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Frequently Asked Questions | Hybrid QDIA

For Plan Sponsors

What is a Qualified Default Investment Alternative (QDIA)?

When a participant contributes money to their workplace retirement plan, it will go into the investment vehicle that the participant has selected. However, in the absence of investment direction from the participant, the plan fiduciary invests the assets in a QDIA—the plan's "default" investment. The QDIA's primary function is to provide a prudent, effective investment solution for participants in the absence of an active choice. The Pension Protection Act of 2006 designated three types of investments that qualify as eligible QDIAs: target date funds (TDFs), managed accounts, and balanced funds.

What is a target date fund?

Also known as a "lifecycle fund," a target date fund is a diversified fund that automatically shifts a participant towards a more conservative mix of investments as it approaches a specified year (e.g., a participant's projected retirement date). TDFs are the most common default investment option selected by plan sponsors today.

What is a managed account?

A managed account is a personalized, professionally managed retirement plan. Each plan includes a personalized investment portfolio that updates automatically as the markets and a participant's life circumstances change. The plan also includes personalized savings and retirement age recommendations, retirement income projections, and more.

What's the difference between a managed account and a TDF?

Managed accounts are personalized retirement plans that evolve as a participant's life does. Unlike TDFs, a managed account recommends when participants should retire and how much they should save, and also provides guidance on how much income they can expect to have in retirement. And instead of the one-size-fits-all portfolio that participants get with TDFs, managed accounts give each participant a personalized portfolio that accounts for their age, gender, salary, outside retirement accounts, and much more.

What is a Hybrid QDIA?

A Hybrid QDIA is a dynamic default solution that serves plan participants at each stage of the employment and retirement lifecycle. This progressive approach pairs two QDIA-eligible investment options: TDFs and managed accounts. Those earlier in their career are defaulted into a TDF and are automatically transitioned to a professionally managed portfolio when they get closer to retirement and their financial situations are generally more complicated.

Is the Hybrid QDIA solution better for participants?

With widespread adoption of the QDIA over the last several years leading to more participants saving more money, it's reasonable to assume that retirement success should be that much easier to achieve. So why, then, are 7 in 10 pre-retirees in the United States reporting that they are not well prepared for retirement? One reason stems from the traditional QDIA options that are available to plans.

The Pension Protection Act designates three types of investments that qualify as eligible QDIAs, the two most notable being target date funds and managed accounts.

Target date funds—or a diversified fund that automatically shifts a participant towards a more conservative mix of investments as it approaches a specified year—are the most common default investment option selected by plan sponsors. While they mark a useful ingredient for retirement success, today, however, they are being asked to do more than ever before: to be a retirement readiness vehicle for a heterogeneous population of plan participants. Inherently, TDFs are not designed to incorporate the planning, customization, tools, and integrations necessary for those in their mid-to-later career stages who seek retirement success.

Likewise, **managed accounts**—or personalized, professionally managed retirement plans—though critical for optimal retirement planning, typically increase their value add over time—particularly in mid-to-later career stages. The technology supporting these platforms has vastly improved over the last several years, helping significantly reduce fees, and the types of investments that can be included are more extensive. Even so, not all younger investors may initially need the enhanced planning and increased functionality that comes with a managed account until they accumulate more assets and/or their financial profiles become more complex.

Given the opportunity to improve on today's most commonly used QDIA options, increasingly, advisors and employers are selecting a Hybrid QDIA solution to better facilitate retirement success for their employees. The Hybrid QDIA fills a significant void—the lack of precision and flexibility—in the retirement ecosystem created by default investment options that are simply not serving plan participants' retirement needs.

A **Hybrid QDIA** provides a personalized and dynamic default solution that serves plan participants at each stage of the employment and retirement lifecycle. This progressive approach pairs TDFs and managed accounts. Those earlier in their career are defaulted into a TDF and are automatically transitioned to a professionally managed portfolio as they get closer to retirement.

The development of the Hybrid QDIA is a very welcome and worthy advancement—the combination of two eligible investment options that create, overall, a more personalized, outcome-enhancing retirement plan at a fee largely on par with traditional QDIAs. TDFs are a prudent investment for those younger participants who don't always require the enhanced functionality provided by a managed account. But, once that participant reaches mid-to-later career stages, it is crucial that they amplify their retirement planning in order to best reach their goals. Studies[1] have proven that managed accounts cost effectively provide increased value to participants, particularly those closer to retirement whose financial needs vary greatly from person to person and are typically more complex. The ability to automate that transition from TDF to managed account at a predetermined date is a valuable, efficient, and prudent feature that defines the Hybrid QDIA.

The benefits of this "best of both worlds" approach very apparently outweigh a single-solution approach for a diverse population of plan participants. TDF managers themselves have identified that hybrid products incorporating a transition are the most advanced in the field of product development. With the growing industry acceptance and momentum the Hybrid QDIA is experiencing today, it is natural to envision a future scenario in which a hybrid approach is both the necessary and sufficient approach for the workplace QDIA.

What are the benefits of a Hybrid QDIA for plan sponsors?

- Strengthens employees' retirement readiness across plan demographics
- Measures and reports readiness for employees and the plan
- Better planning for all employees, including personalized investment strategies
- Enhances employees' financial planning capabilities
- Structure of QDIA is easily adjustable over time
- Upholds and protects your fiduciary duty by providing a cost-effective, best-in-class solution
- Supports employee engagement and talent retention

[1] Successful Retirement Plan Communications for Various Population Segments; Aon Hewitt

The Impact of Managed Accounts on Participant Savings and Investment Decisions; Morningstar Research

Managed Accounts Growing More Attractive in DC Plan Market; Cerulli

PSNC 2020: New Thoughts About QDIAs; Plan Sponsor

Recalculating Route: The Value Add of Managed Advice; NextCapital Advice

What are the benefits of a Hybrid QDIA for plan participants?

- Provides ongoing personalized planning, including savings rate and retirement age advice, improving participant retirement outcomes
- Prompts retirement awareness through proactive retirement readiness updates
- Combines the best of both worlds: employees earlier in their careers benefit from the low-cost, efficient allocation strategies of age-based funds, while more tenured employees benefit from the added personalization, planning features, and investment advice of managed accounts
- It's cost-conscious; fees are on par with current QDIA solutions
- Brings the peace of mind that comes with a smart, secure retirement strategy

What is the cost of a Hybrid QDIA to plan sponsors?

Plan sponsors incur no fees or costs with the implementation and ongoing support of a Hybrid QDIA solution. Fees are collected at the participant level and are calculated based on the assets held in each participant's account.

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Fees are calculated based on the assets held in each participant's account. [**INTERNAL NOTE: INSERT PLAN'S ACTUAL PRE-TRIGGER AND POST-TRIGGER BPS HERE**]

The purpose of a QDIA is to offer a prudent option for participants in the absence of an active investment choice. Does a Hybrid QDIA require engagement (by those participants triggered into the managed account) in order to realize the benefit?

THIS ARGUMENT ASSUMES THAT THE HYBRID SOLUTION IS MORE EXPENSIVE THAN THE PLAN'S CURRENT QDIA

No. While the more data provided the more personalized the advice will be, a hybrid solution is designed to provide value whether there is participant engagement or not. Some points to consider:

- **Significant technological advancements.** In the mid-2000s, managed account providers received little participant information from sponsors by default—often only account balance and age. Today, providers are able to pull in significantly more information without participant engagement, such as salary, account balance, age, contribution rate, retirement age, gender, state of residence, marital status, health information, and outside assets. Over the last several years, as the ability to customize with less engagement has grown, so too has the value proposition for Hybrid QDIAs.
- **Trust in plan sponsors.** Studies like this one assert that many sponsors think of passive members as "uninterested" or "unengaged" in their retirement savings, but passive members say they trust their plans and lack skill rather than interest. The heterogeneity, trust, and general lack of investment knowledge of passive members make opting out of the default less likely and smart defaults more appealing.
- **Quantitative benefits.** In a 2020 analysis conducted by NextCapital, "unengaged" managed account participants were shown to benefit from additional returns when compared to a target date fund. We observed the average value-add for unengaged participants to range from 11-21 basis points over a target date fund, while certain unengaged cohorts saw a value-add ranging from 8-70 basis points.
- **Tactful communications that drive engagement.** [**INTERNAL NOTE: DISTRIBUTOR TO INSERT ENGAGEMENT PROGRAM**]

How does implementing a Hybrid QDIA impact my fiduciary responsibility as a plan sponsor?

The QDIA options that plan sponsors are able to select today were determined in 2006. Since then, vast innovations in finance and technology have occurred at lightning speed, while the eligible QDIA options have remained the same. The development of the Hybrid

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As a fiduciary, it is your duty to act solely in the best interest of your employee base while remaining ERISA compliant. As sponsors, and the professionals with whom they work to make plan decisions, become more educated on such structural QDIA enhancements, they must earnestly and continually analyze the efficacy of their current QDIA selection. To learn about an innovative QDIA solution, such as the hybrid model, that is designed to use personalization and planning to strengthen retirement outcomes and NOT do more to understand its benefits for their own employee base will, by definition, increase fiduciary liability.

Why?

TDFs are a prudent investment for those younger participants who don't always require the enhanced functionality provided by a managed account. But, once that participant reaches mid-to-later career stages, it is crucial that they amplify their retirement planning in order to best reach their goals. Studies have proven that managed accounts cost effectively provide increased value to participants, particularly those closer to retirement whose financial needs vary greatly from person to person and are typically more complex. The ability to automate that transition from TDF to managed account at a predetermined date is a valuable, efficient, and prudent feature that defines the Hybrid QDIA.

The benefits of this "best of both worlds" approach very apparently outweigh a single-solution approach for a diverse population of plan participants, and the implementation of such a solution, thereby decreasing plan sponsors' fiduciary risk. For more information about plan sponsor fiduciary responsibilities, please see the IRS guide to A Plan Sponsor's Responsibilities.

How do I set up the plan for my participants?

[**INTERNAL NOTE: DISTRIBUTOR INSERT SUPPORT PROGRAM**]

What participant data does the Hybrid QDIA solution need?

At a minimum, the solution requires the following data to provide an appropriate age-based portfolio:

- Name
- Date of Birth

For those more tenured participants enrolled in the managed account subset of the Hybrid QDIA solution, a personalized retirement plan should incorporate the following data:

- Salary
- Employment status
- Employee deferral rate

[**INTERNAL NOTE: IF THE PLAN HAS DIFFERENT REQUIREMENTS FROM THE ABOVE, PLEASE EDIT AS APPROPRIATE**]

What are all of the data points that can be considered?

The following data point are provided by the recordkeeper: [**INTERNAL NOTE: EDIT THE BELOW LIST BASED ON SPECIFIC RK DATA**]

- Date of Birth
- Gender
- State of Residence
- Current Salary
- Recordkept Account Balance
- Recordkept Account Savings Rate
- Desired Retirement Age (if available)

Social Security and a participant's target retirement income estimates are automatically calculated. Users can override either.

User-entered data points can include:

- Marital status, spouse gender, spouse age, and spouse salary
- Education level
- Health/wellness
- Salary risk
- Other guaranteed income sources (e.g., pensions or annuities)
- Other retirement accounts (manual or aggregated) with contributions

What is the trigger age when going from the age-based fund into the managed account?

The plan's trigger age is configurable at the request of the plan. [**INTERNAL NOTE: INSERT RK-SPECIFIC DEPENDENCIES, IF ANY**]

Do participating employees have to wait until they are the designated "trigger age" to enroll in the managed account?

No. Any participant defaulted into the age-based fund can enroll in the managed account solution at any time; they do not have to wait until they are automatically transitioned.

Can eligible participants be enrolled in bulk?

Yes. An entire group of participants can be enrolled in the Hybrid QDIA without participants or advisors having to enroll online through the user interface.

Can participants change their target retirement income amount?

Yes. Those participants in the managed account subset of the Hybrid solution can fine-tune their advice recommendations by updating their profile and providing additional information. The more information a participant can provide, the better — personalization further powers the solution in giving participants a customized retirement plan that helps them retire successfully. Participants can update their income targets, external accounts, external sources of income, social security projections, risk tolerance, and other criteria at any time.

Can participants change their suggested savings rate?

Yes. As with target retirement incomes and other inputs, those participants in the managed account subset of the Hybrid solution can adjust their recommended contribution rates. Note that the recommendations, however, are optimally designed to help participants retire successfully as part of their personalized retirement plan.

What should participants do if they expect their information to change in the future?

In order to ensure that participants in the managed account get the most complete, personalized plan possible, it's recommended that they update their information whenever their personal or financial situation changes. This includes going through a major life event, such as getting married, buying a home, changing jobs, etc.

How often are the portfolios rebalanced?

Portfolios are automatically rebalanced on a regular schedule (e.g., quarterly) and/or when participants update their personal information.

[**INTERNAL NOTE: Elaborate on or override response if/when the specific situation is different than what's listed**]

Do managed accounts consider taxes when they recommend contribution amounts?

Yes. Managed accounts will typically recommend that participants contribute to a pre-tax account (like a traditional 401k) prior to a Roth account. Such recommendations are based on certain assumptions, including, for example, that taxable income in retirement is less than taxable income before retirement. While taxes are considered, it should not be treated as tax or legal advice. Participants are encouraged to speak with a tax professional to ensure their retirement investments align with their respective tax situation.

What happens when a participating employee leaves our organization? Can they leave money in their account?

This depends on your plan rules. As long as you allow the employee to remain in the plan, they can continue to participate in the hybrid solution.

What if a participating employee would like to unenroll out of the Hybrid QDIA?

Participants can unenroll from the service at any time without penalty.

Is reporting available?

Reporting about enrollments, activity, assets under management, positions, and reasonable allocations are available.

[**INTERNAL NOTE: Elaborate on or override response if/when the specific situation is different than what's listed**]

Please explain your initial and ongoing participant engagement and education program?

[**INTERNAL NOTE: DISTRIBUTOR INSERT ENGAGEMENT/EDUCATION PROGRAM**]

What kind of technical support is available for participants?

[**INTERNAL NOTE: DISTRIBUTOR INSERT SUPPORT PROGRAM**]

How is participant data protected? What security practices are in place to ensure that participant data is not compromised?

NextCapital, the solution's platform provider, takes privacy and security seriously, and they're committed to providing a secure solution for all customers. By leveraging Amazon Web Services and combining industry-leading practices, NextCapital ensures that participant data is kept private and remains available at all times. For more information, see https://www.nextcapital.com/security.html.

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