

## Considering a Passively Managed DC Plan? There's No Such Thing.

While some defined contribution plan sponsors may say that they want to keep it simple and “just go passive,” we would suggest that there really is no such thing as a passively managed defined contribution (DC) plan or, for that matter, even a passively managed target-date strategy. Many active decisions to define the structure and select the suitable investments for a plan must be made by the plan sponsor in its role as a settlor or as an Employee Retirement Income Security Act (ERISA) fiduciary. In the role of fiduciary, sponsors must meet multiple duties of care, including acting with the skills and diligence of a prudent person as they structure the plan (with a focus not on results but rather on process) and diversifying plan investments in such a manner that the risk of large losses is minimized. To fulfill these legal duties, plan sponsors must make a number of critical decisions that could determine whether or not their plans will succeed; that is, the plans will help enable participants to meet their future retirement liabilities.



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Ms. Schaus is a senior vice president in the Newport Beach office and leads PIMCO's Defined Contribution Practice. Prior to joining PIMCO in 2006, she was a founder and president of Hewitt Financial Services, which includes DC investment consulting and research as well as brokerage and personal finance. She has written extensively on defined contribution issues, including the regular publication PIMCO DC Dialogue™ and her 2010 book, *Designing Successful Target-Date Strategies for Defined Contribution Plans*. Ms. Schaus has been named by 401k Wire as among the 100 most influential leaders in defined contribution for 2009, 2010 and 2011. She is the founding chair for the Defined Contribution Institutional Investment Association, serves on the board of the Employee Benefit Research Institute and is a past member of the Financial Planning Association board. She has 30 years of investment experience and holds an MBA from the Stern School of Business at New York University and an undergraduate degree from the University of California, Santa Barbara.

### Active decision #1: Savings rates and investment risk

Plan sponsors can influence whether their plans succeed or fail in two primary ways: by exerting their influence over the savings rate and by establishing a level of investment risk in the plan.

**Savings rate:** Plan sponsors influence the plan's savings rate by determining how much money they will contribute and by deciding whether participants will be required to make a contribution that they will match, or if they will make employer contributions with no strings attached. Today, the most common plan sponsor match is 50 cents for every dollar a participant contributes, up to 6% of the participant's paycheck, according to the Plan Sponsor Council of America.

Another way plan sponsors can encourage savings is by getting creative with their matching contributions. For instance, a plan sponsor could take the traditional route and match 50 cents for every dollar up to 6% of pay, or it could take a less conventional approach and match 25 cents for every dollar the employee contributes up to 12% of pay. The second approach costs the plan sponsor nothing more, but may entice more participants to save at a higher rate. Alternately, sponsors that automatically enroll employees in a DC plan could start them off at a much higher level (contributing 6% of their salary to the retirement plan instead of the traditional 3% starting point, for example) and then gradually boost that contribution level until it reaches 10% of their compensation.

**Investment risk:** The most important goal for the majority of DC plans is meeting an investor's income-replacement target. So, a central question for fiduciaries to answer is: What amount of retirement income "shortfall risk" am I willing to accept in the plan design? If an investor's goal is to replace 50% of his paycheck throughout retirement, would it be acceptable to reach only a 30% or 20% replacement level?

Plan sponsors who want participants to be exposed to limited amounts of this shortfall risk may turn to individual Treasury Inflation-Protected Securities (TIPS) as an investment choice. Although TIPS carry some risks, they are backed by the full faith and credit of the U.S. government and are designed to provide a return that keeps pace with inflation as measured by the Consumer Price Index (CPI). In our February 2011 PIMCO DC Dialogue™ newsletter, professor Zvi Bodie explains that "we may consider TIPS as the closest we can get to a "risk-free" portfolio, especially for retirees who need to retain the purchasing power of their assets. Their savings must keep pace with inflation."

Another way to influence risk is by determining the investment choices available in each tier of the plan, such as the "do-it-for-me" tier (for most plans, this is the default investment that retirement plan participants are placed into if they don't choose an investment from the plan menu) or the "do-it-myself" option (usually a list of core investments from which participants can create their own blend).

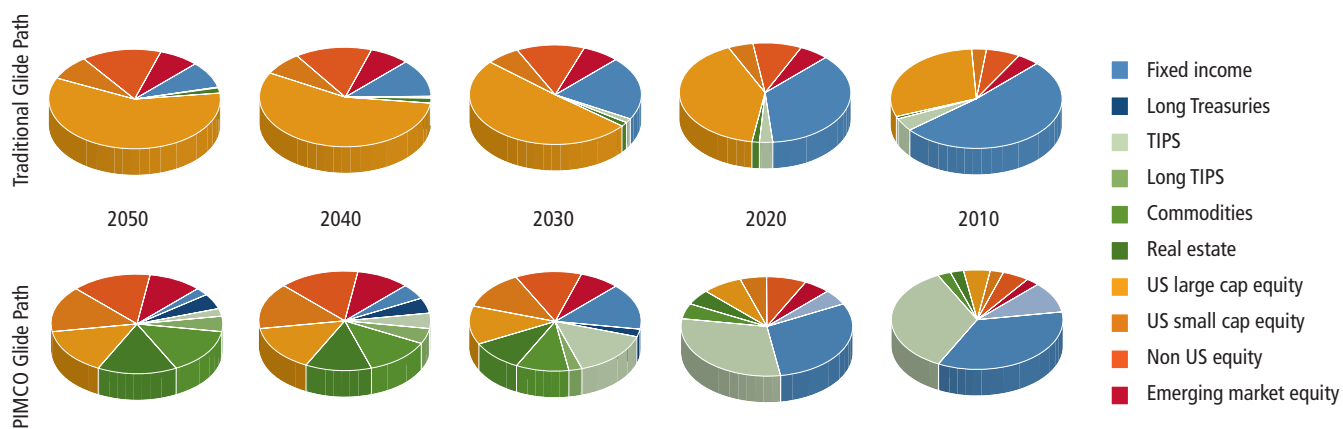
Finally, the "target-date" strategy you select for your retirement plan can have a dramatic impact on portfolio volatility and, ultimately, the success of the plan. Target date strategies are popular in retirement plans partly because their asset allocation mix changes automatically over time, typically becoming more conservative as an investor reaches his or her target retirement date. But different target date strategies can have vastly different asset allocation mixes. So, carefully evaluating the way a target date strategy's asset allocation changes over time (a trajectory referred to as its glide path) is critical.

#### **Active decision #2: How is risk best allocated?**

Once the overall risk budget is set, the plan fiduciary must decide how best to allocate that risk. At PIMCO, we typically start by factoring in the risk budget as a constraint and then contemplate strategies designed to maximize investment return potential as we identify the asset classes in the glide path. Other managers tend to take the opposite approach, looking first at the asset classes and then at the associated risks. By identifying over 200 risk factors, or drivers, we can build portfolios that we believe tend to be typically better diversified than many others and are designed to avoid overexposure to any single part of the market. We look for assets that we believe show the potential to reduce risk and increase expected return throughout various economic environments. By starting with risk exposures to determine asset selection, plan fiduciaries may be better able to address the plan fiduciary's diversification requirement.

As shown in Figure 1, the market average glide path tends to be heavily concentrated in equity risk throughout the glide path. This average glide path shows higher risk, measured by volatility for each vintage, plus lacks diversification of sources of risk. Particularly concerning for retirement assets, the integration of inflation-hedging assets in the market average glide path is marginal. By comparison, the PIMCO approach appears to present much lower overall risk, as well as greater diversification of risk, including relatively significant inflation-hedging asset exposure.

Figure 1: Figure 1: Market Average Glide Path vs. PIMCO Glide Path



Source: MarketGlide as of 31 March 2011

### Active decision #3: Should risk be actively hedged?

Despite best efforts to manage risk via asset diversification, we believe such portfolios are unlikely to ward off the potentially devastating impact of systemic market shocks often labelled “left-tail events.” For this reason, plan sponsors may consider adding market-shock hedging instruments or insurance to plan offerings such as target-date strategies.

As explored in our December 2010 paper “Designing Outcome-Oriented Defined Contribution Plans,” tail-risk hedging is an investment management approach that aims to cushion a retirement plan participant’s assets during systemic market shocks. Notably, active tail-risk management may not only help mitigate risk, but also has the potential to enhance portfolio returns, since managers can sell the hedging strategies as they increase in value. There are three basic approaches to tail-risk hedging that retirement plans may consider:

- **Reduce exposure to risk assets by purchasing U.S. Treasury securities.** When equity markets fall, this strategy can help reduce exposure to the negative impact of equity returns and introduce the potentially heightened return of Treasuries, given a likely inflow of assets to this perceived “safe haven.”

- **Buy direct hedges such as long-dated equity puts, put spreads, or collars.** During equity market corrections, these strategies may increase in value to help offset losses. For instance, S&P 500 Index put options may be added to a portfolio to cushion the impact of an equity market decline.
- **Invest in indirect hedges.** These hedges include options, swaps, and interest rate swaptions in deep liquid markets sensitive to macroeconomic events. Such strategies tend to move in the opposite direction of the long exposure they are intended to cushion. For instance, with credit protection, as equity markets correct, corporate bond spreads relative to Treasury securities tend to widen, thus producing a potential offset to the equity market losses.

Insurance solutions such as deferred or variable annuities also may offer a degree of market protection (subject to certain conditions), longevity insurance, or both. We have found interest in insurance solutions to be high, yet there are often many obstacles that still stand in the way of most plan sponsors moving forward with them. Plan sponsors may be reluctant to add these options, given their concerns with cost, transparency, fiduciary oversight, and the risk of insurance company default. Still, increased support, especially from the government, may encourage more plan sponsors to consider adding these risk-reducing solutions.

## Conclusion: All DC plans require active decision-making

In the retirement world, we believe that measuring risk is not as simple as measuring the tracking error relative to a benchmark. Rather, we define risk in DC plans as the participant failing to meet his or her real retirement income needs an inflation-sensitive liability. So, plan sponsors should not simply “set it and forget it” when designing a DC plan or selecting a target-date strategy. To help participants meet their income goals, we suggest that plan sponsors carefully consider the active decisions we have outlined here and dismiss the notion of a passive approach to managing their retirement plan.

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To read our full discussion of this topic, please contact your PIMCO representative or email us at [pimcodcpractice@pimco.com](mailto:pimcodcpractice@pimco.com) and request a copy of “No Such Thing as Passive: Three Active Decisions Plan Fiduciaries Must Make in Offering a Defined Contribution Plan...and Default Investment” August 2011.

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*All investments carry risk. The risk-free rate can be considered the return on an investment that, in theory, carries no risk. Risk-free assets usually refer to short-dated government bonds.*

PIMCO does not offer insurance guaranteed products or products that offer investments containing both securities and insurance features.

**All investments contain risk and may lose value.** Inflation-linked bonds (ILBs) issued by a government are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Sovereign securities are generally backed by the issuing government, obligations of U.S. Government agencies and authorities are supported by varying degrees but are generally not backed by the full faith of the U.S. Government; portfolios that invest in such securities are not guaranteed and will fluctuate in value. Tail risk hedging may involve entering into financial derivatives that are expected to increase in value during the occurrence of tail events. Investing in a tail event instrument could lose all or a portion of its value even in a period of severe market stress. A tail event is unpredictable; therefore, investments in instruments tied to the occurrence of a tail event are speculative. Derivatives may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. Swaps are a type of derivative; while some swaps trade through a clearinghouse there is generally no central exchange or market for swap transactions and therefore they tend to be less liquid than exchange-traded instruments. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market.

Glide Path is the asset allocation within a Target Date Strategy (also known as a Lifecycle or Target Maturity strategy) that adjusts over time as the participant’s age increases and their time horizon to retirement shortens. The basis of the Glide Path is to reduce the portfolio risk as the participant’s time horizon decreases. Typically, younger participants with a longer time horizon to retirement have sufficient time to recover from market losses, their investment risk level is higher, and they are able to make larger contributions (depending on various factors such as salary, savings, account balance, etc). Generally, older participants and eligible retirees have shorter time horizon to retirement and their investment risk level declines as preserving income wealth becomes more important.

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