



## BEST PRACTICE

### **Asset Allocation Guidance for Defined Contribution Plans (1999 and 2009) (CORBA)**

**Background.** Defined contribution (DC) plans, including supplemental plans, are an important financial element of public-sector retirement that help participants attain their retirement goals. Plan sponsors have a responsibility to understand structure, costs, and fees of the plan.

A large and increasing number of state and local governments provide some form of a defined contribution retirement plan for their employees, in most cases a voluntary deferred compensation arrangement under Section 457 or Section 403(b) of the Internal Revenue Code. These arrangements may be in addition to, or in lieu of, a traditional defined benefit pension plan. Under most defined contribution plan arrangements, the participating employees self-direct investment of the funds credited to their individual accounts from a menu of investment options selected, or offered, by their employers.

**Recommendation.** The Government Finance Officers Association (GFOA) recommends that public employers as plan sponsors work actively with the plan administrators to provide investment options and education to help employees who participate in defined contribution plans attain their income replacement goals in retirement. (See the GFOA's Best Practice on *Participant Education – Guidance for Defined Contribution Plans.*) To accomplish these objectives, the following practices are suggested:

1. To provide adequate diversification, plan administrators should ensure participants are offered a broad spectrum of investment choices that include all the major asset classes (e.g., equities, fixed income, and cash equivalents). The investment choices should include several passively managed investment options such as low-fee index funds. Another option is a family of asset allocation funds.<sup>1</sup> In addition to mutual funds, plan administrators should consider lower-cost commingled funds and separate account funds as investment options. For more information, see the GFOA Best Practice, *Investment Policies Governing Assets in a Deferred Compensation Plan* and the accompanying *Investment Policy Checklist for Assets in a Deferred Compensation Plan*.
2. The investments provided should be screened for sales charges, fees, and expenses; the age and size of the fund; the fund's past performance; the fund's risks, turnover rate, and volatility; and recent changes in the fund's operations, including changes in fund managers. When choosing investment options, keep in mind that too many investment options can confuse participants and even reduce participation in DC plans.
3. The investment structure should be broad enough for proper diversification, and also to accommodate participants' varying levels of risk tolerance. Investment choices should also accommodate the needs of different age groups and retirement goals, taking into account participants' preferences regarding an income stream throughout retirement, lump sum distributions, and the desire to leave money to heirs.
4. The plan sponsor should make asset allocation tools, including software, literature, or consulting services, available to participants. Access to personal financial planning services should be offered as part of the investment program, and any additional fund fees or expenses required for these products should also be disclosed. See the GFOA's Best Practice on *Monitoring and Disclosure of Fees for Defined Contribution (DC) Plans*.

5. Record keepers should provide participants and plan sponsors with quarterly summaries of their investment portfolios by asset class and with benchmark comparisons. Where possible, graphs with comparative information should be included.
6. Participants should be regularly reminded of their potential need to review and update their asset allocations as they age or experience various life events. For example, a reminder might be issued to participants as they cross certain age levels or change employment status.

#### **Note**

<sup>1</sup> Asset allocation funds are mutual funds that provide investors with a pre-mixed portfolio of securities from the three main asset classes. The main types of asset allocation funds are balanced funds, which usually have a mix of stocks and bonds; life cycle or target date funds, which contain a mix of stocks, bonds, and cash, that start out with a more aggressive mix of investments and gradually become more conservative as the investor ages or nears retirement; and life-style funds, which are actively managed in response to market conditions. Key considerations when choosing a provider for these funds are the evolution of the fund's investment strategy over time; the pros and cons of indexing versus active management; the choice between packaged and customized offerings; the impact of these funds on participant portfolios and adoption; and potential biases toward proprietary products.

#### **References.**

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- GFOA Best Practice, *Investment Policies Governing Assets in a Deferred Compensation Plan*, 2004.
- GFOA Checklist, *Investment Policy Checklist for Assets in a Deferred Compensation Plan*.
- *Evaluating and implementing target-date portfolios: Four key considerations*, Vanguard Investment Counseling & Research, March 2008.
- GFOA's Best Practice, *Monitoring and Disclosure of Fees for Defined Contribution (DC) Plans*.
- GFOA Best Practice, *Participant Education – Guidance for Defined Contribution Plans*, 2009.

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