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# Market and Regulatory Trends Call for Improvements in Defined Contribution Plans

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## Abstract

Recent market and regulatory trends suggest plan sponsors face some new responsibilities to maximize the performance of defined contribution plans. With new regulations on the horizon that will give plan sponsors some new fiduciary duties regarding educating and informing their participants about their benefits, it is the ideal time to look beyond minimum regulatory requirements and consider more proactive improvement opportunities. Plan sponsors should consider more passive investment strategies, develop or improve investment policy statements and enhance their educational offerings to improve the overall performance of their defined contribution plans.

## Keywords

defined contribution plan, investment strategy, investment policy statement, participant education, target date funds, passive investment strategy, 401(k) plans

As the American economy continues a steady shift toward employee-managed retirement savings, defined contribution plans are becoming an increasingly important part of a competitive benefit plan offering. Perhaps even more significantly, they are becoming an increasingly important tool to assure the future health and welfare of a generation of the workforce.

This is a big weight on the shoulders of benefit plan sponsors who toil faithfully to administer and assure the compliance of defined contribution plans, and it is growing heavier all the time. Continued concerns about the future of Social Security and defined benefit pension plans suggest that today's middle-aged employees in particular are pinning their best hopes for a retirement nest egg on the performance of their defined contribution plans and any personal retirement savings.

Of more immediate concern to plan sponsors, there are new regulatory requirements developing or taking effect that will require sponsors of defined contribution plans to make some changes in how they administer their plans. For example, the U.S. Department of Labor (DOL) acted to implement provisions of the Pension Protection Act that would make investment advice more accessible for millions of Americans with 401(k)-type plans.

With important safeguards and conditions attached, plan sponsors will be allowed to give investment advice using computer models or through advisors compensated on a level-fee basis, meaning that the fees do not vary based

on the investments selected by the participant. Even more recently, the DOL's Employee Benefits Security Administration issued a new rule calling for new disclosures related to fees and expenses, investment options and other information in 401(k)-defined contribution plans. The rules take effect in early 2012 to require plan sponsors to furnish information to participants or beneficiaries in a way that will facilitate their own investment allocation decisions.

On the surface, most plan sponsors are likely focused on their new responsibilities under these new rules and what they must do to meet the minimum requirements. Those are important areas of focus, but the real challenge for plan sponsors is to take a more strategic vision for how to implement these new rules and see in them the opportunity to improve the overall performance and potentially even reduce the cost of the defined contribution plan as a result of this process.

Given the growing significance of defined contribution plans both to the economy and to the long-range mission of the organization, plan sponsors should seize this opportunity to do more than just meet the minimum regulatory requirements. Now is the time to look more strategically at the defined contribution plan and assure

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it functions in a way that achieves maximum performance at the lowest possible cost for the benefit of all stakeholders—the workforce, the organization and even the economy as a whole.

Plan sponsors can achieve this approach to compliance and improvement of the defined contribution offering by focusing on three specific areas:

- Study and adopt a more passive investment strategy
- Develop or upgrade the investment policy statement (IPS) for the plan, especially to reflect a thoughtfully developed investment strategy
- Enhance the method of providing financial education to participants.

### Passive Investment Strategy

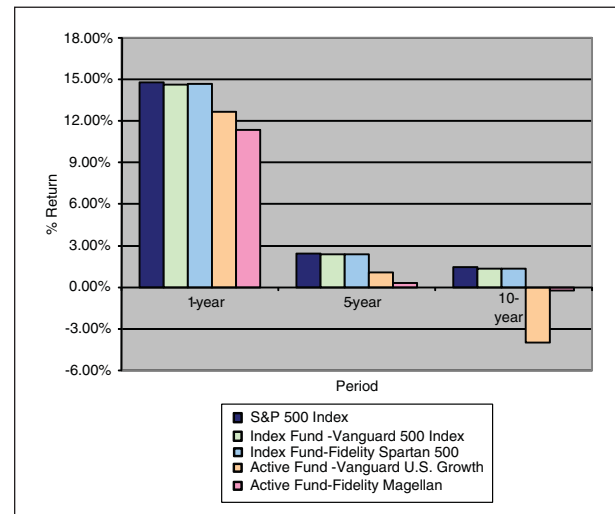
Plan sponsors naturally seek to manage the funds in a defined contribution plan to achieve maximum performance and maximum returns. This has led many plan sponsors to choose an active management style, studying and selecting funds that are expected to outperform the market as a whole. And why not? The potential to outperform the market is an attractive incentive to take a hands-on approach to managing the fund.

Unfortunately, the evidence of the past decade suggests that actively managed funds have fared no better than passively managed index funds. In fact, the majority of actively managed funds underperform index funds. The two largest mutual fund investment companies, Vanguard and Fidelity, offer index or passive funds along with actively managed funds as part of their portfolio platform. Over the past 10 years, the actively managed funds did not provide as consistent or large returns as their index fund counterparts (Figure 1).

Although the example funds highlighted in Figure 1 roughly illustrate this reality, there are some actively managed funds that do occasionally outperform a given index, usually the Standard & Poor's 500. However, once the increased costs of these actively managed funds are added to the equation, any excess gains earned by these funds are eroded.

Index funds typically have lower expenses because of their lack of constant oversight and frequent trading; they simply seek to duplicate whichever index they are created to mimic. The typical actively managed equity fund has annual operating expenses of approximately 0.5% of assets. Conversely, the typical index fund has expenses of approximately 0.56% annually.<sup>1</sup>

These numbers should be sobering to plan sponsors who continue to actively manage their funds in the belief that they are maximizing their performance potential. Plan sponsors generally spend 1% more in ongoing management expense



**Figure 1.** Average annual returns (as of December 31, 2010), index versus actively managed

to actively manage a fund, yet that additional cost is not translating into improved performance for the majority of funds. As plan sponsors continue to seek cost reductions, that 1% cost difference between active and passive management approaches is becoming increasingly difficult to overlook.

However, there appears to be a contradiction in priorities among plan sponsors in the United States. When Mercer asked plan sponsors to rank their priorities for established defined contribution plans, most respondents placed greater importance on providing adequate retirement funds for employees than on reducing plan costs.<sup>2</sup> These plan sponsors are overlooking the potential to reconcile these two priorities rather than ranking one over the other. Passive investment strategies can offer this reconciliation by providing for lower plan costs while at the same time achieving less risky returns, which can translate into more positive investment experience for future retirees.

Apart from the increased cost and reduced overall performance of the past decade, actively managed funds suffer from another distinct disadvantage. It is difficult to select a fund manager who is going to produce the kind of returns plan sponsors are hoping to achieve. Past performance is not always a good predictor of future performance, so selecting a fund manager with a stellar track record does not necessarily assure future returns.

As a result of performance and cost considerations noted above, plan sponsors should begin to consider the increased usage of index funds as part of the overall portfolio structure of their plan's offerings. Another advantage of index funds is that they do not have to be as frequently monitored with respect to performance since they are intended to provide the same returns as the index that they were created to follow. This can alleviate administrative burdens on the investment committee.

From a fiduciary perspective, passive investing in index funds has advantages in defensibility. As stated in Section 227 of the Restatement (Third) of Trusts (the Prudent Investor Rule): “The greater the trustee’s departure from one of the valid passive strategies, the greater is likely to be the burden of justification [for selecting the proposed active strategy] and also of continuous monitoring [of it].”<sup>3</sup> It is much easier to explain and justify to participants a return similar to that of the S&P 500 Index than it would be to explain or justify a negative departure from that which could result in an active management investment environment.

## Target Date Funds

In addition to index funds, the use of target date funds (TDFs) also presents an opportunity for plan sponsors to achieve cost savings and allow participants to take on a level of risk commensurate with their personal time horizon and risk aversion. The use of TDFs as default investment alternatives is growing, most directly as a result of DOL regulations issued in 2007, authorizing the use of TDFs as “qualified default investment alternatives” (QDIAs) for fiduciary relief under the Employee Retirement Income Security Act of 1974 (ERISA) Section 404(c).<sup>4</sup> Investment firms running TDFs make asset allocation decisions on behalf of investors based on some predetermined target retirement date in the future, so they represent different investment styles and asset classes depending on the time horizon to the target date.

With their use growing as a means of providing participants with a default investment alternative, it is becoming more important to minimize risks, lower costs and provide greater predictability around their performance. On average, expense ratios for TDFs range from 0.21% to 0.85%.<sup>5</sup> Plan sponsors should be thinking carefully about whether their plans and their participants might be better served by adopting the TDFs.

TDFs offer the same basic advantages for participants who choose to invest in them on their own, whether they are motivated by the simplicity and convenience of a professionally managed fund or are not confident making their own allocation decisions. The risks related to active management might be acceptable to investors who understand the risks and can see the difference between market and manager risk but that risk is much harder to swallow for less sophisticated investors.

TDFs are often thought of as a version of passive investment strategy, since they are essentially “funds of funds.”<sup>6</sup> However, given this fund structure, the underlying investments that comprise the TDF itself can be either actively or passively managed, depending on the characteristics of the fund. It is an important step for any plan fiduciary to evaluate those underlying funds with an investment

advisor or among the investment committee to determine which management strategy is being used.

For example, if a TDF that is being considered by your investment committee for addition to the plan’s investment offerings contains the word “conservative,” this can sometimes have implications that the fund is mostly invested in bonds and is, therefore, a long-term, passive investment. However, a close inspection of the underlying funds of this “conservative” TDF may actually contain some percentage of equity funds or other investments that are actively managed, and this can affect the bottom line returns of the fund once costs associated with that are considered.

Another important distinction for plan sponsors and their plan investment committees to make is which asset allocation technique is being used by the TDF manager. There are two basic techniques that are used by TDF managers; identifying and differentiating between the two is a key consideration to be made in determining whether a certain TDF is a good fit for your participant population. Essentially, TDF managers can use either a strategic or a tactical asset allocation method.

Strategic asset allocation involves using a long-term goal for asset allocation among major asset classes (such as equity securities, bonds, money market/capital preservation and others). This asset allocation goal is based on participants’ risk aversion, time to retirement and expected retirement needs, among other factors. This allocation is relatively stable in the short term and is only adjusted minimally if any of the above considerations change.

A tactical asset allocation is often thought of as being more concerned with outperforming the market. This strategy involves setting a short-term allocation of assets into various asset classes and then systematically adjusting them by weighting certain asset classes more or less based on more short-term expectations about the performance of those asset classes. For example, a TDF manager using a tactical asset allocation strategy may reduce the percentage of assets allocated to bonds if he or she expects interest rates to rise in the near future. This strategy is basically representative of an actively managed investment strategy.

Not surprisingly, tactical asset allocation strategies have not achieved significant excess returns and usually come with increased costs over time.<sup>7</sup> Again we can see the relative attractiveness of passive-style investment strategies even within TDFs. As a result, it is imperative that plan sponsors review TDF managers in sufficient detail to determine which methodology is being used and whether or not that is in keeping with the overall goal of the investment policy of the plan.

Ultimately, the goal of a TDF is to give less engaged participants a carefully selected, diversified portfolio appropriate to their time horizons and their risk tolerances to enable them to save for retirement. It takes only a few

broad categories of assets to achieve this goal. The risks related to actively managing the investment allocation need not be endured to achieve what these investors need.

The use of TDFs certainly has been challenged in the past few years as some investors near retirement suffered significant losses with high equity allocations. It does not mean TDFs are misguided. Rather, it means plan sponsors and their investment advisers need to better design the plans and better manage the risks so that TDFs meet the needs they are intended to target. TDFs still represent a great deal of investment sophistication for participants who may have difficulty making asset allocation choices in line with their time horizons and risk tolerances.

Another recent development at the DOL also highlights the increased attention that TDFs are receiving from the current administration. A recently finalized rule amends the “qualified default investment alternative regulation” and the “participant-level disclosure regulation.” Specifically, the rule now requires participants to be furnished with comprehensive information regarding an explanation of how the asset allocation of the TDF will change over time (“glidepath”), a graphical illustration of this glide path and the relevance of any particular “target date” included in the name of a fund.<sup>8</sup>

According to a recent survey, TDFs account for approximately 53% of default investments for those plans with auto-enrollment features.<sup>9</sup> However, of this amount, 86% of these TDFs are actively managed. This highlights a significant opportunity for those plans to reevaluate their TDF offerings and determine if a passive approach through index funds may provide cost savings and improved investment performance.

## Investment Policy Statement

ERISA does not contain an explicit requirement for plan sponsors to develop and adhere to an IPS for their defined contribution plans. Many plan sponsors have no such statement, have statements that are obsolete or have little correlation to how the plan is managed in practice. Yet an IPS is a cornerstone to maximizing performance of a defined contribution plan (see Figure 2).

The IPS is meant to provide guidelines for how investments in a defined contribution plan will be chosen. A robust IPS should outline the investment objectives, preferred investment types, expected returns, risk tolerances and other factors that will steer investment selections. However, at its most fundamental level, any IPS should offer these guidelines in adherence to three basic principles that govern all fiduciary action<sup>10</sup>:

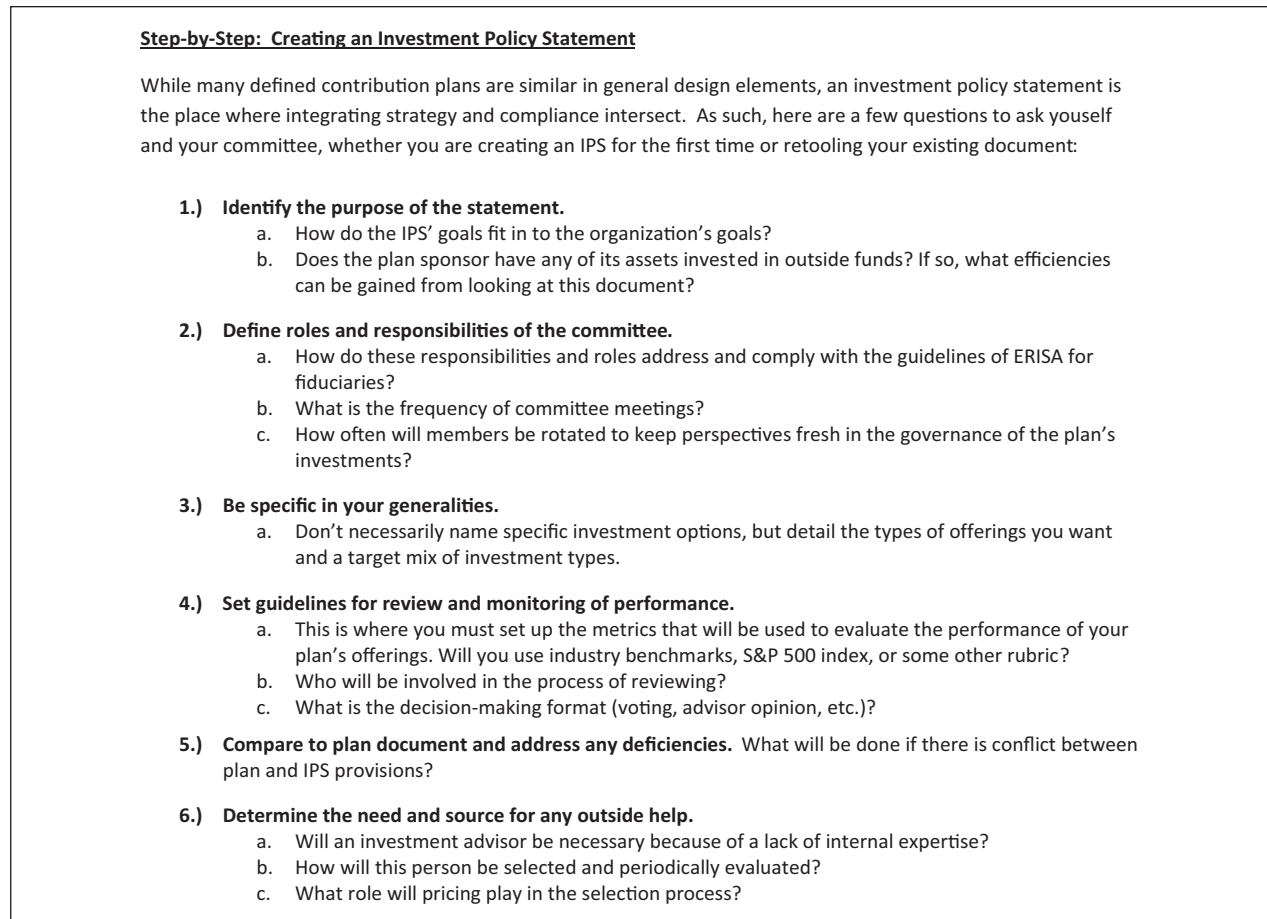
- *The plan’s investment assets must be adequately diversified.* Sponsors of many small to midsize plans choose their investment options from the

platform of proprietary funds offered by their plan trustee or custodian. However, with many large plans, including those of publicly traded companies, common stock of the employer is an attractive option by which the company can obtain additional capital investments. In the current economic situation, this option is likely to appear less viable to plan participants already skeptical of equity markets. In fact, over the past 10 years, the share of individual 401(k) accounts invested in company stock has been in a steady decline, with only 9.2% invested in employer securities in 2009.<sup>11</sup> From both a fiduciary standpoint and a practical standpoint, it is wise to limit the amount of plan assets invested in employer securities.

- *All investments must be prudent investments as determined by the investment committee.* This principle is in keeping with the “prudent investor” standard as defined by ERISA. Although this standard does not explicitly preclude a plan sponsor from selecting high-risk investment options, the level of risk and return must be commensurate with what a “prudent investor” would assume given the participant population and the plan’s expected short- and long-term liquidity needs.
- *All investment decisions must be made exclusively on behalf of the interest of participants and their beneficiaries.* Along with the “exclusive benefit” requirement, it is suggested that the plan sponsor’s investment committee document any important decisions made in the process of selecting, evaluating or otherwise amending investment offerings or other decisions affecting the investment experience of plan participants.

Many small to midsize plans do not have formal investment committees. Although this is not ideal, there are legitimate reasons why it may not be feasible to have one, especially for smaller organizations. However, regardless of the structure of the group making investment decisions and despite how small the group may be, it is of paramount importance to document the discussions of any gathering of plan trustees and fiduciaries. A simple documentation of these events can offer strong evidence as to the awareness of and adherence to fiduciary requirements under the law.

The recent succession of proposed and final regulations by the DOL regarding required disclosures to participants seems to indicate a transformation in the regulatory environment in which plan sponsors find themselves operating. With this heightened attention being paid to fiduciaries and their activities by the governing authorities,



**Figure 2.** Step by step: Creating an investment policy statement

it is more important now than ever to not only be cognizant of your duties but also to ensure that the fulfillment of these duties is being sufficiently documented as a means of protecting yourself and your organization from potential liability.

Perhaps most critically in the context of the current regulatory environment and changes that are on the horizon, an IPS is the means by which a plan sponsor can define its provisions for QDIAs in a way that can drive plan performance. In 2010, adoption of auto-enrollment features in defined contribution plans was up approximately 10% over 2009 in midsize and large plans.<sup>12</sup> This trend highlights the attention that is likely to continue to be paid to QDIAs in subsequent years, especially as the current administration is turning its attention increasingly toward employee benefits and retirement income. With TDFs as the most prominent QDIA currently being offered by plan sponsors,<sup>13</sup> the structuring of these investments and the role of the IPS in defining the goals of these vehicles is likely to come under more scrutiny.

To set a foundation for how a plan sponsor can use TDFs to maximize plan performance, the IPS should

include a number of criteria for how target dates will be selected and monitored. For example, it should reflect an understanding of the asset allocation methodology used by TDFs. It should be based on a determination of whether TDFs should be invested aggressively, moderately or conservatively.

The IPS is the place to establish the glide path, or the changes in asset allocations as the target date for TDFs approaches. Plan sponsors need to think through and determine whether the target date should be set as the retirement date or some date into the future beyond retirement, perhaps 5, 10 or 15 years. Generally, the later the target date the more aggressive the funds. If the target date is set into the future, it suggests the plan sponsor expects participants to reinvest their retirement distributions into the same funds. That should be established and explained in the IPS so the objectives are clear to participants and investment managers.

A recent study by Russell Investments indicated that more conservative allocations are appropriate for the years at and during retirement since these are the years when a participant is most vulnerable to the volatility of

the market.<sup>14</sup> Anticipating these types of issues, discussing them with your investment advisor and addressing them in your IPS are important steps to take to exhibit your dedication as a plan sponsor to providing the tools with which participants can adequately plan for accumulation of retirement resources.

Even further, plan sponsors also need to think through and articulate in the IPS the experience and credentials it expects for the individual who selects underlying investments and determines the asset allocation and glide paths. Along those lines, the IPS should describe the expected capabilities of the management organization.

Beyond the current imperatives on articulating a policy for the use of QDIAs or TDFs, plan sponsors can gain so much more by formalizing an investment policy. It gives weight and credibility to a plan sponsor's long-term commitment to the success of the defined contribution plan to help employees achieve their retirement savings goals, making it a valuable attraction and retention tool. It sends a signal that the plan sponsor is not managing the defined contribution plan by whim or knee-jerk reaction to market events but according to a thoughtfully developed methodology.

Plan sponsors shy away from formalizing an IPS for a multitude of reasons. They may not have the time or the resources to develop an appropriate document. They may believe that an IPS will impose unnecessary boundaries or restrictions on decision making regarding the plan. Some even fear an IPS will increase fiduciary liability.

These concerns are misguided in a number of ways. Employers who open a plan and make investment selections have already established a tacit investment policy and their responsibilities as fiduciary. Having a more carefully articulated policy will not add to those responsibilities but instead will provide a benchmark for performance and decision making that benefits all stakeholders in the plan. Plan sponsors may allow the IPS to fall to the bottom of a long list of documents that must be prepared because it is not required by any particular regulation, but plan sponsors who are committed to maximizing the performance of the plan need to take a more proactive approach.

A well-developed IPS will benefit the sponsor of a defined contribution plan in a number of ways. It documents the prudence of the decision-making process, giving the plan sponsor some protection against prospective claims that a particular action breaches fiduciary responsibility. It also defines how the plan will satisfy a host of regulatory requirements, further insulating plan sponsors against claims.

The IPS may take some time to draft at the outset, but the parameters it establishes for investment decisions will make any future selection or decision-making process all the more efficient because it will direct the selection process. When the criteria for selecting funds are mapped out

in a well-written IPS, it will naturally filter the selection process and hone the focus on a subset of funds that meet those criteria.

Equally important, a well-written IPS will set standards for measuring and reporting fund performance, making the evaluation of fund performance a straightforward, objective process. Plan sponsors can review periodic performance reports focusing their attention only on funds that are not meeting IPS criteria, making ongoing diligence easier to perform.

In the process of drafting a formal investment policy, there are some common errors that investment committees often make:

- *Ignoring changes in the benchmark or group against which performance is measured.* What good is a benchmark in your investment policy if it does not adapt with the reality of the situation? Pay careful attention to the time periods that are being compared and make sure to adjust for any demographic changes in participant population, both at your organization and your competitors and peers.
- *Changing investment offerings based on recent high performance.* Although periodically reviewing the investment offerings is highly recommended for a successful investment strategy, reviewing new "hot" investments should always be done under the guidelines of the formal investment policy.
- *Inadequate experience on committee.* Many employee benefit professionals are not investment experts. However, as a Vanguard article showed, 80% of the investment committee members surveyed rated their committees' knowledge level as above average, and more than 60% said their committees seldom make mistakes.<sup>15</sup> Despite this potential overconfidence, it is always a good idea to include an outside investment advisor as an attendee to any investment committee meetings so that they may offer the investment expertise that is necessary to achieving an informed group decision.

A periodic review of the IPS and relying on it to both determine when an investment decision needs to be made and how to proceed with that decision is one of the best practices used by successful investment committees.<sup>16</sup>

## Financial Education for Participants

Plan sponsors have always provided a baseline of financial information to their participants with the objective of

### **Education vs. Advice: Widening the Thin Line**

With the passage of the Pension Protection Act of 2006, plan sponsors were afforded more latitude with respect to being able to offer investment advice to participants. However, some plan sponsors are still confused as to what the Department of Labor will consider "education" versus "advice."

Here are items of information that can be offered by plan sponsors without being considered "advice" by the Department:

#### **1.) Plan Information:**

- a. Listing of the various investment options offered by the Plan;
- b. Descriptions of the funds themselves, including prospectuses;
- c. Risk vs. return characteristics (i.e. matrices, charts, etc.)
- d. Historical return information (including a caveat that past performance does not guarantee future returns)

#### **2.) Financial Information:**

- a. Diversification (highlighting the importance with simple examples);
- b. Dollar cost averaging;
- c. Inflationary considerations and how this can affect retirement readiness;
- d. Tax advantages of pre-tax and after-tax deferrals
- e. Budget tools for anticipated needs for retirement resources

**Figure 3.** Education versus advice: Widening the thin line

encouraging their participation and maximizing their benefit. The Pension Protection Act took some important steps to automate participation in defined contribution plans, but it still fell short of giving plan sponsors any specific duty or encouragement to help participants become more educated about the potential of their benefit offerings to fund their retirement dreams.

Now, new regulations are generally focusing on assuring plan participants have more information about their benefits, along with the costs, inherent risks and the options they must weigh in making good decisions.<sup>17</sup> That does not necessarily mean they will be capable of making good decisions. This is the missing link in many defined contribution plans. Sponsors can bury participants in information, but how well prepared are those participants to use that information to make decisions that will maximize the benefit?

With the likelihood that sponsors will be allowed to give participants limited advice, there is an opportunity to enhance the education offering in a way that benefits everyone involved. Research has shown that participants who engage in even a minimal amount of financial education are better off than those who pay little or no attention to their investments.

There is a great deal of potential for most plan sponsors to expand and improve their educational offerings to participants (see Figure 3). An education program should provide consistent, ongoing communication using a number of different media to engage participants. This might include face-to-face meetings, phone calls, dedicated call centers or hotlines, seminars, webcasts, podcasts, web tools, postcards, letters, newsletters, and, of course, e-mail.

The content of a comprehensive education program should be geared toward the average consumer, avoiding jargons and acronyms that are not familiar to people outside of human resource or financial professions. It should clearly explain concepts that plan sponsors understand but are not part of the average participant's daily dialogue. It cannot assume, for example, that participants understand things such as matching contributions, automatic enrollment, default investment options, distribution options, loan provisions, disability and survivor coverage and other similar aspects of their defined contribution benefits.

An education program needs to demonstrate the importance of financial planning and the important role that diversification and asset allocation decisions will have on long-term returns. It needs to encourage participants to think about their time horizon to retirement, their investment objectives and their tolerance for risk as they make critical decisions. Most participants have a long way to go to fully understand the possible outcomes to their investment plans and the income they may need in retirement.

No financial education is complete unless it provides access to investment advice and financial planning tools. According to a poll conducted by the Society for Human Resources Management in 2010, only 1% of the plan sponsors surveyed expressed an intent to make changes in investment advice services to 401(k) plan participants.<sup>18</sup> This seems to indicate a deficiency in adequate resource planning, which will likely change pursuant to the recent DOL regulations regarding participant disclosures. Plan sponsors will need to study carefully the DOL guidelines when they become effective and assure that their financial education program provides access to such

advice and planning in a manner that is compliant. Compliance with the new DOL participant disclosure regulations will be required beginning January 1, 2012.<sup>19</sup>

Investment advisers to defined contribution plans should be able to provide resources that will assist in developing and presenting an education program for participants. They may even be willing to lend a hand in planning and developing the program. Investment advisers, of course, will benefit if a given defined contribution plan is performing at optimal potential, so they too have a vested interest in helping participants better understand their benefits and how to manage them.

The education program needs to put plenty of focus on helping participants and other eligible employees understand the benefits of getting engaged. For some eligible nonparticipating employees, it may be difficult to see past a paycheck-to-paycheck approach to making financial decisions. An education program needs to reflect an understanding of that approach and help participants grasp the benefit of longer range planning.

Finally, an education program needs to provide on-the-spot opportunities for action. Employees should be able to enroll in the plan at the conclusion of a face-to-face gathering or at the end of a webcast or podcast. They should be able to sign up for a one-to-one consultation with an investment adviser or access additional information immediately. The effort to engage an eligible employee or a participant is wasted if there are obstacles that delay action or barriers that make it difficult to act.

Feedback is also important to design and adjust a comprehensive education program that will have the most meaningful impact on workforce behavior and plan performance. Plan sponsors need to conduct surveys or establish other means to continually monitor the effectiveness of their various education efforts and to evaluate their effectiveness in engaging participants and eligible employees.

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### Bios

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