Just out of Reish

QDIA Demographics

The approach that plan sponsors should take in designing the investment strategy for pooled defined contribution plans

THE DoL's QDIA regulation approved three types of investments for the fiduciary safe harbor for defaulted participants: age-based investments, risk-based investments, and managed accounts. The age-based and managed-account alternatives must consider the age of the defaulting participant. However, for the risk-based alternative, the regulation mandates that only one investment be offered as the QDIA and that the investment take into account the demographics of the participant population as a whole. More specifically, the preamble to the regulation says:

"Unlike the first alternative, which focuses on the age, target retirement date (such as normal retirement age under the plan), or life expectancy of an individual participant, the second [risk-based] alternative **requires a fiduciary to take into account the demographics of the plan's participants, and would be similar to the considerations a fiduciary would take into account in managing an individual account plan that does not provide for participant direction**. A number of commenters asked the Department to clarify the demographic factors that should be considered by the fiduciary. The Department understands that the only information a plan fiduciary may know about its participant population is age. Thus, when determining a target level of risk appropriate for participants of **a plan as a whole, a plan fiduciary is required to consider the age of the participant population**. However, a plan fiduciary is not foreclosed from considering other factors relevant to the participant population, if the fiduciary so chooses." [Emphasis added.]

The interesting point is that the DoL believes that plan fiduciaries for pooled plans must take into account the demographics of the participants. In other words, a pooled plan must be invested in a manner that is consistent with the retirement needs of a participant group with those demographic characteristics. However, what are the characteristics to be considered, and what is their impact on how the portfolio is designed?

For QDIA purposes, age is listed as a known and important factor. That makes sense for QDIAs—and for pooled plans as well. However, plan sponsors have employees of all ages, so how is age to be considered? Arguably, the fiduciaries would look to the predominant age groupings: Is the workforce much older than average or much younger than average? For example, for an "average" workforce, the fiduciaries might select the traditional investment mix of 60% equities and 40% bonds. If the workforce is considerably older than average, a larger percentage might be allocated to bonds and vice versa.

What other factors may be considered? The preamble is not particularly helpful in answering that question, but common sense suggests some items. The existence of a defined benefit pension plan provides a secure source of income, which might support a more "aggressive" allocation in the defined contribution plan. On the other hand, the existence of an ESOP might suggest a more conservative allocation in the defined contribution plan. If the employee group is high-paid and knowledge-based, a more aggressive allocation may be appropriate since they can tolerate the volatility better. On the other hand, if the employee population is low-paid and subject to layoffs in recessions—and would suffer more from losses than would benefit from gains—that suggests a more conservative allocation.

As a practical matter, fiduciaries likely will be given a fair amount of discretion in making these decisions. At a minimum, they should evaluate thoughtfully the demographics of their workforce and make a considered decision about how that information affects their investment strategy. For risk management purposes, if their investment allocations are more conservative or aggressive than those commonly used for balanced investing (e.g., outside the 50% to 70% equity range and the 30% to 50% bond range), the fiduciaries should document the rationale for their decision.

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