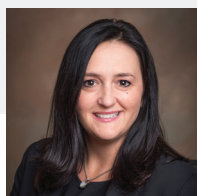




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ADVANCING THE WAY WE THINK ABOUT PERCEPTIONS OF RISK AND ACHIEVING OUTCOMES

KEY TAKEAWAYS

- A survey of 289 defined contribution (DC) plan sponsors conducted by T. Rowe Price provides a fresh perspective on the connections between long-term plan objectives, plan sponsor perceptions of risk, and the evaluation and selection of target date strategies and other qualified default investment alternatives (QDIAs).
- The research finds that a majority of plan sponsors are more focused on long-term retirement outcomes than on addressing perceived short-term risks. Plan sponsors also seek to address the diverse needs of their full participant populations (including participants who have already retired) rather than placing focus on specific segments of the plan population (e.g., participants approaching retirement age).
- Plan sponsor perception of “risk” is complex and often nuanced depending on how it is defined with respect to plan objectives. The research indicates that mitigation of longevity risk and preservation of growth opportunities take precedence over addressing short-term investment volatility and downside risk when evaluating target date investment strategies.
- Plan sponsors agree that attempts to reduce the risk of an adverse sequence of investment returns often presents potential trade-offs and may reduce retirement income potential.
- In working together to meet retirement challenges, plan sponsors and investment managers should advance the way all parties think about perceived risks and desired outcomes, particularly when evaluating target date strategies that are often the designated QDIA of choice.

Many DC plan sponsors are increasingly interested in helping their participants achieve better retirement outcomes rather than simply satisfying basic fiduciary requirements. As part of this trend, the DC industry has made significant strides to positively influence participant behavior and potentially improve outcomes with automatic enrollment and automatic contribution increase provisions, as well as through an ever-widening array of targeted employee outreach

efforts. These efforts are more than purely altruistic; in addition to laying the groundwork for better participant outcomes, these efforts may also improve employee retention and productivity, provide greater freedom for aging participants to retire when they want to, and potentially reduce risks of future litigation.

In light of this expanding set of objectives, the evaluation and selection of target date strategies or other

eligible QDIAs has taken on renewed meaning and importance. Although investment selection is only one factor influencing success in meeting plan objectives, different QDIAs often yield different outcomes and participant experiences. Therefore, plan sponsors that desire to do more than the minimum for their participants will need to dedicate significant effort in selecting a QDIA best positioned to help them achieve their goals.

A TALL ORDER: “WE WANT BOTH”

When evaluating target date strategies, plan sponsor considerations range from the fairly technical (“How do we benchmark them?”) to the strategic (“Should we select a to-retirement or through-retirement glide path?”) to the conceptual (“Should we assume this is all our participants have or just a fraction of total household assets?”). In part, this complexity stems from the multiple goals that plan sponsors often have in mind.

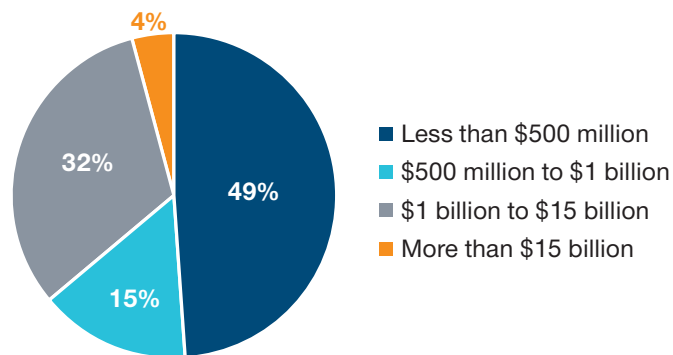
Do plan sponsors want the opportunity for participant balances to grow over time, or do they want to protect accumulated balances from market volatility as participants enter retirement?

The resounding answer is an unqualified, “Yes, both.”

IT HELPS TO KNOW WHAT YOU’RE SOLVING FOR

If balancing growth and reducing risk is the goal (and it is), the good news is that all target date strategies are constructed with this shared goal in mind. However, given the range of plan sponsor preferences and objectives, selecting, an unassailably “correct” QDIA can be difficult.

FIGURE 1: Respondents by Plan Asset Level



Source: T. Rowe Price. Figures shown in U.S. dollars.

To gain insight into this process, it is instructive to look to the academic field of consumer psychology to understand how purchasers weigh options and make selections. In fact, experienced DC professionals already may be familiar with a widely cited study analyzing the effect of having fewer choices (in this case, jelly varieties at a grocery store) on shoppers’ inclination to purchase and on their subsequent reported consumer satisfaction.¹ However, this is only one example of how the field of consumer psychology applies to DC plans. More broadly, the study of choice is far more complex and is not always in complete alignment with the simple maxim of “less is more.”²

Plan sponsors have a range of differentiated QDIA choices—an ideal situation if they want to more precisely match investment strategies to their individual pattern of risk perception and intended plan objectives. The potential downside is that this matrix of risks and objectives can overlap and contradict in ways that can be difficult to parse and address. Framed this way, fiduciaries are clearly confronted with a challenging task when selecting a QDIA that is best aligned to their desired outcome.

Thus, we come to the central questions of our survey-based research: What risks are plan fiduciaries most focused on resolving, and how do they prioritize these varied risks when evaluating and selecting a target date strategy? Do plan sponsors prioritize the mitigation of longevity risk or of investment volatility, given that these can be competing aims? Do they focus on addressing the special needs of near-retirees, even if it might undercut the needs of other plan participant cohorts? Furthermore, do they understand the inherent trade-offs involved when making these choices or prioritizing one preference over another?

SURVEY OBJECTIVES

The survey results discussed below are based on the collected responses from T. Rowe Price’s survey of 289 plan sponsors, conducted in early 2018. They help provide broader insights into fiduciary views on risk, especially when those risks are presented within the context of each other.

The patterns of these responses provide a data-driven framework for exploring three primary questions:

¹Iyengar, Sheena S., and Mark R. Lepper, “When choice is demotivating: Can one desire too much of a good thing?” *Journal of Personality and Social Psychology* 79.6 (2000): 995.

²Although the findings of the “jelly study” are often misinterpreted as definitive proof that having fewer choices is always and in all cases preferable to having more choices, there is a much larger body of research on the subject, some of which demonstrates an opposite effect (i.e., under certain conditions, having more choices is better). For a meta-analysis on the subject see: Chernev, Alexander, Ulf Böckenholt, and Joseph Goodman, “Choice overload: A conceptual review and meta-analysis,” *Journal of Consumer Psychology* 25.2 (2015): 333–358.

- **Interpret:** How do DC plan fiduciaries perceive and prioritize the risks that participants face when working toward their retirement objectives?
- **Translate:** To what extent is the QDIA selection and evaluation process influenced by fiduciaries' perceptions and prioritizations of these risks?
- **Align:** Are fiduciaries' perceptions of risks logically aligned with the stated long-term objectives of their participants?

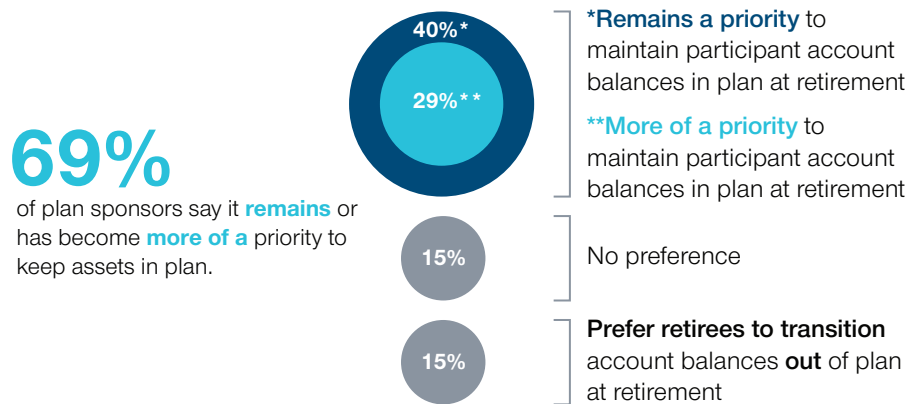
GROWING SUPPORT FOR KEEPING RETIRED PARTICIPANTS IN PLAN

One of the most interesting findings the research points to is plan sponsors' growing desire to accommodate the needs of plan participants after they retire. At face value, it's a curious position for plan sponsors to take: To the extent that DC plans are operated to attract talent, reduce employee turnover, or generally improve employee satisfaction and productivity, keeping retired participants beyond their duration of employment may seem counterintuitive. However, the plan sponsor community increasingly is conscious of its potential role in serving participants both before and after retirement.

In the survey, 69% of DC plan sponsors indicate that retention of participant assets is preferable to retirees transitioning their account balances out of the plan. In fact, a sizable subset (29% of the total) report that keeping retired participants in the plan recently has become more of a priority for them. Only 15% said they prefer that participants roll over their balances out of the plan at retirement.

There are likely a host of factors influencing this trend. From an outcome-centered perspective, helping retirees transition into and live well during retirement fulfills the larger objectives of the plan. It also can be a potent

FIGURE 2: Retaining Participants After Retirement



Source: T. Rowe Price.
Numbers may not equal 100% due to rounding.

signal to current employees, enhancing their perception of the plan's value and the generosity of their employer. Helping participants retire well also aligns with better management of aging workforces, possibly reducing employee health care costs and addressing declining employee productivity.

MORE TO THE STORY THAN SEQUENCE OF RETURNS

Consistent with an increasing interest in retaining retiring participants, the majority of plan sponsors (78%) report they primarily are focusing on their full active participant populations—including early-career and midcareer employees, as well as those nearing or already in retirement—when choosing asset allocation solutions (e.g., target date strategies or other QDIAs). That said, adequately providing for large and often heterogeneous populations requires factoring in a broad set of needs and carefully balancing conflicting considerations.

Plan sponsors are ultimately expected to make complex decisions with imperfect information. This can lead to investment option decisions that are influenced, sometimes heavily, by the cognitive bias of what plan sponsors individually feel rather than

what data suggest. In particular, greater emotional sensitivity to loss than to gain (i.e., loss aversion) is a widely known cognitive bias and a well-researched phenomenon.³ Loss aversion is often framed in terms of the risk that a participant may encounter an adverse sequence of returns (SoR) when account values may be at their peak near retirement or exacerbated by plan withdrawals used to generate retirement income.

This has led some plan sponsors and consultants to favor lower-equity glide paths, sparking the development of investment products following a “to retirement” glide path and generally stoking the debate about how target date strategies ought to be allocated when they are within some boundary around the target year.

However, in T. Rowe Price's view, it is also easy to lose sight of the larger balance between growth, risk, and long-term outcomes. A fiduciary who becomes over-sensitized to volatility also may be less inclined to investigate the opportunity costs of the lower growth that a too-conservative glide path might provide, leading to an unintentionally unbalanced evaluation process and a potentially poor outcome.

³Note that loss aversion is related to, but distinct from, risk aversion. Whereas risk aversion is a cognitive bias that drives a desire to reduce uncertainty, loss aversion more specifically refers to desire to avoid loss, taking into account what was previously experienced, owned, or even expected.

LONGEVITY AND INCOME POTENTIAL TAKES PRECEDENCE OVER DOWNSIDE RISK AND VOLATILITY

Our survey asked respondents to rank the influence of five different risks on their investment selection—longevity risk, participant behavioral risk, downside risk, volatility risk, and inflation risk. Their responses suggest that, despite the potential influence of cognitive bias, plan sponsors are considering risk in a broader context—including the possibility that a lower-equity target date glide path might fail to provide the growth that participants need to accumulate sufficient savings for retirement.

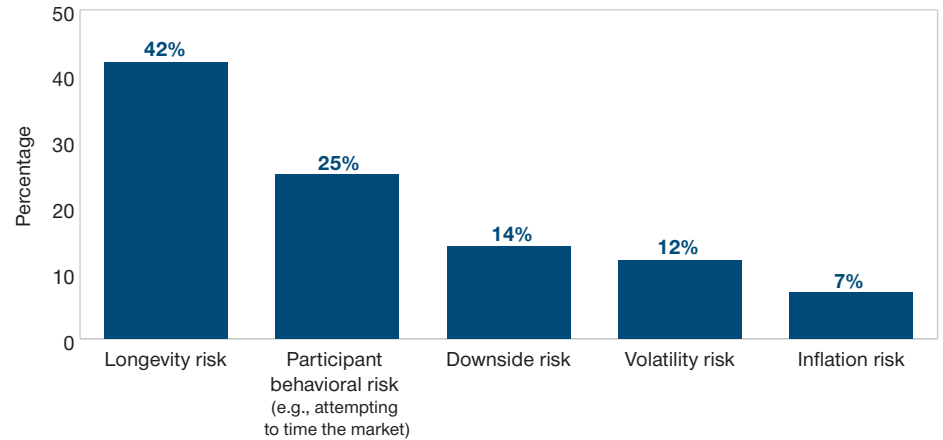
Plan sponsors report that the danger of participants running out of money in retirement is top of mind, with 42% identifying longevity risk as the topic of most concern—three times the number who prioritize downside risk (14%) or volatility risk (12%). A quarter (25%) of sponsors prioritize participant behavioral risk, while the remaining 7% indicate that inflation risk is their highest concern.

The research also suggests that plan sponsors believe that longevity risk is among the broadest and most long-term risks faced by their participants, and is not just a concern for the already-retired. In truth, participants begin to address longevity risk with the first dollar they contribute to a plan. A shortfall late in life is the result of failing to accumulate enough savings to generate sufficient retirement income, either because of insufficient contributions, inadequate investment growth, or some combination of the two. From a fiduciary perspective, successfully mitigating longevity risk is logically addressed with a long-term mind-set—again consistent with the desire to keep participants in the plan after they retire.

Further supporting the long-term view over reduction of short-term risks, only 35% of plan sponsors indicate that

...it is also easy to lose sight of the larger balance between growth, risk, and long-term outcomes.

FIGURE 3: Risk of Most Concern for Plan Sponsors



Source: T. Rowe Price.

FIGURE 4: Higher Retirement Income or Less Downside Risk?

When choosing an asset allocation solution (e.g., target date or other QDIA), it is a priority to ensure that participants...



Source: T. Rowe Price.

potential point-in-time downside of returns is the most influential consideration when selecting a QDIA. In contrast, nearly two-thirds (65%) agree that seeking the highest retirement income opportunity is a more influential priority in their QDIA asset allocation evaluation decisions.

LONGER PERFORMANCE PERIODS PREFERRED

Over 90% of respondents say they believe that the best way to evaluate investment returns is over a three-year or longer time horizon, with 60% favoring an evaluation period longer than five years.

In contrast, only 3% say that the best way to evaluate investment performance is by analyzing a single downside experience during a specific market event, such as the global financial crisis.

This preference for longer-term time horizons is interesting given that fiduciaries often review historical or expected performance alongside a curated set of historical or predicted “worst case” scenarios, selectively presenting periods with the lowest returns (e.g., the bottom-fifth percentile), intentionally skewed to model a

lower range of outcomes. Although potentially useful in order to set a floor for expectations, out-of-context framing of worst-case performance alongside more comprehensive longer-term data may play directly to a loss-aversion bias, skewing the emphasis of the evaluation and potentially corrupting a clear and balanced assessment.

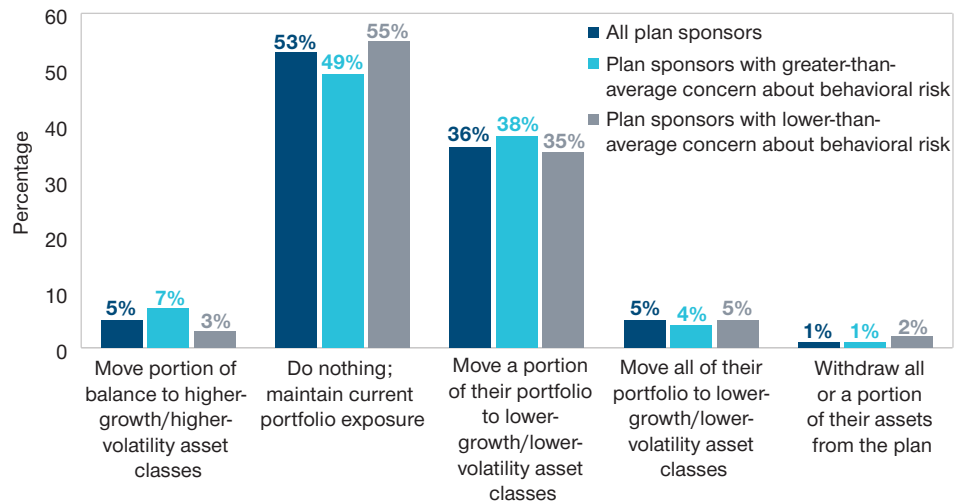
PARTICIPANT (MIS)BEHAVIOR?

Participant behavioral risk—the risk that participants might make poor investment choices, like abandoning an investment strategy in the depths of a downturn—was the second most prevalent top concern among the plan sponsors we surveyed. Participant behavioral risk is often framed as a functional consequence of volatility or downside risk, based on the fear that participants are more likely to abandon an investment in the event of steep losses (i.e., to “sell low”).

This concern is a valid reason why plan sponsors might lean toward lower-volatility investments and lower-volatility QDIAs in particular. However, participants may not “flee to safety” as readily as might be anticipated. Commenting on a recent *positive* behavior gap among target date funds, Morningstar notes that “target date fund investors appear to have been the picture of consistency,” finding that target date funds received positive net inflows in all but seven of the 287 months from March 1994 through January 2018.⁴ Moreover, looking specifically within T. Rowe Price-administered DC plans, our data show that fewer than 2% of participants exchanged or rebalanced their plan holdings during periods of relatively poor equity market performance experienced in August 2015 and January 2016.⁵

FIGURE 5: Expected Participant Response to a Market Decline

During a 20% market decline, I expect DC plan participants invested in a target date or other QDIA to...



Source: T. Rowe Price.

A substantial number of plan sponsors indicate concern about participant behavioral risk, but when asked to anticipate actions that participants might actually take in the event of a 20% market decline, only a minority of the plan sponsors we surveyed say they expect that participants would reallocate their holdings and effectively “sell low.” More specifically, 53% say they expect that participants would continue to hold their investments and a further 5% expect that participants would seize the opportunity to move a portion of their balance to a potentially higher-growth asset class. Only a distinct minority of plan sponsors say they anticipate that participants would reallocate all (5%) or a portion (36%) of their portfolio to lower-volatility asset classes or withdraw

from the plan entirely (1%). These plan sponsor response patterns suggest a potential misalignment between fear of participant behavioral risk and the expected impact of the risk itself.

Isolating the responses of specific plan sponsors who reported a greater-than-average concern about participant behavioral risk, we see that response patterns are similar to the larger sample. Nearly half of these plan sponsors expect that participants would continue to hold their current asset allocation (49%) or move a portion of their balance to a higher-growth asset class (7%) rather than remove assets from the plan (1%), move their entire balance to safety (4%), or reallocate a portion to a lower-volatility asset class (38%).

These plan sponsor response patterns suggest a potential misalignment between fear of participant behavioral risk and the impact of the risk itself.

⁴Source: *Success Story: Target-Date Fund Investors*, Morningstar, Inc., February 2018. On the Web at: <http://www.morningstar.com/articles/850872/success-story-targetdate-fund-investors.html>. Morningstar defines a behavior gap as “the difference between target-date funds’ dollar-weighted and time-weighted return.” Further, “when [investors] shrewdly buy low and sell high, the average dollar they invest outpaces the fund’s return, producing a positive difference, or positive ‘behavior gap.’”

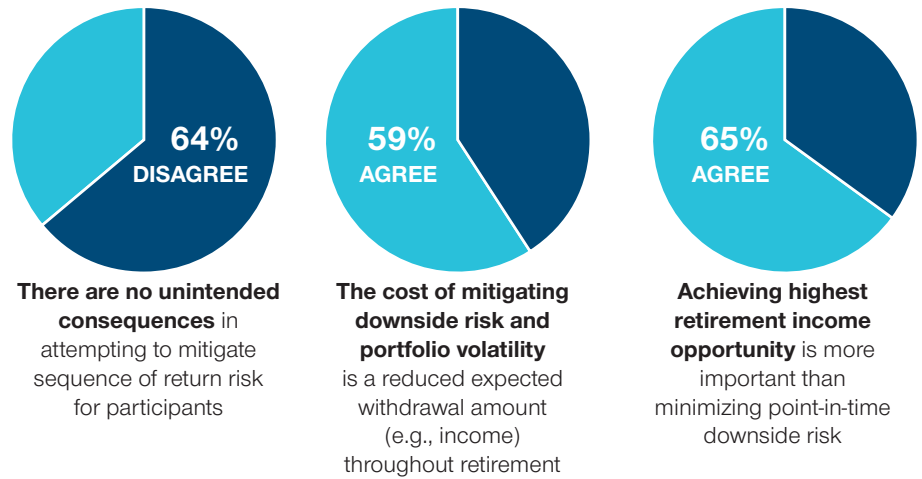
⁵*How Retirement Investors Respond to Volatile Markets*, T. Rowe Price, May 2016. On the Web at: <https://www4.troweprice.com/gis/content/dam/fai/Collections/DC%20Resources/Investor%20Response%20to%20Volatile%20Markets/Investor%20Behavior.pdf>.

ACKNOWLEDGING TRADE-OFFS

A majority of the plan sponsors surveyed acknowledge that seeking to reduce near-term risk may impose a trade-off, with 64% of respondents disagreeing with the statement that “there are no unintended consequences in attempting to mitigate sequence of return risk for participants.” This suggests that most sponsors recognize that efforts to mitigate risk through asset allocation (e.g., by selecting a target date strategy with a lower-equity glide path) could have negative consequences, including a lower account balance entering retirement and a potential reduction of retirement income.

Broadly, 59% of plan sponsors acknowledge that “the cost of mitigating downside risk and portfolio volatility is a reduced expected withdrawal amount (e.g., income) throughout retirement.” This demonstrates awareness that attempts to aggressively manage volatility and downside risk on behalf of participants—perhaps due to heightened concerns about adverse sequence of returns—may present with trade-offs and weaken retirement outcomes. As cited earlier, 65% say that it is more important to seek a higher long-term retirement income opportunity than it is to manage potential reductions in participants’ balances.

FIGURE 6: Anticipated Costs of Mitigating SoR and Downside Risks



Source: T. Rowe Price.

CONCLUSION

The findings of T. Rowe Price’s DC plan survey reveal insights about the prioritization of risks by plan sponsors and, more broadly, explore the alignment of risk perceptions with plan objectives. Encouragingly, in our view, plan sponsors maintain a wide perspective regarding their fiduciary obligations and favor supporting long-term positive outcomes over mitigating more short-term risks.

There is also a relatively widespread acknowledgment of the unintended

consequences of attempting to sidestep short-term risks—including the risk of an adverse sequence of returns near or in retirement. Further, the majority of plan sponsors do not expect participants to abandon investment strategies if the plan’s QDIA encounters volatility.

In general, there is no single “correct” QDIA. However, by improving the clarity of plan objectives and correctly prioritizing risks to those objectives, plan sponsors may select investment strategies that are best positioned to help provide participant outcomes that they desire.

SURVEY METHODOLOGY

T. Rowe Price’s survey was sponsored by *Pension & Investments* (P&I) magazine and conducted from January 29 through February 20, 2018, by Signet Research, a marketing research firm. The survey universe for results presented within these findings consisted of members of P&I’s Research Advisory Panel, a list of plan sponsors selected from the P&I database. Responses were received from 289 plan sponsor officials. Respondents participated via online surveys and were offered a chance to win prize awards as incentives for their participation. T. Rowe Price designed the survey questions and is solely responsible for the interpretation of the results.

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