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The Most Important Assumption

Since the launch of the first target date fund (TDF) in 1993, its story has been an elegant and simple one—select the date around when the participant plans to retire and the fund will take care of everything. As the retirement date approaches, the TDF will rebalance to a more conservative mix, and manage that mix not only into retirement, but throughout it as well. The TDF is a "one stop shop" where the participant can "set it and forget it." It was that easy; pick a fund corresponding to the participant's retirement date and they were done.

If only it were that simple.

The TDF has proven to be no silver bullet for plan participants with most studies showing that those invested in TDFs are just as poorly prepared for retirement as those not invested in TDFs. While the TDF may have made the investment decision easier, it did not necessarily make the retirement outcome better. It's true that TDFs are likely better than participants building their own asset allocation, but, is it really that difficult? Simply ask a participant to explain the difference between stocks and bonds. If this leads back to the TDF, what next? If the TDF isn't the answer, what is? How can participants make a better investment decision when the very solution touted to do so fails in its endeavor?

It may help by first understanding the TDF's flaw—assumptions. Every TDF makes assumptions—risk, future returns and funding levels. Achieving a successful retirement outcome is complex enough without being consumed by all the assumptions that comprise potential outcomes. In fact, beyond simple and elegant are the assumptions each TDF provider makes on your behalf. All create projected different retirement outcomes. No two TDFs are the same, including their outcomes.

"Ten percent of nothing is nothing."

Among all of the assumptions lies the most important assumption of all—the savings rate. As the saying goes, "Ten percent of nothing is nothing." While investment assumptions are important to the investment mix and the optimal target date fund, the participant savings rate and the degree to which they are funding their retirement are critical. As the saying above implies, the highest earning TDF will never get participants to where they want to be if they haven't saved enough in the first place.

Which leads to the most important point— target date providers make different assumptions about participant savings rates. Assumptions are made based on and for the average participant. Even then, assumptions vary greatly. A participant is only average after the other million people in the sample are included, then divided by a million, and one is added (the participant). Further, those most disadvantaged in this exercise are the participants not saving enough as well as the participants purportedly doing well for themselves by saving more than enough. These two groups are severely underrepresented when using averages. The industry, in general, thinks participants don't save enough.

Acknowledging this, how do we make the investment decision better for participants if it's not TDFs? Surely participants can't do this themselves, or can they?

Yes, they can! When the savings rate and funding for retirement play such an integral role in retirement, it is easier than you think. Defined benefit plans call this "liability driven investing" (LDI). The concept simply means how much a participant saved (funded status) plays an integral role in asset allocation. For participants on track to save enough, their asset allocation should be more conservative than participants who are barely funding their plan. Late savers need to take more risk in their portfolio if they hope to retire as successfully as the participant who has saved enough.

Is the savings rate really an assumption after a participant enrolls?

In fact, savings rates are known for every participant once they have enrolled. The most important, and typically, wrong assumption becomes a fact after this point. Enter the risk-based TDF—a TDF that has multiple glidepaths based on different assumptions. The most important assumption, of course, is the participant savings rate. Multiple glidepaths allow participants the ability to get on the right glidepath, incorporating its individual savings rate. This is similar to a defined benefit plan incorporating their funded status. No assumptions are needed! Participants with double digit deferral rates should use a conservative glidepath while participants deferring 6 percent or less should use an aggressive one. Neither should use a moderate glidepath, but that is exactly what is provided by an industry based on assumptions. The participant already decided how much to defer. They know how well (or not) they are funding their retirement. Now, if only they had more than one industry standard glidepath to choose from, they would be able to make their own better investment decision.

Current Stresses Eclipse Retirement Planning for Working Millennials

In John Hancock Retirement Plan Services' 2014 annual Financial Stress Survey[1], they discovered that working Millennials[2] experienced financial stress of a more immediate nature than their older counterparts.

Fifty-eight percent say they are not knowledgeable about retirement savings strategies.

Fifty-three percent of working Millennials on the John Hancock platform are on track to replace 70 percent or more of their income in retirement.

Almost a third of working Millennials say they are too worried about their current situation to plan for retirement.

- Sixty-six percent do not own a home.
- Fifty-nine percent feel overwhelmed.
- Fifty-five percent rate their financial situation fair or poor.
- One hundred percent say they contribute to their retirement plan "the amount that feels right."

By implementing auto features, you can potentially eliminate retirement worries in order to help working Millennials with their other stresses. By offering budgeting, saving and stress management workshops, you are providing Milliennials with tools, so they can develop good habits at a young age and take control of their finances.

[1] In May 2014, John Hancock Retirement Plan Services sponsored a commissioned research study to learn about people's stress levels, the causes of their stress, and how we might help them combat their stress. The study was conducted by respected research firm Greenwald and Associates, in talks with 1,500 current John Hancock plan participants.
[2] Individuals younger than 36.

This article was originally published by John Hancock Retirement Plan Services in *Current stresses eclipse retirement planning for working Millennials*. Slight modifications were made for compatibility purposes.

Best Practices in Hardship Distributions

These days, many plans are experiencing an uptick in the number of participant requests for hardship distributions. Much of this increased activity may be attributed to our prolonged and tepid economic recovery.

As these requests are considered, you want to be sure not to act to the detriment of your plan. Improper handling of a hardship request can ultimately result in plan disqualification. It is important to understand what the law, and your plan document, allow so your actions do not result in unintended but impermissible hardship distributions.

First, the law requires that any hardship distribution can only be made due to a participant's immediate and heavy financial need.

The law does not permit a distribution in excess of the amount necessary to satisfy the need, which cannot be met by other resources reasonably available to the participant. Unless the plan has knowledge to the contrary, the regulations allow a plan to rely on the participant's written representation that the need cannot be reasonably relieved by insurance, liquidation of other assets, cessation of contributions, distributions, or non-taxable loans from employer plans of commercially available loans.

Also, assets available for distributions are limited to the participant's accumulated elective contributions, exclusive of earnings but reduced by losses.

If the plan allows hardship distributions, the plan document must specifically state so.

A few safe harbor provisions have been granted. A safe harbor set of guidelines for what qualifies as an immediate and heavy financial need can be incorporated into the plan document. Also, regulations provide for the availability of safe harbor provisions to be included in the plan document to aid in determining if the distribution may be deemed necessary as long as any other loan or distribution available under the plan has been exhausted and the participant is suspended for making elective contributions for at least six months.

There is also a requirement for documentation of the hardship request activity. This includes maintaining a copy of the participant's application with appropriate representations, as well as your determinations regarding: immediate and heavy need; availability of other resources; and appropriateness of the amount of distribution.

Take this opportunity to review your plan's hardship provision to make certain you are following procedures correctly. Remember, inconsistent, sloppy, or overly liberal distributions may result in significant issues for the plan.

Company Stock and Fiduciary Considerations

In recent years, there has been a substantial increase in litigation involving retirement plans that have invested in the stock of their sponsoring company. The only definitive way for plan fiduciaries to avoid liability with respect to plan investments in employer stock is to avoid such investments altogether. Nevertheless, many employers, believing that employer stock is beneficial to their plans, continue to maintain it as an investment.

If company stock is available in your retirement plan, you may wish to consider hiring an independent fiduciary. Best practices dictates that the independent fiduciary should have no actual or perceived relationship with the company or its directors and should have exclusive control over the investment-related decisions for the plan, at least with respect to investment in company stock. This eliminates the concern regarding potential insider information and also helps to shift the fiduciary exposure to the independent fiduciary. That said, until this has been accomplished, your company's retirement committee likely doesn't have a choice but to monitor, and make decisions in regards to, company stock (unless the plan document expressly states that the plan must offer company stock). Absent a plan provision requiring company stock, the fiduciaries remain tasked with taking prudent action in the best interests of participants, which includes actions taken with respect to the company stock. For more information, contact your retirement plan advisor.

Communication Corner: Three Things to Know About Asset Allocation

This month's employee memo discusses the importance of diversifying portfolios and three important facts to know regarding asset allocation.

Call or email your Meltzer plan consultant if you have questions or need assistance.