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Employee Benefits Update

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Is it time to give a fresh look at "alts" in retirement plans?

Are your plan participants gaining the benefit of a truly broad diversification of retirement portfolio assets? The answer might depend on whether they're covered by a defined benefit (DB) plan or a defined contribution (DC) plan. Here's a look at why DB plans offering "alternative" investments, also known as alts, may make a big difference.

A couple of studies

Alts are assets other than publicly traded stocks, bonds and cash investments. However, ERISA places limits on permissible alt investments: Qualified retirement plans cannot invest in "collectibles" (such as antiques), S corporation stock and life insurance contracts.

According to a study by the Center for Retirement Research at Boston College, average annual returns between 1990 and 2012 of corporate DB portfolios were 70 basis points higher than those of DC plan portfolios. More recent data shows that this gap has narrowed somewhat, but was still at 50 basis points for the decade ending in 2016.

There's a perception by some DC plan fiduciaries that the presence of alts in a TDF could elevate their exposure to litigation.

Why the disparity? Several factors account for it. But according to a study by Georgetown University's Center for Retirement Initiatives, it's partly attributable to the fact that DB plans are far more likely to have some alts in their portfolios. The 2018 Georgetown study, *The Evolution of Target Date Funds: Using Alternatives to Improve*

Retirement Plan Outcomes, tackles this disparity. It notes that 15% of average portfolios of the largest corporate DB plans contain stakes in hedge funds, private equity holdings, real estate and other alts such as commodities.

Why invest in alts

One key purpose of investing in alts is to provide a buffer from the impact of stock and bond market volatility, to the extent that alts are "noncorrelated" assets. This means they don't follow the same broad pattern as conventional investments, particularly in down markets. "The key for plan sponsors is to look ahead to better protect their participant portfolios against the inevitable drawdown that always occurs when the equity markets turn the other way," according to the Georgetown study. "Because [DC] plan participants fully absorb the gains and losses of their accounts, market events can drastically impact their ability to retire," it asserts.

Recognizing that target date funds (TDFs) are typically used as a DC plan's qualified default investment alternative (QDIA), the study's authors focused on issues surrounding incorporating alts into TDFs. Because some alts, such as hedge funds, private equity and direct investment in real estate, lack the liquidity of publicly traded securities, offering them to DC plan participants on a stand-alone instead of in a TDF may be practical. However, be sure to educate participants

so they don't get into trouble by investing heavily in alts without fully understanding them.

When DC plan participants have access to a self-directed brokerage "window," they can invest in some "retail" alts, including:

- Real estate investment trusts (REITs),
- Mutual funds that deploy unconventional trading strategies such as hedging with futures contracts or that use leverage, and
- Exchange-traded funds (ETFs) focusing on precious metals and commodities.

Self-directed brokerage accounts haven't caught fire in the DC plan world due partly to fiduciary concerns and lack of interest by participants. But some employers with a majority of highly compensated employees have seemed to show some interest.

The bottom line

According to the Georgetown study's model projection, the annual inflation-adjusted retirement income for a full-career participant could be 17% higher if the participant had invested in a broadly diversified TDF containing some alts, instead of a TDF lacking that degree of diversification. While the idea of folding some alts into TDF portfolios might sound appealing from a theoretical perspective, it's easier said than done.

The primary stumbling block identified in the study is a perception by some DC plan fiduciaries that the presence of alts in a TDF could elevate their exposure to litigation. That threat can be mitigated, the study suggests, with a "careful and prudent process focused on enhancing potential participant outcomes" while addressing "any concerns such as liquidity and pricing, benchmarking, fees and governance."

With respect to the liquidity challenge, "even over the short term and in a stressed environment, a diversified portfolio including alternative asset classes still has 72% to 76% of its assets available to satisfy daily liquidity, rising to 81% over a three-month period." Also, the study points out that participants are more inclined to stay put in TDFs during periods of volatility than those invested in less diversified funds. The challenge of providing daily pricing for funds with some illiquid assets such as equity real estate also can be met, the study suggests, by using an "unbiased proxy" to estimate pricing daily between appraisals.

The future

Alts often require more intensive management (and therefore higher fees) than standard liquid securities. Litigation over high plan fees is reasonably on the minds of plan sponsors and fiduciaries. But, the study argues, that concern can be allayed if participant outcomes are improved due to a "positive net-of-fee value proposition." While one study is insufficient to motivate plan sponsors to jump into alts with both feet, it does provide food for thought that could ultimately lead to a concrete decision.

Compliance Alert

Upcoming compliance deadlines:

9/16* Extended deadline for S corporation tax returns (IRS Form 1120S)

9/16* Extended deadline for partnership tax returns (IRS Form 1065)

9/30 Summary Annual Report (SAR) due for Form 5500 that was due July 31, unless extension was granted (for returns extended to October 15, SAR deadline is December 15)

** This reflects an extended due date, as the 15th falls on a Sunday this year.*

Time for class

Widening the scope of training for retirement plan committee members

Learning the ropes of overseeing a retirement plan isn't a "one and done" exercise. Periodic training updates for retirement plan committee members acting in a fiduciary capacity is a prudent approach ensuring that they maintain the current knowledge essential to carry out their duties. More fundamental is ensuring that new committee members get a strong grounding in plan operations and their responsibilities promptly on being appointed to a plan committee, if not before.

Topics to cover

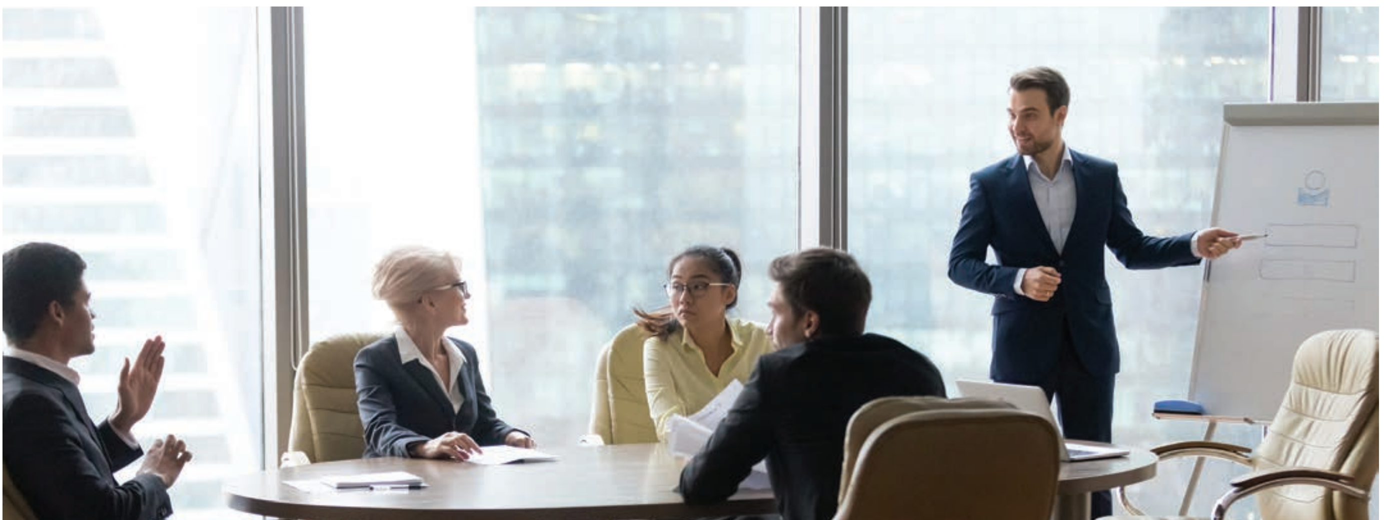
In the beginning of their tenure, new plan committee members are often in the vulnerable position of not even knowing the topics they need to bone up on, let alone already knowing the essential information they need to possess within those topic areas. The good news is that most plan committee members are given some formal fiduciary training on joining the committee. Fewer receive follow-up training on a regular schedule, however.

In the past, fiduciary training often focused almost exclusively on overseeing plan investment performance and investment manager selection. Today, fiduciary training is often broader in scope, covering responsible supervision of all plan vendors and operations. The Plan Sponsor Council of America (part of the American Retirement Association) offers a training course on fiduciary training. Some topics covered in that course that companies should consider presenting to their committee boards include:

ERISA and the fiduciary role. Be sure your committee members know how they become a fiduciary, fiduciary roles, and when they are and aren't acting as a fiduciary. Review fundamental duties, consequences of fiduciary breach, and limiting fiduciary liability.

Selecting and monitoring service providers. Highlight parties in interest and prohibited transactions under ERISA, the service provider exemption, plan vs. settlor expenses, fee disclosure requirements, scope, and the solicitation process.

Participant communications. Discuss reporting and disclosure requirements, fundamental fiduciary duties, fee disclosures, participant education and advice.



Other fiduciary topics to cover include federal ERISA enforcement priorities, highlights of recent landmark court rulings, and plan fee categories, including allocation methods and revenue sharing.

Liability reminders

Retirement committee members are generally conscientious in their efforts to fulfill their fiduciary obligations to participants, even without fully weighing the adverse consequences should they fall short. Nevertheless, remind members what such penalties can be. For example, a plan loss attributable to a fiduciary's negligence can result in plan committee members being held personally liable for a substantial portion of the loss. "Prohibited transaction" violations, inadvertent or otherwise, also can trigger large civil penalties against offenders up to 100% of the "amount involved."

Plan committee members and other fiduciaries who diligently follow organized processes for decision making, even when bad results occur, often avoid penalties.

Although not required by the Department of Labor, many plan sponsors adopt a committee charter to outline the committee's responsibilities. Committee members then sign the charter, stating acknowledgment and acceptance of their fiduciary responsibilities.

The doctrine of "procedural prudence" plays a large role in ERISA enforcement agencies and courts. (See "Ponder the true meaning of prudence" at right.) Educate members on procedural prudence, the duty of loyalty, lines of authority, and decision making dynamics. Plan committee members and other fiduciaries who diligently follow organized processes for decision making, even when bad results occur, often avoid penalties.

Ponder the true meaning of prudence

A foundational concept in ERISA governing retirement plan fiduciaries is the "prudent man rule." This requires fiduciaries to perform their duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

But does that mean fiduciaries should, essentially, follow the herd? Tom Brakke, an investment advisor, educator and ERISA commentator, has posed that question in a recent blog post. Such herd mentality "can be problematic," Brakke asserts, if the herd is moving in the wrong direction. For example, in the face of lower bond yields, many investment managers have sought to boost returns on pension portfolios by investing in more risky securities.

According to Brakke, fiduciaries discussing what constitutes prudence isn't enough. Prudence, he maintains, "comes from exploration and examination, marked by acuity and practical wisdom." This sets the bar higher than what Brakke characterizes as "prudence by rote," consisting merely of running through checklists. While checklists can be helpful for fiduciaries, they can be too rigid for the real world.

It's worth the cost

It's more than worthwhile to put in the extra training for your plan's committee members. And remember, as in other areas of education, e-learning platforms for self-paced retirement plan committee/fiduciary training can help eliminate the potential learning impediment of schedule conflicts. □

DB plan de-risking strategies in full swing

Private sector employers have been retreating from the defined benefit (DB) pension model for decades. This is largely motivated by a desire to "de-risk" the company from a financial obligation that's as variable as financial market behavior. More recently, holdouts on that trend have been given new motivation to depart from the DB design: escalating Pension Benefit Guaranty Corporation (PBGC) premiums. 2015 legislation set the stage for annual increases through 2019, after which the increases will be indexed for inflation.

De-risking by lifting out

A path to wind down a DB — short of immediate termination — is a "risk transfer" in which responsibility for making good on obligations to a segment of the plan's beneficiary base, typically retirees, is turned over to an insurance company. A "lift-out," as this process is also called, is also somewhat common to settle liabilities for vested benefits of active employees, particularly if the DB plan is frozen.

A recent survey of DB sponsors by an investment consulting firm found that about one-third were actively considering pursuing a lift-out strategy.

To start a lift-out risk transfer strategy, the company must pick an insurance carrier from which to purchase a jumbo annuity contract. That process must conform to selection criteria laid out by the U.S. Department of Labor (DOL) in Interpretive Bulletin 95-1. That document dictates that plan sponsors pick the "safest available annuity," although that isn't always an easy call. It's not enough just to look at a carrier's ratings by rating agencies, the DOL warns.

The document also acknowledges that sometimes "the interest of the plan participants and beneficiaries may require the selecting fiduciary to consider the cost of the annuity (to the extent that the cost is borne by the participants and beneficiaries) in addition to the annuity provider's claims-paying ability." Even so, it adds, "cost considerations may not justify the purchase of an unsafe annuity."

In addition to eliminating financial uncertainty, a lift-out strategy can generate savings if the annuity provider can, without the regulatory necessity of paying PBGC premiums, manage the annuity liability it's assuming more cost-effectively than the plan sponsor. A recent survey of DB sponsors by an investment consulting firm found that about one-third were actively considering pursuing a lift-out strategy, more than double the percentage from the prior year.

Talking about it

If you decide to go with a lift-out, communicate this clearly to plan participants. Provide them with information about why you're making the change and what they can expect.

Coordinate with the insurer to develop a communication strategy explaining the process to plan participants, being careful not to release nonpublic information during the

process. This should include information regarding customer support for participants. If the buyout is part of a plan termination, make sure that required termination notices are provided to participants.

Final steps

Additional tasks for plan sponsors in picking an annuity provider include establishing the administrative process for the shift of operational responsibilities to an annuity provider, and negotiating contract terms. Be sure to build safeguards into the contract to allow for last-minute shifts or corrections to your retiree census data. If you're looking at options to wind down your DB plan, contact your benefits advisor, actuary and an attorney to clarify your de-risking objectives and ensure you are in compliance with all requirements. □

Make your SPDs user-friendly

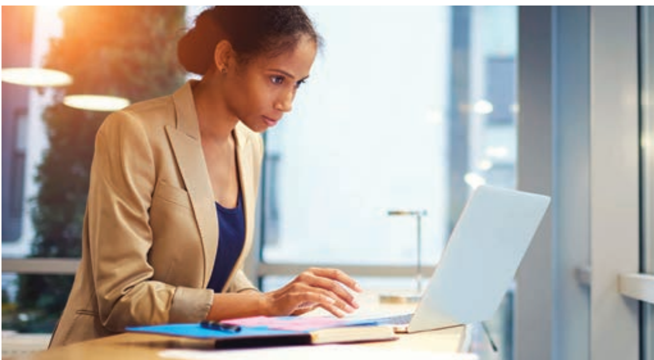
The text of a summary plan description (SPD) is usually the product of a tug-of-war between cautious ERISA attorneys who worry about the use of general, simple statements, and human resources professionals familiar with their average employees' reading level. The attorneys often tug harder, and the result is a document that many employees pick up, glance at, and promptly toss. That's not a good outcome.

What does ERISA require?

ERISA regulations describe the style and format for your SPD. Key language in the SPD must be written so that it's "understood by the average plan participant." It must be "sufficiently comprehensive to apprise the plan's participants and beneficiaries of their rights and obligations under the plan."

And how can you make that calculation? The regulations' "method of presentation" guidance indicates that you should factor in participants' "level of comprehension and education" as well as the complexity of the plan's terms. Taking these factors into consideration will usually require:

- The limitation or elimination of technical jargon and of long, complex sentences,
- The use of clarifying examples and illustrations,
- Clear cross-references, and
- A table of contents.



The regulations also caution against presenting the facts in a way that would "have the effect" of misleading or simply not informing participants and beneficiaries. Specifically, the regulations require that descriptions of benefit limitations, reductions and other restrictions of benefits not be relegated to fine print or footnotes. Also, you have to present both the plan's advantages and disadvantages without exaggerating the benefits or minimizing the limitations.

Finally, adapt legal documents like SPDs to emerging writing practices using "inclusive" language that seeks to embrace gender diversity.

Get it right

An SPD is one of the most important documents of your plan. It's one that participants will come back to time and time again. Contact your benefits specialist to make sure your SPD meets the requirements and is written in a way that participants will read and understand. □

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The solution for skyrocketing audit fees

Finding ways to cut costs while maintaining quality seems to be at the top of every executives to do list. As the person responsible for your organization's employee benefit plan audit, we can help you not only reduce your audit costs but also provide a higher level of service.

Pension auditors must sift through enormous amounts of financial data in accordance with the requirements of numerous laws, regulations and professional standards. If they don't know what they're doing, they can easily get lost in the numbers, run up large fees and fail to provide an accurate assessment of a plan's financial status.

Pension audit specialists

Insero & Co. specializes in pension plan audits. Our professionals have extensive experience in this area and to ensure that our audits meet the highest standards of quality, our firm is a member of the American Institute of Certified Public Accountants (AICPA) Employee Benefit Plan Audit Quality Center and is registered with the Public Company Accounting Oversight Board (PCAOB).

Insero & Co. is the independent registered public accounting firm for many companies that file a form 11-K with the Securities and Exchange Commission. We currently perform audits for more than 150 plans ranging in size from 100 to 60,000 participants, and from $1 million to more than $10 billion in assets.

Big firm capabilities, small firm attentiveness

As our many satisfied clients will testify, we offer the comprehensive benefit services of a large national firm, but at less cost and with a higher level of service. With more than 125 accountants, professional consultants and support staff, our firm is large enough to bring robust resources to bear on almost every client need, yet small enough to provide the personal attention and relationship-based service that is important to our clients.

The culture of Insero & Co. is hands-on and proactive, shaped by the old-fashioned notion of doing what is in the best interest of the client. In addition to pension and corporate audits, we provide a full range of tax, accounting and consulting services, including internal audit/Sarbanes-Oxley services, outsourced accounting and wealth management.

Go with the experts

We would welcome the opportunity to discuss your audit or other needs and put our expertise to work for you. Please contact Vince Leo at 585-697-9683 or Mike Giess at 585-697-9639 and let us know how we can be of service.

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