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## The Evolution of Workplace Advice

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## The Evolution of Workplace Advice

### Abstract

Defined contribution (DC) pension plans have helped many individuals accumulate assets for retirement. However, DC plans do not typically offer retirement income options. We first consider the question of whether DC plans offer retirement income advantages compared to retail options. We find that DC plans advantages include costs, access and efficacy. However, successfully extending DC plans into the income phase of retirement requires recognizing the importance of choice. Companies choose what features to offer in their 401(k) plan, and individuals choose whether to avail themselves of available options. The remainder of the paper explores some of the key aspects of company and individual preferences that must be recognized if successful policies and income options are to be developed for DC plans and participants.

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Economics

### Comments

The published version of this Working Paper may be found in the 2013 publication: *The Market for Retirement Financial Advice*.

# **The Market for Retirement Financial Advice**

EDITED BY

Olivia S. Mitchell  
and Kent Smetters

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## Chapter 6

### **The Evolution of Workplace Advice**

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*Christopher L. Jones and Jason S. Scott*

The past few decades have brought a profound shift in employer retirement plans, away from professionally managed pension assets, and toward individuals bearing the burdens of their own investment and saving decisions. Tens of millions of employees today are faced with making investing and saving decisions in defined contribution (DC) plans that will have a significant impact on their future quality of life. In response to these changes, employers are increasingly providing employees with access to specific investment advice. Yet the workplace environment creates substantial challenges for traditional methods of providing investment advice. This chapter shows how the workplace advice market has evolved over the last fifteen years, how technology has changed the creation and delivery of investment advice, and how the regulatory environment has influenced the availability and usage of advice in DC plans.

A key characteristic of workplace investment advisory services in the United States is that they must address the requirements and preferences of three distinct groups of stakeholders: government regulators, plan sponsors (employers), and plan participants (employees). One can think of each of these stakeholders as representing filters through which any successful advice solution must be able to pass. For instance, a workplace advice solution that fails to meet regulatory requirements is a non-starter in the marketplace. Likewise, one that meets regulatory requirements but fails to address plan sponsor concerns will not be provided. And individual participants must also want to use the advisory services if they are to have any impact on investment behavior. Finally, an advisory service must be able to cost-effectively meet the needs of a wide spectrum of plan participants.

Successful workplace advisory services must also address the needs of varied workforces, helping employees create appropriate investment strategies to achieve their retirement goals. Many plan participants have little experience with investing and hold modest account balances, unlike the affluent customers of traditional registered investment advisors (RIAs). For instance, the median 401(k) account balance in Financial Engines' member base in 2011 was approximately \$38,000.<sup>1</sup> Providing personalized

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investment advice to clients with such modest balances places additional requirements on the scalability of the advice provider's business model. Moreover, plan participants differ in terms of their knowledge, level of engagement, risk preferences, and financial circumstances. Addressing the advice needs of such participants therefore requires a multi-faceted approach to engagement and communication. As gatekeepers to the employee population, plan sponsors play an important role in determining which advisory services are available to their plans. Fiduciary responsibilities under the Employee Retirement Income Security Act (ERISA) require plan sponsors to engage in an appropriate selection process in hiring a provider of workplace advisory services. Because of this due diligence requirement, plan sponsors are an important constituency in the development and distribution of workplace advisory services. Finally, as we will see, the actions of government regulators and policymakers, particularly the Department of Labor (DOL) and Congress, have played an important role in shaping evolution of workplace investment advice.

### **Workplace advice: filling the vacuum**

In the mid-1990s, DC plans, and especially 401(k) plans, began to play a central role for many US workers. Originally viewed as supplemental plans to augment traditional defined benefit (DB) pensions, many companies now use the 401(k) as the primary retirement vehicle offered to employees. This move shifted the burden for making investment decisions and bearing investment risk onto individual investors. Many plan sponsors and policymakers began to recognize the large gap between the knowledge and expertise of typical plan participants, as well as the need to make informed investment decisions to shape retirement outcomes.

During most of the 1980s and 1990s, help offered to rank-and-file employees was mainly limited to generic education about investing concepts. Communications provided to plan participants discussed general concepts of diversification and asset allocation, but most did little to provide specific help in constructing an appropriate portfolio using plan investment options. Moreover, many firms provided simple deterministic retirement calculators designed to illustrate the value of compounding and regular saving.

A key problem with these simple models was that they encouraged risk-taking by characterizing asset allocation as a 'return-return' tradeoff. That is, many such calculators asked participants to provide an assumed rate of return used to compound uniformly over the investment horizon, so as to produce an estimate of future retirement wealth. But because these calculations were purely deterministic, it appeared that there was no



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downside to simply picking the asset allocation with the highest expected return; they ignored investment risk. While institutional investors, notably DB pension plans, had long used sophisticated simulation techniques to help assess the impact of investment risk and make informed choices about risk preferences, such tools were not widely available to individual investors until the mid-1990s. The complexity and costs of developing such models put them out of reach for all but the most affluent investors and their advisors.

Economics and technology were not the only barriers to participants obtaining access to high-quality investment advice in the workplace: sponsor concerns played a role as well. Plans sponsors were wary of jeopardizing their fiduciary protections under Section 404(c) of ERISA.<sup>2</sup> Many sponsors became concerned about providing assistance that might be construed as offering direct investment advice to their employees, fearing that if participants followed such advice and subsequently lost money, employers might be sued. Nevertheless, it grew increasingly clear that many plan participants did a poor job of investing their 401(k) accounts. Common mistakes included overconcentration in employer stock, chasing past performance, selecting inappropriate risk levels, and failing to take advantage of savings opportunities including employer matching contributions. Both employers and government regulators began to view participants' decision-making with alarm, finding that most participants were neither well informed about retirement investing, nor adequately engaged in managing their investments.

The regulatory environment also played a key role in explaining the dearth of workplace advice during the early 1990s. In the United States, 401(k) plans are subject to ERISA which imposes strict limitations on entities providing advice to qualified plan participants. At its core, ERISA seeks to protect plan participants from self-dealing and other conflicts of interest. In the early years of the 401(k) industry, the natural providers of investment advice at large scale, namely large record keepers and asset management firms, were generally prohibited from offering plan participants investment advice. Under ERISA, such advice from an investment manager in the plan would trigger a *prohibited transaction*, with severe penalties for the infracting institution. The ERISA prohibited transaction rules prevent an investment manager from offering advice on its own products, when there is an economic incentive for self-dealing. Since neither plan sponsors nor plan providers showed much interest in offering investment advice due to these legal and compliance concerns, plan participants were largely left on their own.

Recognizing the reluctance of sponsors to offer needed help to plan participants, regulators looked for ways to clarify how such help could be provided safely. In 1996, the US Department of Labor (DOL) issued

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Interpretive Bulletin 96-1, which sought to encourage plan sponsors to offer more help to struggling employees. The bulletin marked a milestone in the market for workplace advisory services, as it helped in two important ways: it provided a clear definition of the line between educational guidance and investment advice for plan sponsors under ERISA, and it showed that the DOL favored making more help available to plan participants. Through subsequent related communications, the DOL offered a roadmap for sponsors on how to provide advice safely by hiring an independent fiduciary to give advice to plan participants. In this way, plan sponsors could avoid liability for the advice provided as long as they engaged in a prudent selection and monitoring process. This signaled a shift in the historical view that participants were ‘on their own’ when it came to making investment decisions in their retirement plans, and it led to many sponsors playing a role in helping their employees with this important and challenging burden.

### **A new model for workplace advice**

The US workplace advice market began to take off in the mid-1990s with the rapid rise in employee access to the Internet. This provided a conduit to reach millions of participants in retirement plans at low cost, and to provide them with interactive advisory services to help them manage their investment choices. In 1995 and 1996, two venture capital-backed startup firms, 401(k) Forum (later mPower) and Financial Engines, were founded in California to provide independent, cost-effective, investment advice for 401(k) plan participants. Both firms adopted the business model of selling independent advisory services to employers who would in turn make these available to their plan participants.

A key attribute of the new approach was to avert the potential for prohibited transactions under ERISA by avoiding the sale or manufacture of investment products. To prevent any incentives for self-dealing, it was necessary to have a business model where advisory services revenues did not depend on the advice itself. By structuring the firm to be independent of the plan funds, it was possible to provide investment advice without violating ERISA rules against self-dealing.

Financial Engines was co-founded in 1996 by William Sharpe, a financial economist and Nobel Laureate at Stanford University, and Joseph Grundfest, a professor at the Stanford Law School and a former Commissioner at the Securities and Exchange Commission (SEC). The founding vision for the company was to bring best practices from academic finance and institutional money management to bear on the needs of everyday investors. With the explosive growth of the Internet, Sharpe saw an opportunity to

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apply technology to the problem of delivering high-quality personalized investment advice to plan participants, irrespective of their account balances.

Until this point, it had been too expensive to rigorously apply the techniques of modern financial economics to individual investment problems on a mass basis. Investment advisors had historically focused on high-net-worth investors, personally interacting with each client to develop a personalized investment strategy. These advisors were expected to have deep expertise in finance and other domains, and as a part of their services, they spent substantial time developing relationships with each client. The costs of providing investment advisory through this model were and still are considerable. For instance, most independent investment advisors charge for their services as an annual percentage of a client's assets. Fees for investment advisory services generally range from 50 basis points (0.5 percent) to more than 200 basis points (2 percent) of assets under management, depending on the types of services provided and the size of the client account. For the process to be profitable for the advisor, the client account must generate sufficient fees to cover advisors' overhead and compensation. This model is not economically feasible for clients with only a few thousand dollars in their 401(k) accounts. The advance offered by Financial Engines and other firms targeting the 401(k) advice market was technology infrastructure that made it economically feasible at large scale to provide personalized investment advice to participants with modest balances. Plan sponsors demanded services that could help all their employees, not just the affluent. By using technology to automate much of the investment analysis process, it now became possible to provide high-quality advice at a much lower cost than in the past.

### Experience with online advice

Financial Engines went live with its first online investment advisory service for 401(k) plan participants in 1998. The online advice service provided plan participants with specific recommendations on which funds to buy and sell, so as to create appropriate retirement investment strategies. Users would log onto the service and interactively explore the tradeoffs associated with different combinations of investment risk, saving, and retirement horizons. This 'outcomes-based' approach emulated techniques used in asset-liabilities studies performed for large pension plans, but now at the scale of individual participants instead of a large DB plan with thousands of beneficiaries. For the first time, plan participants could get realistic views of their retirement outcomes via sophisticated Monte Carlo simulation. Moreover, they could explore how different decisions might alter the

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probabilities of reaching their goals. Finally, leveraging the expertise built into the optimization engine, they could receive specific recommendations on how to take the best advantage of investment options available in their 401(k) plans. The cost of the service was picked up by the employer, so that participants could use it without any out-of-pocket expense. This was an important consideration in getting plan participants to take advantage of the service, since requiring participant-initiated payments up front would have placed an additional barrier to adoption of the service.

Sponsors who were early adopters of these new services and benefits generally reacted favorably to the availability of personalized investment advice for their employees. Many sponsors were familiar with the failure of generic education to ‘move the needle’ and change investor behavior, and some were concerned about the potential litigation risk associated with high levels of company stock held by some employees.

Larger plan sponsors also played an important role in the evolution of online advice programs, demanding on close integration with their record-keeping platforms to provide participants with convenient access to their own data, as well as the ability to execute transactions at the press of a button. In addition, various plan complexities needed to be handled gracefully. For instance, some plans had trading restrictions that shaped how participants could trade over time. Plans with stable value funds often had equity wash provisions that constrained how money could flow out of the stable value fund into other fixed income options. Other sponsors had multiple plans for certain participants. Between 1998 and 2011, Financial Engines expanded the capabilities of the online advice service to address these needs and provide a more convenient experience for plan participants.

Nevertheless, there were still challenges in getting some participants to pay attention to personalized advice. Many did respond more favorably to personalized advice than they did to generic education, but the uptake of professional advice was not universal. Convenience proved to be a major factor in the adoption of online advisory services. One of the most important convenience features was the ability to download participant data from the record-keeping system so as to minimize the amount of information that had to be manually entered by each plan participant. Financial Engines also found that sponsor endorsement of the advisory services was important in driving adoption. To this end, participants needed to be made aware of the service, as well as how it could benefit their futures. Participants tended to value the due diligence provided by their employers, and they were more likely to trust the advice when it was endorsed by their employers.

As Financial Engines gained experience with different plan populations, it became apparent that demographic factors influenced adoption patterns

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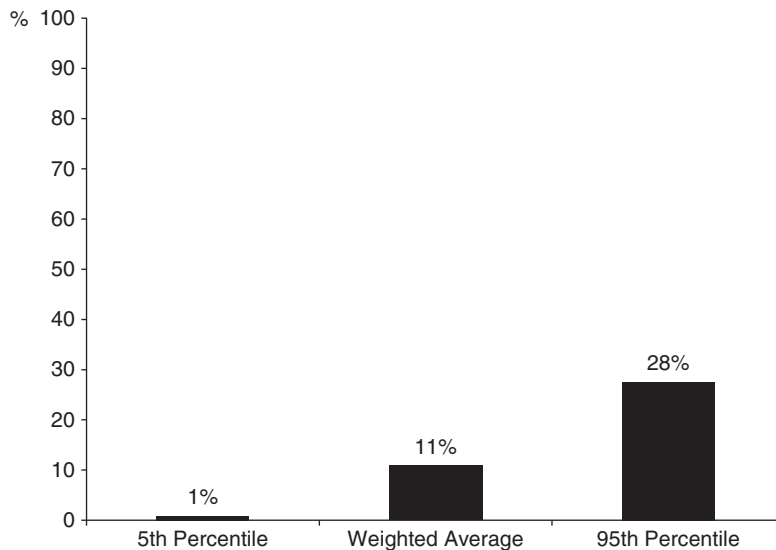


Figure 6.1 Online advice usage

*Source:* Authors' computation from the Financial Engines database (December 31, 2011).

for online advice. The usage of online advice was also observed to vary widely by plan sponsor. In the first year of deployment, an average plan sponsor might see around 10–15 percent of the workforce use online advice. Yet white collar workers, particularly those in technology-related fields, often had adoption rates that were double or triple this average. By contrast, plan sponsors with a population dominated by factory workers in manufacturing or transportation often saw lower usage. Figure 6.1 shows the distribution of online advice adoption across a sample of more than 450 plan sponsors at Financial Engines as of the end of Q4 2011.

The variation in usage is striking, varying from 28 percent at the 95th percentile, to only 1 percent at the 5th percentile. The average usage weighted by participants was 11 percent. The top end of usage was generally the result of favorable demographics and aggressive communication programs. The lower end of the distribution included firms that either had recently introduced advice or had made no communication offers.

Online advice users also differ somewhat from the broader plan participant population: they tend to be slightly younger and significantly wealthier than average participants. They also save more and are generally more engaged with the 401(k) plan than their average co-workers. Table 6.1 provides a comparison of online advice users and the general plan population.<sup>3</sup>

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TABLE 6.1 Demographic comparison of online advice users

	Online advice users	Overall covered workforce
Average age (years)	46.3	46.4
Average balance (\$)	159,103	89,549
Median balance (\$)	74,828	30,579
Average salary (\$)	87,813	69,358
Average savings rate (as percent of salary)	9.0	7.0

*Source:* Authors' calculations from a Financial Engines database query Q1, 2012.

Overall, online advice services tend to appeal to wealthier, more engaged plan participants, who tend to be influential in plan sponsor decisions around plan design. In this sense, they differ from the average participant in most companies offering advisory services.

**The 2001 SunAmerica Advisory Opinion**

There was a significant regulatory development having an important impact on the workplace advice market in 2001. The SunAmerica corporation petitioned the DOL for an Advisory Opinion to permit the company to provide investment advice under its own brand to 401(k) participants in plans where its products were included in the lineup, but with the condition that the advice would be generated by an independent third-party expert. The DOL (2001) issued the SunAmerica Advisory Opinion providing specific conditions under which this arrangement could avoid prohibited transaction prohibitions under ERISA. The practical impact of this Advisory Opinion was that now, larger asset management firms and record keepers in the 401(k) space could work with independent advisory firms to bundle investment advice with other services offered to plan participants and do so under their own branding. Over the next few years, many 401(k) financial service firms joined forces with independent advisors like Financial Engines to provide integrated advisory services on their platforms. By allowing 401(k) firms to offer advice under their own brands, it became easier to deeply integrate investment advice into the 401(k) platform and further increase customer convenience. This also accelerated the adoption of advisory services by plan sponsors, as often the advice was bundled in with other 401(k) services.

These developments offered independent advisory firms like Financial Engines an opportunity to expand the reach of advisory services and thus further leverage the large fixed costs associated with building sophisticated

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advisory platforms. They also accelerated the view that independent advisory services in 401(k) plans were an emerging 'best practice' among larger employers. As the market for online advisory services matured, it became increasingly clear that only a subset of plan participants was willing to spend the time and effort to interact with an online advisory service to interactively build and implement retirement plans. Despite ongoing communications campaigns, it was difficult to achieve adoption rates much beyond one-quarter of the plan population for most sponsors. The key question then became, how to reach the other three-quarters of the participant population?

### Managed accounts

Financial Engines embarked on a development effort to design services to better address the needs of the participants disinclined to use online advice in 2003. Extensive participant interviews and focus groups were conducted to determine what this population of 'reluctant investors' was looking for in terms of retirement help, and two key themes emerged. First, many participants were not interested in, or did not have the time to, engaging in an interactive online planning experience. Instead, they sought a 'hands-off' solution that would allow them to delegate the responsibility of managing their accounts with minimal day-to-day involvement. For such participants, managing a retirement portfolio was a burden they preferred not to bear. Another segment of the population, particularly older participants closer to their retirement dates, was looking for access to human advisors to whom they could address questions and validate their decisions. At times, the latter participants were nervous about implementing decisions without consulting with an expert. Combining insights from these two population segments, it became apparent that a service was needed that offered access to telephone-based advisors with a discretionary account management structure.

The idea of discretionary management in a 401(k) account was easily accommodated within ERISA through Section 3(38), which permits fiduciary investment managers to make decisions on behalf of plan participants while shielding the plan sponsor who selects the investment manager from liability associated with the investment decisions of the manager. This long-established framework, in place for decades in traditional DB plans, was familiar to plan sponsors. Of course, prohibited transaction prohibitions still apply, as they do for investment advice. Since Financial Engines and other independent vendors of managed accounts were not selling or managing the plan funds, they could avoid the potential for self-dealing. In practice, getting sponsors comfortable with hiring an investment manager

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to offer managed accounts was actually easier than overcoming liability concerns in the early years of selling online investment advice.

Financial Engines launched its first managed account clients in 2004, and by year-end it had amassed over \$1 billion in assets under management. The service was structured as a discretionary managed account program, where Financial Engines took over control of the investment portfolios on behalf of participants. Once a participant enrolled, Financial Engines would generate a Plan Preview illustrating the proposed portfolio allocation based on information drawn from the record-keeping platform. The Plan Preview disclosed the data and assumptions on which the advice was based, and it provided participants with the ability to further personalize their proposals online or by calling phone-based investment advisor representatives. Program members could customize their risk preferences, retirement ages, outside assets, and preferences for holding company stock within the program. If a member personalized his or her account, a revised Plan Preview would be generated showing the new recommendations. At any point along the way, managed account users had the ability to speak with investment advisory representatives who could answer general retirement questions, help participants personalize their retirement plans, and provide help with retirement income planning. In the case of Financial Engines, investment advisors use specialized software to generate these investment recommendations and provide forecasts and diagnostic statistics. As with online advice, these investment recommendations are strictly generated by the advice platform, insuring consistent high-quality advice independent of which advisor a participant works with.

A key distinction between online advice and managed accounts is that a member need not take any action to have the plan implemented. Once a member joins the program, Financial Engines takes care of the transactions required to move funds to the target portfolio, and then it monitors each account on an ongoing basis, making adjustments as required. Similar to target date fund strategies, the allocation of the managed account portfolio gradually becomes more conservative as a member approaches his or her retirement date. Unlike a target date fund, each portfolio is individually tailored to the participant. For instance, a more risk-averse participant might see an allocation tilted toward fixed income investments, compared to a risk-seeking participant. Also, a managed account approach can adapt to plan-specific circumstances such as the existence of a cash balance plan or a position in restricted company stock. By personalizing fund allocations to account for such individual and plan differences, the program can offer participants more efficient allocations better suited to their needs.

Another important attribute of managed accounts is that plan participants pay the fees for the program from their DC accounts. As a rule,



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managed account participants pay an asset-based fee for the discretionary management of their accounts, similar to the way in which fee-only investment advisors charge for their services. This account fee is usually deducted from the participant's account balance once a quarter (in arrears). Since plan sponsors do not have to pay for the services, there are fewer barriers to offering such a program to a plan population. Naturally, since participants pay for this service, it is still necessary to overcome the potential reluctance to pay for account management. But because of the scale economies provided by the large plan market, 401(k) managed account services are typically offered at a fraction of the standard discretionary management fees charged in the retail marketplace. Typical retail fees for discretionary management range from 75 to more than 150 basis points of assets under management annually, whereas the fees for Financial Engines' managed account services range from 20 to 60 basis points, depending on the enrollment method and the size of the participant's account balance.

We have also found that participants who select managed accounts differ from the larger plan population.<sup>4</sup> First, managed account users tend to be older on average, by about one to two years. Second, average account balances of managed account clients are similar to the overall plan average, but median account balances are higher. For instance, in our managed account population, the average balance is 105 percent of the overall participant population, but the median balance is 145 percent of the overall average. This implies that managed account users tend to have fewer very large accounts, and fewer very small accounts. Many plan participants with very large balances often have established relationships with outside investment advisors. For participants with very small balances, there is generally little urgency to getting help with an investment strategy for retirement. Third, in terms of salary and savings rates, managed account users are similar to the overall participant average (see Table 6.2).

Interestingly, online advice users tend to place a high premium on maintaining control over their accounts and investment decisions.

TABLE 6.2 Demographic comparison of managed account users

	Managed account users	Overall population
Average age (years)	47.5	46.4
Average balance (\$)	93,884	89,549
Median balance (\$)	44,301	30,579
Average salary (\$)	70,138	69,358
Average savings rate (as percent of salary)	7.2	7.0

*Source:* Authors' calculations from a Financial Engines database query Q1, 2012.

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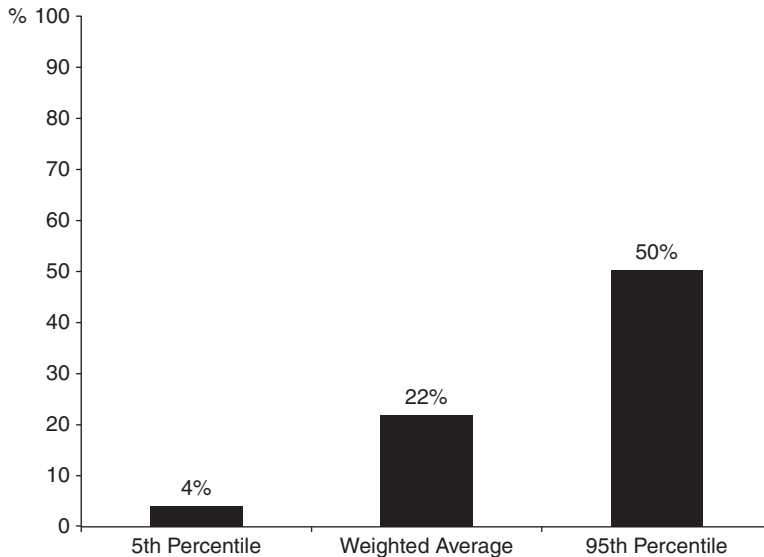


Figure 6.2 Aggregate usage (online and management)

*Source:* Authors' computations from the Financial Engines database (December 31, 2011).

By contrast, most managed account users see value in being able to delegate investment decisions to a trustworthy expert. Consequently, the usage of managed accounts in plans that previously offered online advice tends to be additive. Figure 6.2 shows the total usage distribution for Financial Engines sponsors (as of year-end 2011). Overall, the usage rates of managed account participants appear similar to that of online advice users, but a different subset of the participant population is involved. With the addition of managed accounts, overall usage of advisory services doubled from 11 to 22 percent. Of course, usage of managed accounts will differ according to participant demographics and the level of communications provided to create awareness and understanding of the program.

From a plan sponsor's perspective, managed accounts can be a valuable addition because they have a demonstrable impact on investor behavior. Unlike online investment advice, where participants are free to ignore the advice or only partially implement a set of recommendations, managed accounts insure compliance by construction. Once participants turn over control of their accounts to the investment manager, the account is optimized and periodically reviewed for any required changes. No participant action is required to implement the advice. By taking the responsibility for implementation of the recommendations out of participants' hands,

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it is possible to insure that appropriate adjustments to the investment allocation are made on a timely basis. This is particularly helpful in persuading participants to reduce their exposure to company stock, a common mistake in 401(k) plans (which can elicit emotional and behavioral reactions). Many participants make the mistake of equating familiarity with safety when it comes to their employer's stock, but company stock is the largest contributor to undiversified risk in many participant portfolios and can be a potential source of litigation risk for employers. Over the course of Financial Engines' managed account program since 2004, over \$6.5 billion of company stock positions have been diversified into fixed income and equity positions.<sup>5</sup>

The introduction of managed accounts also had a profound impact on participants' utilization of workplace advisory services. The innovation made it possible for 'reluctant investors' to receive similar benefits from professional help that had been previously limited to the most engaged participants. But events in 2006 provided a further push toward more widespread usage of advice in the workplace.

### The Pension Protection Act of 2006

In the early 2000s, researchers found that 401(k) plans which changed their default options often saw dramatic changes in the choices made by their participants. Specifically, automatic enrollment substantially increased plan participation across the board. Yet, for all its benefits, auto-enrollment created new challenges for plan sponsors. Concerns regarding fiduciary responsibility again became central, since implementation required plan sponsors to select a default investment. Given the realities of auto-enrollment, a large fraction of employees would likely be fully invested in whichever investment was selected as the plan's default. Many sponsors worried about potential liability if they selected a default investment that subsequently lost money. To avoid this problem, sponsors pioneering auto-enrollment techniques often selected a money market or stable value fund as their plan default. This approach avoided the potential for subsequent losses, but it created the chance that defaulted employees might spend their entire investment careers fully allocated to short-term fixed income investments.

The Pension Protection Act of 2006 (PPA) was passed, in large part, to encourage widespread use of automatic enrollment, and to address sponsor fiduciary concerns. The PPA created a safe harbor for the investment allocation by identifying three Qualified Default Investment Alternatives (QDIAs). Utilizing a QDIA as the default investment provides a safe-harbor shielding employers against liability from automatic enrollment should the

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QDIA suffer a loss. The three QDIAs identified were (a) a professionally managed account, (b) a target date fund, or (c) a balanced fund.

Post-PPA, many plan sponsors selected either a target date fund menu or a professionally managed account as their QDIA, primarily because these two options were more personalized to the plan participant. Both decreased investment risk as participants aged, with the managed account option providing additional levels of personalization. The PPA was a boon to the managed account business, since the halo associated with being a QDIA caused many sponsors to consider managed accounts even if they had not considered switching to automatic enrollment. As Figure 6.3 illustrates, the net increase in managed account clients peaked at over 120,000 in 2007, the year following enactment of the PPA.

The PPA described a mechanism to automatically enroll new employees into a DC pension plan and created a safe harbor if the default investment option was a QDIA. But by focusing exclusively on new hires, the vast majority of plan participants were ignored. This led many sponsors to adapt auto-enrollment for the entire workforce, a step made possible because of the guidance and safe harbors provided by the PPA: plan sponsors essentially

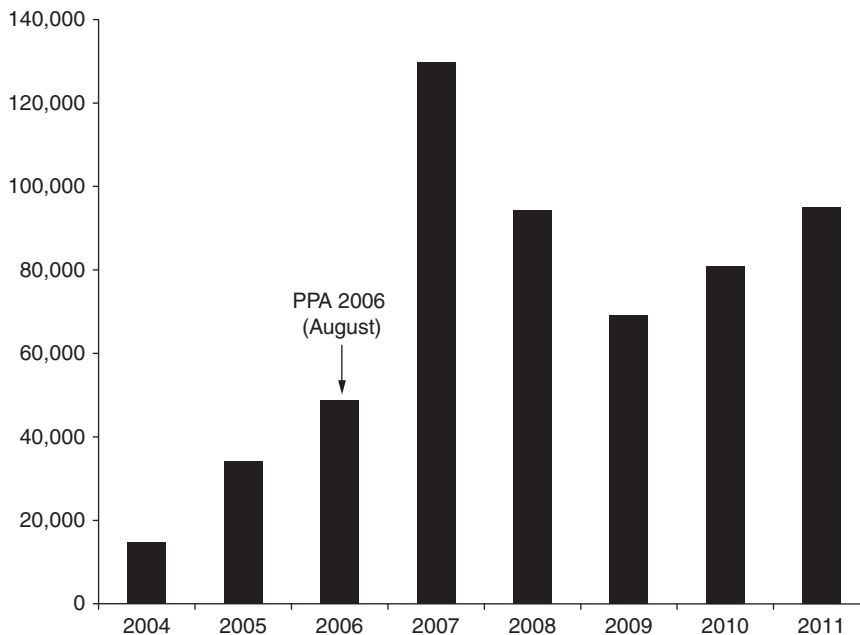


Figure 6.3 Net new managed account members

Source: Authors' computations from the Financial Engines SEC Filings.

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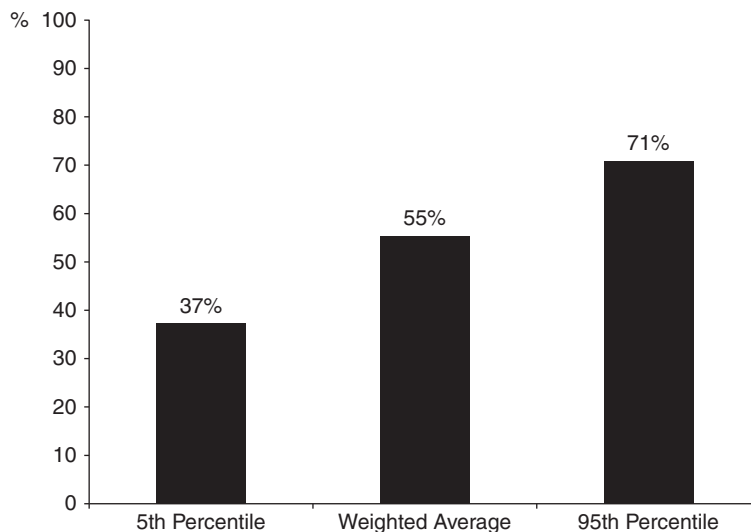


Figure 6.4 Aggregate usage with defaults

*Source:* Authors' computations from the Financial Engines database (December 31, 2011).

're-enroll' existing participants into a default investment option and follow the same procedures outlined by the PPA. The main advantage of plan re-enrollment is that all participants are provided with a reasonable asset allocation, and participants must make an active election to alter their portfolios. For example, a company might be concerned with high levels of employer stock held inside its 401(k) plan. To make clear that company stock holdings were the result of an active participant decision, a company could re-enroll the entire plan into a QDIA. Then participants wishing to hold company stock, or any other investment allocation, would need to either opt out of the QDIA prior to the re-enrollment, or subsequently proactively alter their investment allocations.

Results illustrate that inertia proves to be a powerful factor. Figure 6.4 reports usage statistics as of year-end 2011 in pension plans that included some form of default (either for new hire or via plan re-enrollment). Clearly, the difference in usage was dramatic. The 5th percentile increased from 4 to 37 percent, indicating that even the lower range usage was substantial. At the high end, defaulted plans had overall usage rates of over 70 percent. The participant weighted average overall usage was 55 percent for clients with some form of default, so usage in a default context was more than double the average usage otherwise.

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### Retirement income in DC plans

With trillions of dollars now accumulating in DC plans and Baby Boomers retiring in large numbers, a key question becomes: how can participants turn their DC assets into retirement income? Unlike DB plans, the 401(k) and other DC plans were not designed to produce a steady stream of retirement income. But recent regulatory changes have been targeted at helping develop the DC marketplace for retirement income. The same factors that governed the development of accumulation help for DC participants are again in play: that is, regulations will define the environment, sponsor preferences will determine which solutions get offered, and, assuming a workable business model, individual preferences will largely determine what gets used.

Since DC plans are increasingly displacing DB plans, a natural starting point is to try and make income from DC plans seem comparable to income from DB plans. This intuition has led sponsors and regulators to focus on annuities as potential income solutions for DC plans. Nevertheless, participant behavior, sponsor preferences, and the current regulatory environment, all suggest that annuity solutions are a difficult sell in the DC marketplace. The core reason is that many people seem reluctant to annuitize assets at retirement. Numerous researchers have studied this ‘annuity puzzle,’ a term referring to the gap between predicted and actual annuity demand. For example, Warner and Pleeter (2001) examined a group of 66,000 military personnel offered the option of a lump-sum or annuity payout; they found that, even though the annuity payout was typically twice as valuable as the lump sum, 90 percent of enlisted personnel and 50 percent of officers opted for the lump-sum payout. Even more relevant, Vanguard recently analyzed the decisions of participants in DB pension plans who were given the option of taking their annuity benefit as a lump sum (Mottola and Utkus, 2007). The results were striking: even in a traditional DB plan where the pension benefit was consistently communicated as an income payout, fully 73 percent of participants over the age of 55 selected a lump-sum payout. For a cash balance type pension plan, where the annuity cash value was more salient, 83 percent of participants over the age of 55 elected the lump-sum payout option. This analysis also dealt a blow to the idea that plan defaults result in high levels of annuity utilization, reporting that:

Less than one-quarter of married participants in our study chose an annuity, even though it is the federally mandated default option for married couples. Married participants worked actively to overcome the default annuity option by submitting a written, notarized waiver. (Mottola and Utkus, 2007: 1)

Given the evident preference for liquidity over annuity income (even for long-standing DB participants), it is small wonder that very few individuals

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with 401(k) or IRA assets annuitize any, much less a majority, of their retirement portfolios.

When people do not elect payout annuities, it remains to be seen what type of retirement income solutions will interest them. A number of possibilities emerge, ranging from solutions that provide income while preserving liquidity, to those that use early retirement payouts from the 401(k) plans to finance Social Security deferrals. While the options that will succeed are not yet known, it is clear that inertia, participant demand, sponsor support, and regulatory clarity will all likely play a large role in shaping the evolving marketplace.

### Conclusion

The current US pension system asks millions of Americans to rely on their employer-sponsored DC pension plans for retirement income security. Yet saving, investing, and creating retirement income from DC plans require a level of financial expertise that many people lack. A positive development is that the economies of scale achievable in the workplace now offer an opportunity to provide financial advisory help to those with insufficient assets to attract the interest of a typical retail advisor. To take advantage of these economies of scale, successful workplace offerings must be aware of a complex environment and satisfy the preferences of many different constituencies.

The regulatory environment is an important framework for such services. This creates some barriers, but more often it can influence plan sponsor perceptions as to the riskiness of specific approaches. If an approach does meet regulatory requirements, the next relevant hurdle is plan sponsor acceptance. Since plan sponsors exercise wide latitude regarding services for their pension plans, sponsor approval is required to achieve widespread success. But ultimately, participants themselves must decide to take advantage of the available help. Solutions that individuals ignore or dislike will not enjoy long-term success. In the process, the importance of a workable business model cannot be over-emphasized. Many approaches to financial advice might meet with regulatory, sponsor, and individual approval, but these are irrelevant if they cannot service the typical 401(k) participant with less than \$40,000 in investible assets.

### Endnotes

1. This datum was derived from a query to the Financial Engines database. Population median account balances were calculated on a sample of approximately 567,000 professional management (managed account) members.

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2. This provides certain fiduciary protections to plan sponsors with respect to the liability arising from investment decisions made by their participants. The protections are conditional on various requirements, including adequate diversification opportunities and other plan characteristics. If the 404(c) conditions are met by the plan sponsor, then it would be shielded from liability deriving from investment decisions made by plan participants.
3. Balances include total sponsored assets collected by Financial Engines (e.g., DC, deferred compensation, cash balance, Employee Stock Ownership Plan (ESOP), profit sharing, and money purchase). In some cases, accounts ineligible for online advice may be included. Traditional DB pension assets are excluded.
4. Balances include total sponsored assets collected by Financial Engines (e.g., DC, deferred compensation, cash balance, ESOP, profit sharing, and money purchase). In some cases, accounts ineligible for management may be included. Traditional DB pension assets are excluded.
5. This evidence was derived from a query to the Financial Engines database (December 31, 2011).

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