HIGHLAND

# SPOTLIGHT
JANUARY 2017

## PLAYBOOK - THE IMPORTANCE OF ADAPTING AND EVOLVING

As the college football bowl season comes to an end and the NFL playoffs are underway, the key to each team's success is its playbook. A playbook consists of offensive and defensive plays tailored to a team's philosophy. It is geared to highlight the strengths of the team members while minimizing their weaknesses. The most important quality for any great playbook is that it is never static—it is always evolving and adapting to fit the rules and the landscape in which it operates.

Throughout 2016, defined-contribution plan sponsors were forced to respond to an onslaught of "new plays" from both regulators and employees. Historically, these plans were used as a supplemental retirement plan, but over time they have evolved to become central to an employee's retirement. As the focus on plans has grown over the years, the level of scrutiny has increased and new rules have developed. As we move into 2017 and beyond, it is essential that plan sponsors reevaluate their playbook and assess how they will adapt and evolve to the current environment.

## HEIGHTENED SCRUTINY AND EVOLVING LAWSUITS

The increased scrutiny over fees and fiduciary best practices were not new in 2016, but the targets broadened to include plans with fewer assets and plans with different structures. Historically, suits targeted the "mega-plan" retirement space, as these plans consist of assets north of $1 billion and have thousands of participants. This changed in 2016 as cases were also brought against smaller plans. LaMettry's Collision was the first suit against a smaller plan—a plan that held $9 million in assets—but it was dismissed in June at the participant's request. CheckSmart ($25 million) was the second smaller plan targeted. These smaller-plan suits have not become the norm, but it is important to monitor this trend.

The other notable change came in August, when the plaintiffs' firm Schlichter, Bogard & Denton, a high-profile name within the retirement industry, filed 12 lawsuits on the same day against some well-known universities. This is a notable evolution within the litigation of retirement plans, as these were the first lawsuits filed against retirement plans structured as 403(b) plans.

> ***Per IRS:***
> *"A 401(k) plan is a defined contribution plan where an employee can make contributions from his or her paycheck either before or after tax, depending on the options offered by the plan."*
>
> *"A 403(b) plan, also known as a tax-sheltered annuity (TSA) plan, is a retirement plan offered by public schools and certain tax-exempt organizations."*

Some of the universities targeted were NYU, Duke, Harvard, Yale, MIT, Northwestern, and Columbia. The suits covered a variety of topics and remind plan sponsors that

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there are many aspects to a retirement plan that need to be monitored. These are the areas targeted:

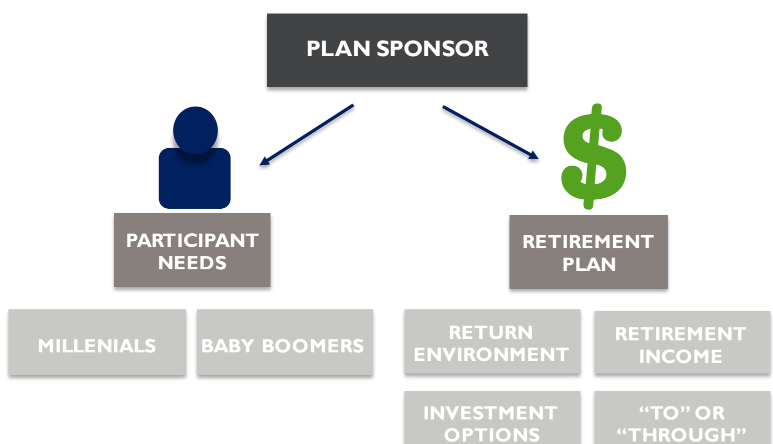
- How often to review record-keeping services
- Using fixed-dollar-per-participant fee versus an asset-based fee
- Using a single record keeper to minimize record-keeping fees
- The number of investment options a plan should offer
- Offering more than one option that is similar in style
- Retaining underperforming managers

The latest evolution came at the end of the year, as Essentia Health's retirement plan was targeted for excessive administrative fees. This lawsuit represents one of the first against a healthcare provider and serves as an important reminder that all plan sponsors are vulnerable. It is important that each plan sponsor revisit their fiduciary practices and ensure all decisions are well documented.

## EVOLVING RULES

2016 was highlighted by the issuance of the final version of the long-awaited Department of Labor (DOL) Fiduciary Rule (see **Spotlight: DOL Fiduciary Rule**). The Fiduciary Rule is viewed by the retirement industry as a monumental overhaul to the laws for administering and overseeing retirement plans. The rule is intended to curb excessive fees and abuses among some players in the industry while also requiring advisors to recognize their fiduciary role. The expectation is that advisors who act as both consultants to the plan and educators to the participants will need to alter their services in order to comply with the Fiduciary Rule. As a response, changes are already in motion at many financial institutions. Merrill Lynch announced that it will no longer give retirement savers the option of paying commissions for trades. Instead, individual retirement accounts (IRAs) housed at Merrill Lynch will be charged on a percentage of their assets. Other large retirement plan providers are following suit. LPL Financial, Edward Jones, and State Farm are also making changes as a response to the rule. While many retirement plan providers are anticipating changes, plan sponsors need to monitor the rollout of the Fiduciary Rule. The impact of the November election has raised questions as to whether the DOL Fiduciary Rule will be repealed or revised, given that many Republicans were against it. As we move into 2017, plan sponsors need to review their current plan by understanding whether the vendors' services have changed, monitoring the rollout of the Fiduciary Rule, and knowing how the rule will impact you as a plan sponsor. Remember, as rules change, playbooks need to be updated to stay competitive.

A potential key development in 2017 is the Retirement Enhancement and Savings Act of 2016. This bill was unanimously approved by the Senate Finance Committee in September and is expected to be addressed in the 2017-2018 legislative session given its bipartisan support. Among other provisions, the Retirement Enhancement and Savings Act would authorize open multiple-employer plans (MEPs), provide annuity safe harbor for Defined Contribution (DC) plan sponsors, require DC plan administrators to provide participants with an annual lifetime income disclosure based on specified DOL guidance, adjust Pension Benefit Guarantee Corporation (PBGC) premiums for Cooperative and Small Employer Charity plans, and change the required minimum distributions on inherited defined contribution plans and IRAs. The ability to provide open MEPs, have safe harbor when adding annuities, and requiring annual lifetime income disclosures may impact the structure, design, and administration phases of retirement plans. Therefore, plan sponsors need to monitor this piece of legislation as they may need to adjust or even revisit the overall goal of the current retirement plan.




## EVOLVING PARTICIPANT NEEDS

Defined contribution plans have evolved over time to become the most important portable source of retirement income. As such, there are a variety of things plans sponsors should consider when they formulate the goals of their plan. The first is that not only have participant needs changed over time, but many of their needs differ within the plan, too. For one illustration, think about the baby boomer generation versus millennials. Baby boomers are either rapidly approaching retirement age or have reached retirement age and face a number of issues. Many realize that they have not saved enough to retire and are forced to keep working. This deferment could put stress on employers as they have increasing healthcare costs due to an aging workforce; it could also create a talent drain as young employees have no upward mobility within a company.

At the other end of the work front are the millennials, of whom many are entering the workforce with large sums of student debt. They are faced with the decision to start saving for future retirement or pay down their current student debt load. Many are choosing to chip away at their debt and not investing for retirement. This potential misallocation of resources is a double whammy to future savings, as employees may be missing out on their employer's matching contribution. By not saving early and letting the savings compound, millennials are going to be faced with the choice of either having to save more later in life or to work longer to be able to have a secure retirement.

Secondly, plan sponsors are now tasked with providing for employees not only to retirement but also through retirement. Participants who have saved and are ready to retire are looking for cost-efficient and effective ways to turn their pool of assets into a steady income stream throughout retirement. Many are realizing that rolling their retirement assets into an IRA is not the best decision, as they may be saddled with higher costs due to the use of advisors and "retail" investment products. They are looking for alternative solutions, but many plans are not designed to offer retirees "in-plan" solutions that could offer institutional pricing. This could become a bigger issue if the DOL Fiduciary Rule becomes effective as it is currently written. Under the new rule, advisors who recommend participants roll their assets into an IRA will be deemed fiduciaries. This change is expected to impact both retirement advisors and participants. Advisors will be saddled with the fiduciary liability when advising participants to roll the assets into an IRA, which may make them less willing to provide advice to retiring participants. Additionally, it is anticipated that participants with smaller balances will be most affected as fewer advisors are willing to provide advice, leaving them with fewer options.

Finally, a big concern facing all participants is the low-return environment. Highland Associates forecasts that future returns will be below their historical norms given the current valuations across the markets and low yields within fixed income. Based on Highland's current forward-looking assumptions, a balanced portfolio consisting of 60% S&P 500/40% Barclays Aggregate will return 3.75% over the next 10 years versus the 7.0% it would have returned over the past 20 years. This not only impacts those trying to retire, but it can also have a major (negative) impact on retirement savings over the long-term. The solution is simple. Participants will either have to work longer or save more to cover the gap.

## HIGHLAND'S VIEW

Having a playbook is essential to every organization as it outlines or details its strategic plan. In light of recent litigation, new laws, and changing participant needs, it is vital that plan sponsors adapt and evolve their retirement plan playbook. It can be costly to rely on a "what worked in the past will work in the future" mentality. As we move into a new year, we recommend that plan sponsors dust off those playbooks and look to make adjustments in order to stay ahead of the competition. Highland's objective is to help clients stay informed and engaged as the 2017 season approaches. Here are some places to start:

- ☑ Review fiduciary process
- ☑ Understand DOL Rule and its impact
- ☑ Monitor the Retirement Enhancement and Savings act
- ☑ Understand the needs of plan participants
- ☑ Look for ways to increase savings
- ☑ Review investment options, seek better valuations
- ☑ Consider retirement income options

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## AUTHORS:


**SCOTT SEALOCK**
VICE PRESIDENT

HIGHLAND

HIGHLAND ASSOCIATES
2545 HIGHLAND AVENUE SOUTH, SUITE 200
BIRMINGHAM, ALABAMA 35205
P. 1-800-405-7729 OR (205) 933-8664 F. (205) 933-7688