NORTHERN TRUST

ALIGNED INTERESTS: A PATH TO BETTER DC PLAN DESIGN

Plan sponsors looking to increase flexibility, reduce costs and gain greater transparency have looked to other options for their plan structures.

ALIGNED INTERESTS: A PATH TO BETTER DC PLAN DESIGN

May 2020

Plan sponsors looking to increase flexibility, reduce costs and gain greater transparency have looked to other options for their plan structures.

FOR MORE INFORMATION

Please visit: northerntrust.com/DC

The increase in popularity of defined contribution plans as the primary employer-provided retirement benefit continues in the United States. It is also firmly established or starting to gain increased traction globally—the United Kingdom, Australia, and the Netherlands, to name a few markets. And while mutual funds continue to be the most popular investment for U.S. DC plans, structures looking more like defined benefit plans are gaining popularity. This is especially true amongst "mega" (+$1B) plans. Plan sponsors looking to increase flexibility, reduce costs and gain greater transparency have looked to other options for their plan structures. Along with (and partially because of) the move from the use of mutual funds, there has been an increase in popularity of two aspects of the retirement landscape: "unbundling" and "white labeling".

THE RISE OF UNBUNDLING

According to Callan Associates' 2019 Defined Contribution Trends study, the unbundling of plan providers continues to grow in the large institutional space. In 2017, the percent of plans that were either fully bundled (recordkeeper, trustee, and investment manager are one provider) or partially bundled (recordkeeper and trustee are the same, but investment manager selections vary) totaled 54%, a significant drop from 65% in 2012. This is even more pronounced among mega-plans, with 56% of such plans being unbundled and less than 10% being fully bundled.[1]

What is driving the move to unbundling? There are several factors, chief amongst them the desire of plan sponsors to select "best in class" providers for the various aspects of plan support. This includes recordkeeper, trustee/

1 https://www.callan.com/wp-content/uploads/2019/04/Callan-DC-Trends-Survey-2019.pdf

custodian, and investment manager. Plan sponsors are able to mix and match based upon their preference, with the ability to add or subtract providers based upon the quality of their specific services. And given the leverage of their asset size, plan sponsors can benefit from lower fees while still receiving the intended results. For example, in 2011, Colorado Public Employees' Retirement Association restructured their DC plan to include unbundling, white labeling, and internal asset management. The plan reports they have "reduced the all-in costs for members to participate in its 401(k) plan by 68% since 2011." These savings were achieved while still providing strong investment performance.[2]

Another driver of the move to an unbundled structure is the plan sponsor's desire to gain transparency for themselves and their consultants.

Another driver of the move to an unbundled structure is the plan sponsor's desire to gain transparency for themselves and their consultants. Mutual funds often lack transparency into their underlying investments. Moving from mutual funds and into separately managed funds provides a better view into the asset strategies of the individual managers the plan sponsor hires. This improved transparency allows a sponsor to gain greater views into portfolio attribution driving the investment returns. Additionally, the transparency allows greater governance over plan compliance. For example, it allows a plan sponsor to dictate the omission of securities conflicting with the company's own social objectives. Finally, the transparency that unbundling provides allows sponsors to specifically track all service provider fees individually. This is not only a critical part of effective 404(a)5 participant fee disclosure, but also a tool for plan sponsors in their fee negotiations with providers.

MOVE TO WHITE LABELING

Along with this move to unbundled services, there has been a similar move to "white labeling" of a plan's investment options. Broadly, white labeling includes any fund that uses a plan-specific net asset value (NAV) instead of a price available in the general market place. This can be as simple as a recalculated NAV representing a generically named single manager fund option (eg, a "Plan XYZ Balanced Option" instead of the "Manager ABC Fund"). Such naming conventions help plan participants identify a fund's investment objective instead of drawing attraction via brand recognition only. At the other extreme, a white labeled option can be comprised of a unitized multi-manager pool structure that is shared across multiple plans in a master trust, including one or several defined benefit plans. In between those two extremes are a multitude of other versions which allow a plan sponsor to tailor their investment structure to fit the objectives of their plan's demographics. Northern Trust's largest 50 DC plans (exceeding $360B in aggregate and greater than $2.5B per plan in assets) use white labeling for 85% of the assets valued in their plans each day.

2 https://www.copera.org/news/colorado-pera-releases-2019-investment- stewardship-report

In tandem with the advantages of unbundling mentioned previously, there are several advantages to utilizing white labeling. These include:

- *Diversity of investment options*. Not only are various managers available, but so are a variety of investment vehicles (e.g., collective funds, separately managed accounts). Such investments are typically less expensive, and the plan sponsor can negotiate lower fees when taking into account other investments unrelated to the DC plan.
- *Fee leverage*. A plan sponsor may choose to commingle DB and DC assets as larger asset pools often result in lower fees. Using unitization, a master trust commingles individual manager portfolios together to support both the DC and DB plans. Additionally, commingled DB/DC structures allow fiduciary oversight of the DB managers to carry over to the DC plan.
- *Flexible plan design*. Plan sponsors have the ability to pool managers together to create multi-manager options. This provides diversification by introducing multiple entities to the plan. Also, managers can be added or subtracted more easily because a white labeled option is manager agnostic, driven by the investment objective (a balanced fund vs. the Manager ABC fund). In a non-white labeled structure, advance notice is needed to make changes and can result in a disruption to the plan participants.

  An example from 2014 illustrates the benefits of white labelling. A well-known investment manager of a fund popular as an option in many U.S. DC plans abruptly left the firm. In some cases, the fund was a stand-alone plan option while in others it comprised a part of a multi-manager structure. Many concerned plan sponsors and their investment committees scrambled to either limit cash flows to the manager or to remove the fund from the plan. Doing so in a non-white labeled environment would take time and planning to execute, with a cost of staff involvement, money, and potential disruption to the plan participants. Plans using white labeled options had the ability to either block the manager from receiving new cash flows or to swap in another manager without disruption to the participants or the potentially significant cost of changing options.
- *Customization.* Plan sponsors have the ability to create customized options, including target date funds comprised of the other plan specific options. Again, the governance of managers becomes more efficient in that oversight extends to multiple options in the plan. Additionally, sponsors can better design the glide paths and components to support the demographics of their participants.

White labelling increases diversity of investment options, fee leverage and flexibility of plan design.

A BETTER DC PLAN DESIGN

As DC plans continue to grow and DB plans shrink as the primary retirement benefit for employees, the need to provide a state of the art program should be the goal for plan sponsors. It is important to examine all options to maximize investment opportunities and flexibility for participants. The scale and resources available to large DC asset pools allow a plan sponsor to leverage the oversight, cost effectiveness, and flexibility historically more typical of DB plans. These advantages can result in a better DC plan design to benefit plan participants.

© 2021 Northern Trust Corporation. Head Office: 50 South La Salle Street, Chicago, Illinois 60603 U.S.A. Incorporated with limited liability as an Illinois corporation under number 0014019. Products and services provided by subsidiaries of Northern Trust Corporation may vary in different markets and are offered in accordance with local regulation. **This material is directed to professional clients only and is not intended for retail clients. For Asia-Pacific markets, it is directed to expert, institutional, professional and wholesale clients or investors only and should not be relied upon by retail clients or investors. For legal and regulatory information about our offices and legal entities, visit northerntrust.com/disclosures.** The following information is provided to comply with local disclosure requirements: The Northern Trust Company, London Branch, Northern Trust Global Investments Limited, Northern Trust Securities LLP and Northern Trust Investor Services Limited, 50 Bank Street, London E14 5NT. Northern Trust Global Services SE, 10 rue du Château d'Eau, L-3364 Leudelange, Grand-Duché de Luxembourg, incorporated with limited liability in Luxembourg at the RCS under number B232281; Northern Trust Global Services SE UK Branch, 50 Bank Street, London E14 5NT; Northern Trust Global Services SE Sweden Bankfilial, Ingmar Bergmans gata 4, 1st Floor, 114 34 Stockholm, Sweden; Northern Trust Global Services SE Netherlands Branch, Viñoly 7th floor, Claude Debussylaan 18 A, 1082 MD Amsterdam; Northern Trust Global Services SE Abu Dhabi Branch, registration Number 000000519 licenced by ADGM under FSRA # 160018; Northern Trust Global Services SE Norway Branch, 3rd Floor, Haakon VII's Gate 6, 0161 Oslo, Norway; Northern Trust Global Services SE Leudelange, Zweigniederlassung Basel, Aeschenplatz 6, 4052, Basel, Switzerland. The Northern Trust Company Saudi Arabia, PO Box 7508, Level 20, Kingdom Tower, Al Urubah Road, Olaya District, Riyadh, Kingdom of Saudi Arabia 11214-9597, a Saudi Joint Stock Company – Capital 52 million SAR. Regulated and Authorised by the Capital Market Authority License # 12163-26 CR 1010366439. Northern Trust (Guernsey) Limited (2651)/Northern Trust Fiduciary Services (Guernsey) Limited (29806)/Northern Trust International Fund Administration Services (Guernsey) Limited (15532) Registered Office: Trafalgar Court, Les Banques, St Peter Port, Guernsey GY1 3DA. Northern Trust International Fund Administration Services (Ireland) Limited (160579) / Northern Trust Fiduciary Services (Ireland) Limited (161386), Registered Office: Georges Court, 54-62 Townsend Street, Dublin 2, D02 R156, Ireland.