-date funds) to domestic equities, bonds, and international equities. One year after reenrollment, about 8 in 10 participants held appropriately diversified portfolios compared with 4 in 10 prior to reenrollment.

Summary

The principles of diversification and asset allocation are essential elements to professional portfolio construction. Yet certain groups of participants in participant-directed DC plans pursue suboptimal strategies, adopting extreme asset allocations or taking concentrated positions in certain asset classes, investment styles, or company stock. Reenrollment into a QDIA is an innovative 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.

References

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