Stop Guessing: Using Participant Data to Select the Optimal QDIA

Finding a Prudent Process

To receive safe harbor regulatory protections, plan sponsors must follow a prudent process for selecting a qualified default investment alternative (QDIA). This process could include specifically considering the demographics of the plan participants when selecting a QDIA. Unfortunately, regulations don't provide guidance on how plan sponsors should consider plan demographics within a prudent process.

Our research, "Stop Guessing: Using Participant Data to Select the Optimal QDIA," outlines a data-driven process that aims to help plan sponsors and their consultants consider plan demographics and use this information to assess whether an investment solution may fit their participants.

Our Proposed Approach

1. Use Readily Available Data to Determine Each Participant's Appropriate Asset Allocation

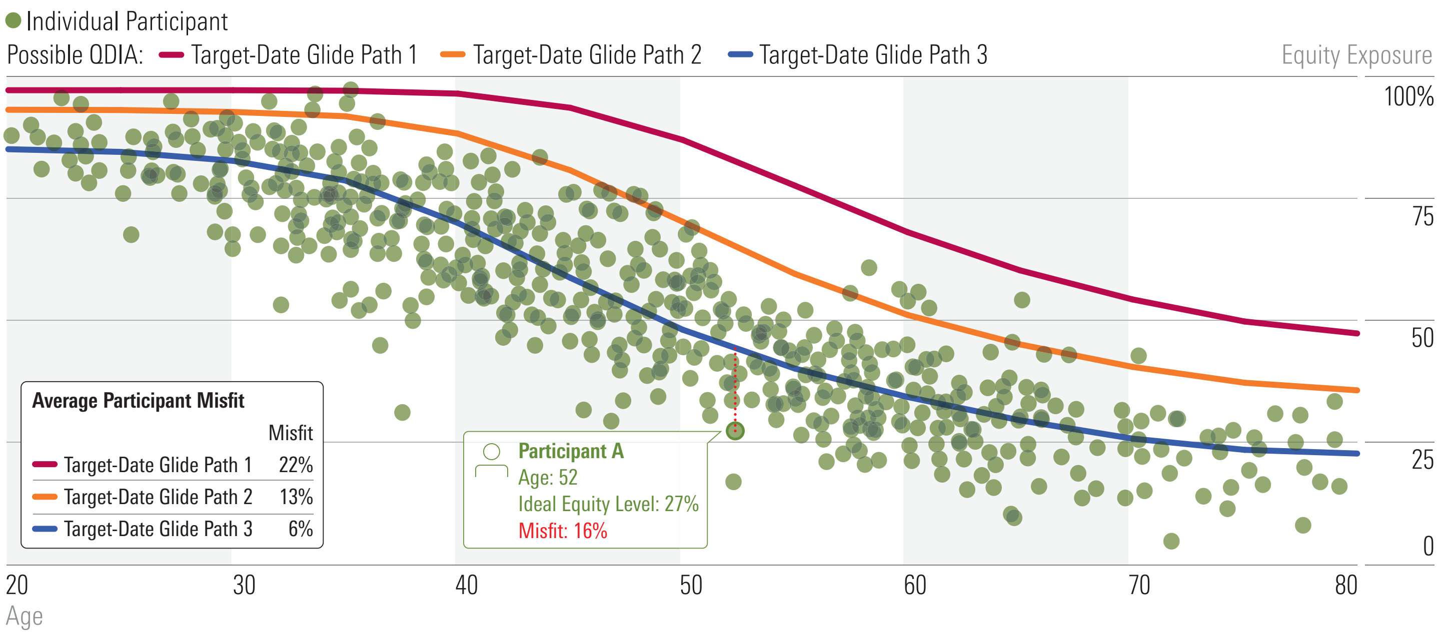
Not so long ago, employers were limited in their ability to access, extract, and use employee demographic information. As the scope of data availability has increased, it has become much easier to develop a rich demographic profile of a plan's participants. A managed account's advice engine can process detailed participant data (such as, gender, age, salary, and savings rate) and arrive at an independent data-driven estimate of an appropriate asset allocation for each participant. These allocations, specifically the recommended equity allocations, can then be visualized through a "bubble chart" (Figure 1) where age is plotted on the horizontal axis and the equity allocation is plotted on the vertical axis. Plotting the equity allocation for all participants in a plan can provide a bigger picture of a plan's investment needs.

2. Compare the Fit of Various QDIA Options

Once a plan's participants are plotted on a bubble chart, QDIA options, such as a target-date fund or a target-risk fund, can be overlaid. Qualitatively, the closer the majority of the bubbles are to the investment solution, the better the potential fit for a particular plan. The larger the difference between a bubble and an investment option, the larger the misfit in equity allocation. Equity misfit can be calculated for each participant and then aggregated to arrive at both an average and median difference within a plan. These figures will show just how far the average or median investor is from their ideal target asset allocation. Assessing the fit of various investment options could be as straightforward as comparing the median misfit between different solutions.

Figure 1: Sample "Bubble Chart"

The green bubbles in this image show the equity allocation for each participant in a hypothetical plan. With three different sample target-date glide paths overlaid, we can see that a conservative target-date fund (represented by Target-Date Glide Path #3) may be a fit for this plan.



3. Weigh the Cost of a Better Fit

An investment solution that better meets participants' needs may not be worth the additional cost, but our framework can help plan sponsors determine whether a better-fit QDIA may be worth it. This quantitative approach can compare the trade-off between the differences in fees and the degree to which a solution fits the plan demographics better. Without going into too much detail, Morningstar Investment Management's approach leverages utility theory to determine a basis point cost that makes a participant indifferent between two investment solutions. This represents the maximum fee that a better-fit solution should cost for it to be beneficial to the participant. In other words, if a better-fit QDIA charges more than the fee determined in our approach, then it may not be worth it for a plan sponsor to use that solution.

Helping Plan Sponsors

Choosing the plan's default investment is not a clear nor easy process. We believe that having a data-driven and repeatable process can help sponsors and their consultants understand their plan participants and select an investment solution that best meets their participants' investment needs. The data-driven process we've outlined here can be used to help determine any of the following:

- The type of QDIA appropriate for a plan
- A glide path that best fits the plan participants
- When a custom glide path makes sense
- The "pivot" age for a hybrid QDIA

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